intro

Introduction: >> The Ordinary Business of Life

Any Given Sunday

It's Sunday afternoon in the summer of 2003, and Route 1 in central New Jersey is a busy place. Thousands of people crowd the shopping malls that line the road for 20 miles, all the way from Trenton to New Brunswick. Most of the shoppers are cheerful—and why not? The stores in those malls offer an extraordinary range of choice; you can buy everything from sophisticated electronic equipment to fashionable clothes to organic carrots. There are probably 100,000 distinct items available along that stretch of road. And most of these items are not luxury goods that only the rich can afford; they are products that millions of Americans can and do purchase every day.

The scene along Route 1 that summer day was, of course, perfectly ordinary—very much like the scene along hundreds of other stretches of road, all across America, that same afternoon. But the discipline of economics is mainly concerned with ordinary things. As the great nineteenth-century economist Alfred Marshall put it, economics is "a study of mankind in the ordinary business of life."

What can economics say about this "ordinary business"? Quite a lot, it turns out. What we'll see in this book is that even familiar scenes of economic life pose some very important questions—questions that economics can help answer. Among these questions are:

- How does our economic system work? That is, how does it manage to deliver the goods?
- When and why does our economic system go astray, leading people into counterproductive behavior?
- Why are there ups and downs in the economy? That is, why does the economy sometimes have a "bad year"?
- Finally, why is the long run mainly a story of ups rather than downs? That is, why has America, along with other advanced nations, become so much richer over time?

Let's take a look at these questions and offer a brief preview of what you will learn in this book.

The Invisible Hand

That ordinary scene in central New Jersey would not have looked at all ordinary to an American from colonial times—say, one of the patriots who helped George Washington win the battle of Trenton in 1776. (At the time, Trenton was a small village with not a shopping mall in sight, and farms lined the unpaved road that would eventually become Route 1.)

Imagine that you could transport an American from the colonial period forward in time to our own era. (Isn't that the plot of a movie? Several, actually.) What would this time-traveler find amazing?

Surely the most amazing thing would be the sheer prosperity of modern America—the range of goods that ordinary families can afford. Looking at all that wealth, our transplanted colonial would wonder, "How can I get some of that?" Or perhaps he would ask himself, "How can my society get some of that?"

An **economy** is a system for coordinating society's productive activities. **Economics** is the study of economies, at the level both of individuals and of society as a whole.

The answer is that to get this kind of prosperity, you need a well-functioning system for coordinating productive activities—the activities that create the goods and services people want and get them to the people who want them. That kind of system is what we mean when we talk about the **economy**. And **economics** is the study of economies, at the level both of individuals and of society as a whole.

An economy succeeds to the extent that it, literally, delivers the goods. A time-traveler from the eighteenth century—or even from 1950—would be amazed at how many goods the modern American economy delivers and at how many people can afford them. Compared with any past economy and with all but a few other countries today, America has an incredibly high standard of living.

A **market economy** is an economy in which decisions about production and consumption are made by individual producers and consumers.

So our economy must be doing something right, and the time-traveler might want to compliment the person in charge. But guess what? There isn't anyone in charge. The United States has a **market economy**, in which production and consumption are the result of decentralized decisions by many firms and individuals. There is no central authority telling people what to produce or where to ship it. Each individual producer makes what he or she thinks will be most profitable; each consumer buys what he or she chooses.

The alternative to a market economy is a *command economy,* in which there *is* a central authority making decisions about production and consumption. Command economies have been tried, most notably in the Soviet Union between 1917 and 1991. But they didn't work very well. Producers in the Soviet Union routinely found themselves unable to produce because they did not have crucial raw materials, or they succeeded in producing but then found that nobody wanted their products. Consumers were often unable to find necessary items—command economies are famous for long lines at shops.

Market economies, however, are able to coordinate even highly complex activities and to reliably provide consumers with the goods and services they want. Indeed, people quite casually trust their lives to the market system: residents of any major city would starve in days if the unplanned yet somehow orderly actions of thousands of businesses did not deliver a steady supply of food. Surprisingly, the unplanned "chaos" of a market economy turns out to be far more orderly than the "planning" of a command economy.

In 1776, in a famous passage in his book *The Wealth of Nations*, the pioneering Scottish economist Adam Smith wrote about how individuals, in pursuing their own interests, often end up serving the interests of society as a whole. Of a businessman whose pursuit of profit makes the nation wealthier, Smith wrote: "[H]e intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention." Ever since, economists have used the term **invisible hand** to refer to the way a market economy manages to harness the power of self-interest for the good of society.

