Introduction: What Is Economics?

$ What It Means

Economics is a social science devoted to the study of how people and societies get what they need and want. Or, in more formal language, economics is the study of how societies divide and use their resources to produce goods and services and of how those goods and services are then distributed and consumed.

Resources are the basic ingredients that are needed to produce the goods and services that people buy. These ingredients can be physical things such as land and factory equipment, and they can be intangible things such as the intellectual and emotional capacities of people, whose work is necessary for the production of goods and services. Whether a society is rich or poor, large or small, resources are, from the viewpoint of economics, scarce. This means that almost everyone in every country would like more goods and services than can ever be produced. Given a limited supply of resources and an unlimited desire on the part of individual consumers and nations, choices must be made about what goods and services to produce, how to produce them, and for whom.

Economists study these often-difficult choices and their significance. They come up with theories about how such choices are made on both individual and collective levels, and they try to make predictions and find solutions to a wide range of societal problems.

Although thinkers in earlier societies sometimes addressed topics that today concern economists, economics as a field did not emerge until after the Middle Ages (a period that lasted from about 500 to 1500), when capitalism became a firmly established economic system. (In capitalism the economy is controlled by private individuals rather than the government.) Much of economic theory grew out of the ideas of Scottish philosopher Adam Smith, whose book *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776) is generally considered the founding text of the field of economics. Later, as a result of the writings of English economist John Maynard Keynes in the 1930s, economics came to be subdivided into two main branches, microeconomics and macroeconomics. These branches focus, respectively, on individual and collective economic behavior. Since Keynes's time many economists have worked on unifying these two branches of theory.

$ When Did It Begin

Throughout history many philosophers and religious thinkers have dealt with economic questions. In ancient Greece, for instance, the philosophers Plato and Aristotle addressed the issue of whether private property was a legitimate concept. Likewise, in the thirteenth century the Italian Christian philosopher Thomas Aquinas discussed the moral aspects of buying and selling goods and services. For much of history, religions such as Christianity and Islam opposed, on moral grounds, such economic trends as the charging of interest (fees paid to those who lend money). But the study of economics did not become systematic until after the Middle Ages.

In the sixteenth through eighteenth centuries, the nation-states of Europe (such as England, France, Spain, and Portugal) wanted to build up power partly by amassing wealth. Out of this desire grew economic theories that dictated the development of capitalism during that time. These theories, later grouped together under the label of mercantilism, generally held that a nation's wealth was equivalent to its store of gold, silver, and other precious metals. This belief led nations to pursue wealth by maintaining an imbalance in foreign trade. If a nation sold more goods abroad than it imported, then that nation would bring in more gold than it would send outside of its borders through trade. In this way, the developing European nations competed with each other by trying to stockpile gold.

In the eighteenth century Adam Smith (1723–90) conceived of his book *An Inquiry into the Nature and Causes of the Wealth of Nations* as a rebuttal to the mercantilist viewpoint, but it was much more than that.

ADAM SMITH

"It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard for their own interest."

ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS,* 1776.

Why He Is Important

Adam Smith (1723–90), Scottish economist and moral philosopher, is widely regarded as the father of modern economic thought. His groundbreaking work *An Inquiry into the Nature and Causes of the Wealth of Nations,* promoted laissez-faire capitalism, the idea that with a minimum of government interference, the economy will be guided by an invisible hand that operates for the good of the entire society. *The Wealth of Nations* was written in a style intended to be accessible to average readers. First published in 1776, just a few years before the Industrial Revolution was launched by the use of steam engines to power spinning machinery, it remains at the foundation of academic, philosophical, and practical debate about the role of government in the economy, the value of free trade, and the nature of rational economic self-interest.

