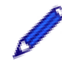
HL IB Economics



Your notes

1.2 How do Economists Approach the World?

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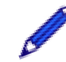
1.2.1 Economic Methodology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Positive & Normative Economics

What is positive economics?

- **Positive economics** is concerned with **objective statements** of how a market or an economy works
- These **positive economic statements** are based on empirical evidence and tend to be **statements of fact**
- They can be proven to be **true or false**
- Examples of positive economic statements include
  - The unemployment rate in India **has fallen** from 8% to 7.3% in the past twelve months
  - Increasing the minimum wage last year in the UK **resulted in improvements** to wage inequality
  - Prices in the EU **have risen dramatically**, partly due to the 20% **increase in the price of oil**

What is normative economics?

- **Normative economics** focuses on **value judgements**
- These judgements are built around **opinions and beliefs** as to what the best economic policies or solutions may be
- These judgements are called **normative economic statements**
- **Normative economic statements** are often the basis for the **manifestos** of political parties and the different economic agendas they put forward
- Examples of normative economic statements include
  - Every economy **should** aim to provide free healthcare for its citizens
  - Corporation taxes in an economy **should** be higher than personal income taxes
  - **The best way** to deal with a rise in crime is to employ more police

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In short answer questions, should you wish to provide an example of a positive or normative statement ensure that normative statements have the word 'should' in them. Positive statements usually include data that is hard to challenge.

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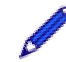
The Role of Positive Economics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- As a social science, Economics deals with **complex and continuously** changing human interactions
- For this reason it is **harder to examine a relationship** between two variables and always conclude it is exactly the same (as can be done in Science or Maths)
- There are a number of tools which are utilised in **economic analysis** to help ensure that **positive (factual) statements** can be made with a higher degree of reliability

1. The use of logic

- When analysing markets, a **range of assumptions** are made about the **rationality** of **economic agents** involved in the transactions
- In classical economic theory, the word **'rational'** means that economic agents are able to consider the outcome of their **choices** and **recognise the net benefits** of each one
- Rational agents will select the choice which presents the **highest benefits**
  - **Consumers** are assumed to act rationally. They do this by **maximising their utility**
  - **Producers** are assumed to act rationally. They do this by **selling goods/services** in a way that **maximises their profits**
  - **Workers** are assumed to act rationally. They do this by **balancing welfare** at work with consideration of both pay and benefits
  - **Governments** are assumed to act rationally. They do this by placing the interests of the people they serve first in order to maximise their welfare

2. The use of hypotheses, models and theories

- The **social sciences** use a variation of the **scientific method** of research which is called the **social scientific method**
- There is an **inability to make scientific experiments** the results of which can be proven time and time again
  - This is due to the complexity of human nature and the significant **number of social interactions** that are taking place in any economy **at any given point in time**

- The steps in the **social scientific method** are similar to the **scientific method** but there is a key difference

