

Core Economics: Concepts and Applications

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Chapter 2: Great ideas in economics

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Chapter 2

Great ideas in economics

What are the great ideas in economics? One way to find them is to look at the work of selected winners of the Nobel Prize in Economics.

It was difficult for me to choose a shortlist – I found myself trying to include many more, as all of them have made valuable contributions. Then, I decided to drop the economists whose work is mainly technical, and directly relevant for economists only. That helped a bit. Then, I created a shortlist based on my views and biases. I discussed it with some economists and took account of their comments to come up with the final list.

There's one catch with this approach. **What about all the people who lived before the Nobel Prize in Economics was set up? It makes no sense to ignore them.**

Chapter flow

We discuss the economists in chronological order, beginning with the early economists, and ending with the Nobel Prize winners in this century.

Early economists

I have selected five people: Kautilya, Adam Smith, David Ricardo, Alfred Marshall, and John Maynard Keynes.

I leave it to you to figure out what happens to the bus system's revenues if the elasticity of demand is 1.0.

Elasticity comparisons

By now, you may have noticed the elasticity is a unit-free number. This makes it easier to compare elasticities for different commodities. For example, we could compare the responsiveness of the demand for bus rides and taxi rides in a city by calculating the elasticities of demand for both of them.

We could also compare the elasticity of demand for bus rides in two different countries. There would be no issues of converting the currency of one country into the other country's currency because the elasticity is not measured in the currency of either country.

Generalization of elasticity concept

Our example has been about the elasticity of demand with respect to price changes. However, elasticity is a general concept that works with any two variables. For example, we can calculate the elasticity of labor supply with respect to changes in income tax rates. Or, we can calculate the elasticity of demand with respect to changes in income. Or, we can calculate the elasticity of demand for loans with respect to the interest rate.

More generally, we can calculate the elasticity of variable X with respect to changes in variable Y. This general definition of elasticity is:

$$\text{Elasticity of } X \text{ with respect to } Y = \% \text{ change in } X / \% \text{ change in } Y$$

John Maynard Keynes

John Maynard Keynes is one of the most influential economists of recent times. Keynes wrote the ideas he is famous for in *The General Theory of Employment, Interest and Money* (1936).

He is one of the few economists who has a whole field of economics named after them. People talk about Keynesian economics and post-Keynesian economics.

And, I can't think of any other economist who has been cited in the way President Nixon mentioned him. Nixon said, "We are all Keynesians now."

Keynes is famous for the idea that when an economy is down, the government can bring it up by spending money. Even if the government doesn't have the funds because tax collections are down due to lower incomes. It's OK for the government to borrow and spend the money.

The Keynesian multiplier

How does Keynes' idea work? **The Keynesian multiplier is at the heart of the matter.**

Let's say that the economy is down, and the government borrows and spends \$ 100 billion. Then, the multiplier says that the GDP will go up by a multiple of \$ 100 billion. Say, the multiplier has a value of 3. Then, the GDP will go up by \$ 300 billion. Now, it seems worthwhile to borrow and spend the money.

Where does the multiplier come from? It comes from a ripple effect that runs through the economy. When the government spends \$ 100 billion, that money goes to some people and some companies. Call them as Group 1. Group 1 increases their consumption because they have just got some extra money. Say they save 20% and spend the other 80%. That means Group 1, who got the initial \$ 100 billion, go out and spend \$ 80 billion.

Now, this \$ 80 billion goes to some other people and some other companies. Call them Group 2. So far, GDP has gone up by \$ 100 billion + \$ 80 billion. Next, Group 2 will spend some of the \$ 80 billion they earned. To keep it simple, let's say they also save 20% and spend 80%. This means that Group 2 spends \$ 64 billion. So far, GDP has gone up by \$ 100 billion + \$ 80 billion + \$ 64 billion = \$ 224 billion.

Keep doing this again and again. Each time you do it, you add to the GDP but less than the previous time. We started with \$ 100 billion, the next round was \$ 80 billion, and then \$ 64 billion. See the pattern? The next number is the previous number multiplied by 0.8. So, after \$ 64 billion, we will get \$ $64 \times 0.8 = 51.2$ billion, and so on.