Life

Adam Smith was born in the village of Kirkcaldy, just north of Edinburgh, Scotland, on June 5, 1723. His father had died shortly before his birth, and he was raised by his widowed mother, with whom he maintained a close bond until her death in 1784. At the age of fourteen Smith was sent to the University of Glasgow, where he was much influenced by the teachings of Francis Hutcheson (1694–1796), an esteemed moral philosopher who believed, among other things, that human beings were guided by innate moral instincts about right and wrong, more so than by a sense of self interest. In 1740 Smith went on to Balliol College at Oxford University, where he received his bachelor's degree in 1744. During his studies at Oxford, Smith discovered the work of David Hume (1711–76), a Scottish philosopher 12 years his senior. Smith was significantly influenced by Hume's essays about money and international trade, and the two later became close friends.

Smith returned to his home in Kircaldy in the late 1740s and then lived in Edinburgh until 1751, when he was appointed professor of logic at the University of Glasgow. The following year, at the age of 29, he became chair of moral philosophy at Glasgow, inheriting the position that had been held by his former teacher, Hutcheson, until 1746. In this capacity he lectured on such diverse topics as natural theology, ethics, jurisprudence, and economics. In 1759 he gained widespread attention with his *Theory of Moral Sentiments,* an examination of ethics, human nature, and the feelings that lead people to act virtuously. Although the work was later eclipsed by the *Wealth of Nations,* Smith still considered it his most important philosophical endeavor, revising it continually until the end of his life.

Moreover, it was based on the extraordinary merit of Smith's debut publication that he was hired as a tutor to the young Duke of Buccleuch, stepson of the prominent English politician Charles Townshend, who contracted to pay Smith a salary of 300 pounds per year for the rest of his life. Unable to refuse such a handsome offer, Smith abandoned his academic post in 1764 to live and travel in France and Switzerland with his pupil. During this period he came into contact with some of the foremost political-economic thinkers of the age, including Voltaire (1694–1778), Jean-Jacques Rousseau (1712–78), Franois Quesnay (1694–74), Anne-Robert-Jacques Turgot (1727–81), and Jacques Necker (1732–1804). Smith's sojourn on the European continent lasted about two years. Thereafter, having secured a life pension, he returned to Kirkcaldy to live with his mother and work on *Wealth of Nations.* When the lengthy masterpiece appeared in 1776, it was immediately recognized as the most systematic, comprehensive, and incisive study of economics ever written. Curiously, two years later Smith was made commissioner of customs in Scotland, which put him in the uncomfortable predicament of having to curtail smuggling, an activity he had defended in the *Wealth of Nations* as a natural consequence of the government's unreasonable import taxes.

Smith argued that a nation's wealth should be measured not just by its horde of gold but also by all of the goods and services that it produces. He also examined the nature of that enormously sophisticated production of goods and services. One of his guiding insights was the notion of the "invisible hand." This was the concept that, in a situation where buyers and sellers compete freely in the marketplace for what is in their own self-interest, the greatest good for all is consistently achieved, as if by the prodding of an invisible hand. The marketplace, in Smith's view, was a self-regulating system in which market prices were determined by the forces of supply (what the sellers want) and demand (what the buyers want).

This, together with Smith's many other crucial insights into the ways that societies use their resources, served as the foundation for much of the economic thought of the nineteenth century. Even in the twentieth and twenty-first centuries, economists continued to refine and reconsider Smith's ideas in new ways.

$ More Detailed Information

Nineteenth-century thinkers, foremost among them the English economists David Ricardo (1772–1823) and Thomas Malthus (1766–1834), followed Smith's lead, fleshing out the details of the self-regulating processes he had described and addressing some of the problems or omissions they saw in his analysis. Ricardo argued against barriers to foreign trade, as had Smith, but Ricardo focused on the ways in which the wages of workers, rent

Socially awkward and consumed by his ideas, Smith remained a bachelor throughout his life. Although he was quiet, reclusive, and incorrigibly absentminded, he was still known to be a brilliant lecturer who could expound his complex thoughts in an a fluid, animated, and thoroughly engaging style. Smith died in Edinburgh on July 17, 1790, having demanded from his deathbed that the bulk of his manuscript writings be destroyed.