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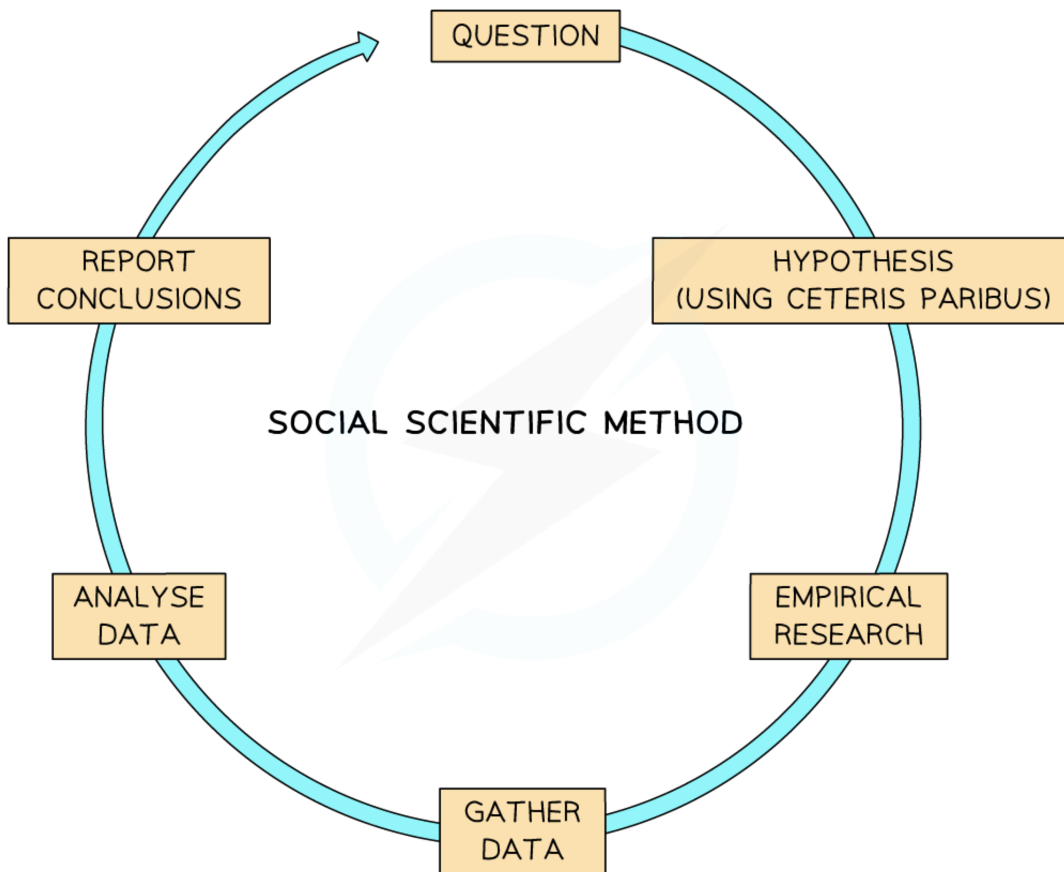

The social scientific method uses empirical research to gather data

- Empirical research **is collected through observations, surveys, opinion polls etc.**
  - The results of **the same hypothesis** can vary significantly when conducted by **different researchers** at **different time periods** and **between different places and cultures**
- **Refutation** is the act of a statement or theory being proved to be wrong by the empirical evidence
  - Refutation helps to determine if an **economic statement is positive**
- **Economic models** are developed by economists once a **hypothesis has been repeatedly proven or rejected** in **different circumstances**

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- A model is a **simplified version** of reality
- All models make a **range of assumptions**. These are often generalisations about behaviour, choices and likely outcomes
- These assumptions are necessary so as to account for complex human behaviour and **constantly changing variables**
- When evaluating different models, the **underlying assumptions** should always be considered

3. The ceteris paribus assumption

- Due to the **large number of variables** that can influence any particular economic interaction in society, economists **create models** using the principle of **ceteris paribus**
  - Translated from Latin, ceteris paribus means **'all other variables remain constant'**
  - It allows economists to **simplify and explain** causes and effects, even if the explanation is somewhat limited by the assumptions
  - E.g. There are **many factors** that affect the level of unemployment in an economy (interest rates, consumer confidence, firms' investment, government policies etc.). Using **ceteris paribus**, economists can simplify the **economic model** to analyse **just two variables** (e.g. unemployment and interest rates)

Rational Decision Making

- When analysing markets, a **range of assumptions** are made about the **rationality** of **economic agents** involved in the transactions
- In classical economic theory, the word **'rational'** means that economic agents are able to consider the outcome of their **choices** and **recognise the net benefits** of each one. Rational agents will select the choice which presents the **highest benefits**
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- In many ways, the **assumption of rational decision making is flawed**. For example, consumers are often more influenced by **emotional purchasing decisions** than a rational computation of net benefits

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In your examinations, the essay questions test your ability to **think critically**. The **command words** for these questions are **evaluate, discuss, or examine**.

One way in which you can demonstrate **critical thinking** is to **challenge the underlying assumptions** of economic theory. The idea of **rational decision making** is **one such assumption**. Do consumers act rationally when they make impulse purchases? Do workers act rationally when they accept terrible working conditions for mediocre pay? Do governments actually maximise public welfare or do they implement policies that mainly benefit their core voter base?

Irrationality distorts markets and produces fundamentally **different outcomes** than what would be achieved if all economic agents acted rationally.