The **invisible hand** refers to the way in which the individual pursuit of self-interest can lead to good results for society as a whole.

The study of how individuals make decisions and how these decisions interact is called **microeconomics**. One of the key themes in microeconomics is the validity of Adam Smith's insight: Individuals pursuing their own interests often do promote the interests of society as a whole.

Microeconomics is the branch of economics that studies how people make decisions and how these decisions interact.

So part of the answer to our time-traveler's question—"How can my society achieve the kind of prosperity you take for granted?"—is that his society should learn to appreciate the virtues of a market economy and the power of the invisible hand.

But the invisible hand isn't always our friend. It's also important to understand when and why the individual pursuit of self-interest can lead to counterproductive behavior.

My Benefit, Your Cost

One thing that our time-traveler would not admire about modern Route 1 is the traffic. In fact, although most things have gotten better in America over time, traffic congestion has gotten a lot worse.

When traffic is congested, each driver is imposing a cost on all the other drivers on the road—he is literally getting in their way (and they are getting in his way). This cost can be substantial: in major metropolitan areas, each time someone drives to work, as opposed to taking public transportation or working at home, he can easily impose $15 or more in hidden costs on other drivers. Yet when deciding whether or not to drive, commuters have no incentive to take the costs they impose on others into account.

When the individual pursuit of self-interest leads to bad results for society as a whole, there is **market failure.**

Traffic congestion is a familiar example of a much broader problem: sometimes the individual pursuit of one's own interest, instead of promoting the interests of society as a whole, can actually make society worse off. When this happens, it is known as **market failure**. Other important examples of market failure involve air and water pollution as well as the overexploitation of natural resources such as fish and forests.

The good news, as you will learn as you use this book to study microeconomics, is that economic analysis can be used to diagnose cases of market failure. And often, economic analysis can also be used to devise solutions for the problem.

Good Times, Bad Times

Route 1 was bustling on that summer day in 2003—but it wasn't bustling quite as much as merchants would have liked, because in mid-2003 the U.S. economy wasn't doing all that well. The main problem was jobs: in early 2001, businesses began laying off workers in large numbers, and as of June 2003, employment had not yet started to recover.

Such troubled periods are a regular feature of modern economies. The fact is that the economy does not always run smoothly: it experiences *fluctuations,* a series of ups

A **recession** is a downturn in the economy.

and downs. By middle age, a typical American will have experienced three or four downs, known as **recessions**. (The U.S. economy experienced serious recessions beginning in 1973, 1981, 1990, and 2001.) During a severe recession, millions of workers may be laid off.

Macroeconomics is the branch of economics that is concerned with overall ups and downs in the economy.

Like market failure, recessions are a fact of life; but also like market failure, they are a problem to which economic analysis offers some solutions. Recessions are one of the main concerns of the branch of economics known as **macroeconomics**, which is concerned with the overall ups and downs of the economy. If you study macroeconomics, you will learn how economists explain recessions and how government policies can be used to minimize the damage from economic fluctuations.

Despite the occasional recession, however, over the long run the story of the U.S. economy contains many more ups than downs. And that long-run ascent is the subject of our final question.

Onward and Upward

At the beginning of the twentieth century, most Americans lived under conditions that we would now think of as extreme poverty. Only 10 percent of homes had flush toilets, only 8 percent had central heating, only 2 percent had electricity, and nobody had a car, a washing machine, or air conditioning.

Economic growth is the long-run trend toward production of more goods and services.

Such comparisons are a stark reminder of how much our lives have been changed by **economic growth**, the growing ability of the economy to produce goods and services.

Why does the economy grow over time? And why does economic growth occur faster in some times and places than in others? These are key questions for economics because economic growth is a good thing, as those shoppers on Route 1 can attest, and most of us want more of it.

An Engine for Discovery

We hope we have convinced you that the "ordinary business of life" is really quite extraordinary, if you stop to think about it, and that it can lead us to ask some very interesting and important questions.

In this book, we will describe the answers economists have given to these questions. But this book, like economics as a whole, isn't a list of answers: it's an introduction to a discipline, a way to address questions like those we have just asked. Or as Alfred Marshall, who described economics as a study of the "ordinary business of life," put it: "Economics . . . is not a body of concrete truth, but an engine for the discovery of concrete truth."

So let's turn the key in the ignition. ■