Adam Smith founded the modern field of economics with the publication of "The Wealth of Nations" in 1776. In exchange for a spending a few years tutoring the young stepson of a prominent British politician, Smith secured a lifetime pension, which enabled him to devote nearly all of his time to developing his ideas.
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Work

The Wealth of Nations marked a radical departure from the principles of the mercantilist economic system, which had been established in Europe since the sixteenth century. Under mercantilism, the government played a protectionist role in the economy by promoting the export of its goods and restricting the import of foreign goods, especially through the use of import taxes, called tariffs. The government also interfered with competition and technological innovation by granting unfair advantages to certain merchants, farmers, and manufacturers over others and by prohibiting the use of new laborsaving machinery.

In the *Wealth of Nations* Smith issues a stringent critique of mercantilism, arguing that free trade and competition, with a *minimum* of government regulation, are the key to national prosperity. The wealth of a nation, he suggested, should be judged not by the amount of gold in the government coffers but by the quantity and variety of goods available to its consumers. Not only will free trade expand the realm of consumer choice and spur economic growth, Smith asserts, but it will also foster the general welfare of the society. Indeed, central to Smith's economic model is the idea that people acting in their own self-interest—"the uniform, constant, and uninterrupted effort of every [person] to better [his or her] condition"—will lead to the creation of high quality goods that meet the needs of, and therefore benefit, the society.

Legacy

It would be difficult to overstate the importance of Smith's contributions to the study of economics. *The Wealth of Nations* established a new paradigm for understanding the process of creating wealth and paved the way for the tremendous economic expansion of the nineteenth century. The text is regarded as the cornerstone of what came to be called classical economics, as well as the definitive vision of free market capitalism. Most prominent economists in the history of the discipline—including David Ricardo and Karl Marx in the nineteenth century and John Maynard Keynes and Milton Friedman in the twentieth—have responded to his work.

levels, and business profits interacted. Because of the complex effects each of these factors had on one another, Ricardo argued, laws that protected British farmers from outside competition were actually harmful to the wider economy. Malthus, meanwhile, examined the questions of overpopulation and the prospect of a general glut, in which an excess of production might lead to economic stagnation.

Karl Marx (1818–83), the German economist and philosopher best known as the author of the highly influential pamphlet *The Communist Manifesto* (1848), built on the ideas of Smith and Ricardo to critique capitalism in his lengthier work *Das Kapital* (1867). Among Marx's wide-ranging conclusions was the influential idea that business owners essentially derived their profits by paying workers less than they deserved (given the value their labor added to the products). The English philosopher and economist John Stuart Mill (1806–73), meanwhile, also saw flaws in capitalism, but he used Ricardo's ideas to suggest ways of correcting rather than abolishing the system, as Marx wanted to do.

The theories of these and other thinkers are now commonly grouped together under the heading classical economics. Most economists throughout the late nineteenth and early twentieth centuries continued to accept the basic ideas of the classical economists. The leading figures in the field during this time often focused less on wide-ranging theories than on supporting preexisting theories with sophisticated mathematical principles. During this time economics moved away from its origins

Important Economists in History

- **Adam Smith** Scottish, 1723–1791

Known as the father of economics, Smith believed that when buyers and sellers competed freely for what was in their own self-interest, the greatest economic good for all was consistently achieved. His book *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776) is considered the founding text in the field of economics.

- **David Ricardo** English, 1772–1823

Ricardo, also a supporter of the free exchange between buyers and sellers, argued against barriers to trade between countries, believing that laws that protected English farmers from foreign competition were actually harmful to the wider English economy.

- **Thomas Malthus** English, 1776–1834

Known for his grim predictions of the future, Malthus believed that the world's population would grow much more quickly than the economy's ability to produce food, leading one day to mass starvation.

- **John Stuart Mill** English, 1806–1873

Although a strong believer in individual and economic freedom, Mill was concerned about the risks of economic competition. He wrote, "I am not charmed with the ideal of life held out by those who think that the normal state of human beings is that of struggling to get on; that the trampling, crushing, elbowing, and treading on each other's heals . . . are the most desirable lot of human kind."