The Role of Normative Economics

- **Value judgements** influence governments' choices with regards to the **economic policies** they choose to adopt and spend money on
  - The USA spends more money on imprisoning drug users than rehabilitating them
  - In the UK, the Government has recently increased its spending on **rehabilitation**
  - To say the **UK approach is better** would be a normative statement
  - To say that the UK government spends more per head on rehabilitation would be a **positive statement**
- **Equity** is concerned with economic fairness in the distribution of resources
  - Individuals and societies have different views on **what is fair** and this influences government policy
    - E.g. Some countries believe it is fair for all of their citizens to be able to access healthcare, irrespective of their ability to pay, whereas other countries believe that 'no pay, no access' is fair
- **Equality** is concerned with everyone being equal and having equal recognition
  - Equality is often a normative concept. When are all people equal? When do people all have equal opportunities?
  - **Statistics on inequality** would be considered to be positive economic statements
    - E.g. In 2018, women in the USA were paid 12% less than men in comparable jobs

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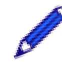
1.2.2 Economic Thought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Introduction to Economic Thought

- Understanding the evolution of **economic thought** over the past 400 years, helps us to understand the strengths and weaknesses of economic policies we use today
- Each period of **economic revolution** was created as a result of challenges societies were facing at the time e.g. **classical economics** was the solution to centuries of **mercantilism** while Marxism was the solution to capitalism and worker exploitation
- There is a strong debate around whether societies should create a **new economics** fit for the 21st century challenges

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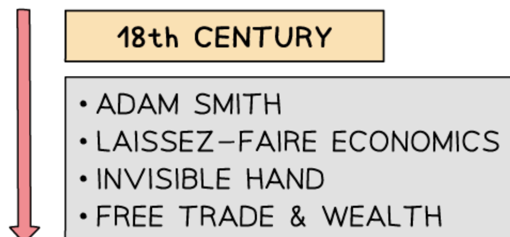

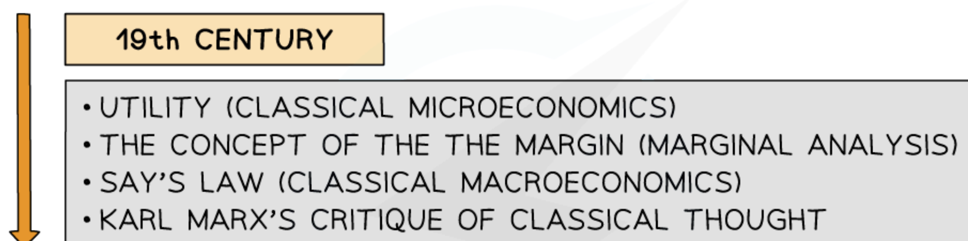

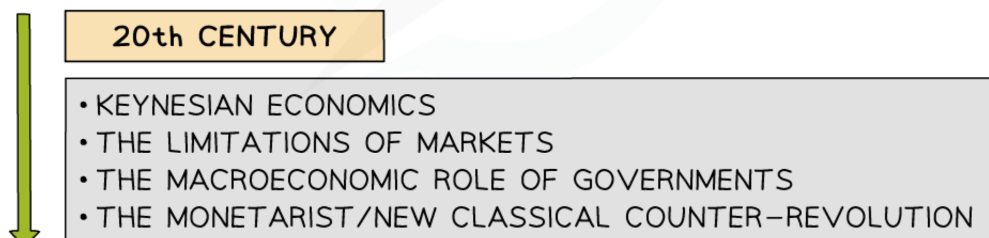

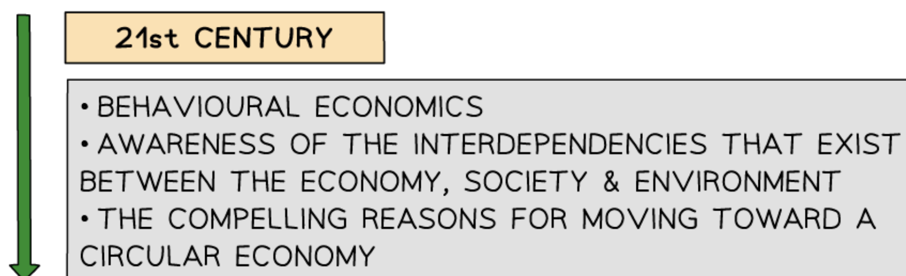

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A summary of the economic schools of thought from the 18th century

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Economic Ideas from the 18th Century

- **Adam Smith** published his famous book on Economics in 1776: *The Wealth of Nations*
  - He is widely regarded as the father of **Classical Economics**
- Written at the start of **The Industrial Revolution**, it captured his thoughts on how markets could be coordinated by demand and supply
  - This book was a natural response to the **previous century of government intervention** in markets in Europe during a period known as **mercantilism**

Key ideas from Adam Smith in the 18th Century

Idea	Explanation
Laissez-faire ('to leave alone') economics	▪ A philosophy which believes there should be **no (or minimal) government intervention** with regard to decisions about resource allocation and production
Invisible hand	▪ The unseen free market forces of demand and supply that coordinate the **best allocation of resources** within society ▪ It is driven by consumers and producers seeking to maximise their **self-interest** ▪ **Personal incentives** and not government decisions determine the allocation of resources
Free trade	▪ Removing the **protectionist measures** found in **mercantilism** would increase production, trade and wealth
Wealth	▪ **Production** creates wealth for individuals and when individuals get wealthy, the nation gets wealthy

Economic Ideas from the 19th Century

- During the **19th century**, several key ideas emerged including classical microeconomics (utility); the concept of the margin; classical macroeconomics (Say's law)

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- During this period **Karl Marx** also developed his critique of classical economic thought

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Key ideas from the 19th Century

Idea	Explanation
Classical microeconomics (utility)	▪ The idea of **utility** as a concept challenged what **classical economists** believed about how a product should be priced ▪ Previously, prices were a function of the costs of production involved. Now prices were seen as a function of the **satisfaction gained in consumption** ▪ Producers should **increase production** for goods with high consumer utility ▪ Utility theory assumes that consumers always act rationally **(yet many purchasing decisions are based on emotion)**

The concept of the margin	▪ **Marginal utility** is the additional utility **(satisfaction)** gained from the consumption of **an additional product**
	▪ The utility gained from consuming the first unit is usually **higher** than the utility gained from **consuming the next unit**
	  ▪ E.g. A hungry consumer gains **high utility** from eating their **first hamburger**. They are still hungry and purchase a **second hamburger** but gain **less satisfaction** from eating it than they did from the first hamburger
	▪ To calculate **total utility**, the **marginal utility of each unit** consumed is **added together**
	  ▪ This means that total utility **keeps increasing** even while marginal utility **is decreasing**

Classical macroeconomics (Say's law)	▪ Say's law of markets was developed in 1802 by the **classical, laissez-faire** economist Jean-Baptise Say ▪ It can be summed up with the phrase **'supply creates its own demand'** ▪ By supplying goods to the market a producer generates income from sales which they can then use to purchase (demand) more products ▪ This law implies that increasing **national output in an economy is vital** to income generation and thus governments should focus on generating

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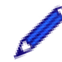
	production and be less concerned with consumption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Karl Marx's Critique of Classical Economic Thought

- Free markets **generated incredible wealth** in the Western World
- Karl Marx, a German philosopher, identified that wealth seemed to come **from worker exploitation** (a natural function of profit maximisation) and that inequality was deepening in societies
  - The exploitation was seen in low wages and poor working conditions
  - The **owners of the factors of production (capitalists)** generated the highest income (wages, interest, rent and profit)
  - If all someone had to offer was labour, and wages were suppressed: then inequality was bound to increase
- Marx argued that capitalism would eventually lead **workers to revolt** and that periods of exploitation would be followed by revolutions
  - These revolutions would require **government intervention** to restore stability and equality
  - Governments would need to be involved in the allocation of resources **(command economy)** to prevent the pattern from repeating
- Marx's ideas were incredibly influential and within a relatively short time frame resulted in more than **a third of the world's population** living in economies influenced by his ideas

Economic Ideas from the 20th Century

- The first half of the 20th Century was dominated by the **two World Wars** and the **Great Depression**
- The economic ideas of the previous century no longer worked
- In this severe recession, **Say's Law became obsolete** as households were unable to buy goods/services due to a complete lack of income
- **John Maynard Keynes**, a British economist from Cambridge felt new ideas were needed
- His ideas were quickly embraced and the next 50 years saw a widespread **Keynesian revolution** as governments adopted **Keynesian economics**