- **Karl Marx** German, 1818–1883

Marx, author of the *Communist Manifesto* and the economic text *Das Kapital*, inspired the worldwide movement of Communism in the late nineteenth and twentieth centuries. He believed that business owners made money, or profit, by paying workers less than they deserved.

- **Alfred Marshall** English, 1842–1924

Marshall reexamined and elaborated on the ideas of his predecessors, developing influential new concepts about prices and the value of products and services. He is credited with transforming economics into a more mathematical, scientific profession and encouraging people to apply economic principles to real world problems.

- **John Maynard Keynes** English, 1883–1946

Keynes believed that a struggling economy could be revived with increased government spending, which would create a demand for goods and services and thereby more jobs for people who produced them. His ideas became popular during the worldwide economic downturn known as the Great Depression (1929–1939).

Economics studies how a society uses its resources to produce goods and services. These seven thinkers were among the most influential in shaping the ideas of modern economics. *Illustration by GGS Information Services. Cengage Learning, Gale.*

in pure theory and observation and became dependent on highly sophisticated mathematical analysis.

Ideas such as the invisible hand (which guided the marketplace, ensuring the greatest good for all) continued to dictate the study and implementation of economic theory. The United States, for instance, had no cohesive economic policy prior to the Great Depression (the severe worldwide economic decline that lasted from 1929 to about 1939). Instead it largely trusted the self-regulating market to take care of itself. But the Great Depression presented economists with problems that their existing theories could not answer.

During the Depression roughly one-third of the U.S. labor force was out of work, which meant that people did not have the money to buy many of the basic necessities of life. Thus, it did not matter that new, enlarged factories with the latest technology were capable of producing goods in previously unimaginable quantities; there was no demand for those goods. The marketplace offered no solution to problems such as this.

It was in this climate that the British economist John Maynard Keynes (1883–1946) offered insights that revolutionized the field. His book *The General Theory of Employment, Interest, and Money* (1936) proposed that the economy, in certain conditions, might not have the capacity to correct itself. In such a situation, he argued, only a national government had the ability to provide solutions. The government could address the lack of demand created by high unemployment (joblessness) by spending money in a variety of ways. He reasoned that when a government spends money, that money goes into the hands of private citizens, who use it to buy what they want and need. This spurs the growth of business.

Keynes's ideas, which overturned many of the classical economists' assumptions, provided an intellectual foundation for many government programs aimed at reducing poverty and regulating the economy. His ideas also led to the creation of a new approach to the study of economics.

Before Keynes introduced his ideas, most economic theory concerned the choices of individual consumers and businesses; in other words, such theories built a picture of the larger economy from the bottom up. After Keynes this way of studying the economy came to be known as microeconomics.

Keynes's arguments showed the necessity of looking at the economy in another way as well: from the top down. He believed that by analyzing trends at the national level (especially factors such as the economy's growth, employment, prices, and the money supply), economists might be able to make discoveries that they were unable to see at the microeconomic level. This top-down view of the economy came to be known as macroeconomics. The field of economics today remains subdivided into these two basic ways of looking at economic activity.

$ Recent Trends

Keynesian economics dominated the academic world and government policymaking through the 1960s, but thinkers such as the American economist Milton Friedman (1912–2006) began to point out flaws in the idea that a government could fine-tune a national economy. Friedman and others brought back classical economic notions of the self-regulating market, arguing that an economy worked best in the absence of government interference. One of the only spheres in which Friedman believed a

government should have a role in managing the economy was the money supply (the amount of money in circulation). Friedman's ideas continued to have influence at the close of the twentieth and the beginning of the twenty-first century, but they were never followed to their full extent.

Today many mainstream economists are engaged in uniting macroeconomic and microeconomic concepts. Whereas Keynesian economists had taken a macro view of the economy that was largely independent of the well-established principles of microeconomics, in the 1970s and beyond economists began finding microeconomic explanations for phenomena that are apparent at the macro level. There are also numerous alternative approaches to economics today, many of which are built on the ideas of nineteenth-century thinkers such as Marx, whose ideas other economists have since left behind.