Key ideas from Keynes in the 20th Century

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Idea	Explanation
The limitations of markets	▪ Contrary to classical theory, Keynes saw that the **Great Depression** had created a situation where markets did not automatically readjust to a new equilibrium ▪ Some markets remained in a **long term period of disequilibrium** where supply was greater than demand ▪ Market forces were **not resolving the situation**
The Macroeconomic role of Governments	▪ Keynes believed that Governments needed to stimulate demand by increasing **government spending** ▪ This would begin to **increase the flow of income** in the economy which would further stimulate demand which would help markets to function again ▪ He developed the term and field of **'Macroeconomics'** by explaining how **aggregate demand** is calculated ▪ He argued that the use of **Fiscal Policy** was essential to stabilise an economy during periods of recession or depression, much more so than the use of **Monetary Policy**

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The Monetarist/New Classical Counter Revolution

- **Monetarism** is an economic school of thought which emphasises the use of **Monetary Policy** to influence an economy
  - Monetarists believe that **poor monetary policy** lead to the Great Depression
  - Monetarists believe that the **use of fiscal policy** leads to **inflation** as government spending increases aggregate demand
- **Milton Friedman** was one of the leading **Monetarists** of the late 20th Century
  - His ideas influenced Ronald Reagan in the USA and Margaret Thatcher in the United Kingdom
  - Both Governments moved away from **Keynesian economics**
- From the early 1980s there was a resurgence in the belief in **classical economics and laissez-faire markets**

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- Government spending reduced and the focus shifted to **Supply-Side Policies**
- One prominent Supply-Side Policy that the USA and the UK embraced was the use of **privatisation**

Economic Ideas from the 21st Century

- The early part of the 21st Century has seen several **significant global challenges** emerge
  - Climate change
  - On-going wars and displacement of populations
  - An increase of global population in the last 100 years by 7 billion people
  - The **Global Financial Crisis** of 2008
  - The Covid Recession of 2020
- **Keynesian economic thought** came to prominence again with the 2008 Financial Crisis as governments chose to spend their way out of trouble
  - Government spending increased to **levels never seen before**, continuing for more than a decade
  - This increased spending was financed by **increased government borrowing**
  - Increased Government borrowing creates **increased tax burdens** for future generations
- Even with Government spending extraordinarily high in many economies, **expansionary Monetary Policy** had to be widely used to bring stability
- This pattern of events prompted calls for societies to **rethink Economics**
  - It called for **an economic philosophy** to emerge that is no longer rooted in 'old thinking'
  - It called for ideas fit for a 21st Century world

21st Century Ideas

Idea	Explanation
The growing role of behavioural economics	▪ A fundamental flaw in economic theory is that **individuals behave rationally** in markets ▪ Behavioural economics recognises this and combines elements of economics and psychology to understand

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	how and why individuals make the **economic decisions** they do
	▪ Understanding human behaviour creates better opportunities for firms and governments to **nudge** people towards better choices
	  ▪ E.g. The use of **choice architecture** for online forms in many countries automatically selects organ donation as a default: individuals have to opt-out as opposed to opting-in
	  ▪ Nudge theory is increasingly used by firms and governments across the world

Awareness of the interdependencies that exist between the economy, society and environment	▪ The **circular flow of income model** has provided a basis for understanding macroeconomies since it was visualised by Frank Knight in 1933
	▪ The model has been criticised as **not fit for the 21st century** as it does not take into account the **inputs and outputs of societies**
	  ▪ It focusses on money as opposed to **well-being and planetary health**
	  ▪ Inputs are the raw materials which are increasingly used in **unsustainable** ways
	  ▪ Outputs are the **carbon and waste** that are generated

The compelling reasons for moving toward a circular economy	▪ A **circular economy** has three main principles 1. Eliminate waste and pollution 2. Recirculate products 3. Regenerate nature ▪ The **increasing climate crisis** provides a strong reason why economies should rush to move away from the **circular flow of income** model to the **circular economy model**

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