# COMMON SENSE ECONOMICS ~ WHAT EVERYONE SHOULD KNOW ABOUT WEALTH AND PROSPERITY 2010

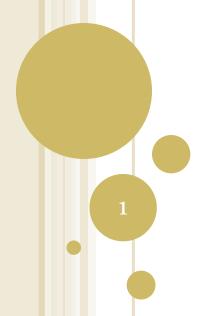
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What Everyone Should Know About Wealth and Prosperity

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COMMON

SENSE



# THE TWELVE KEY ELEMENTS OF PART I WILL

- Provide a bridge between common sense and basic principles of economics,
- Help you begin to "think like an economist," and
- Provide important insights with regard to how the world really works.

### ELEMENT 1. INCENTIVES MATTER.

#### WHAT ARE INCENTIVES?

- Incentives are the rewards and penalties associated with choices.
- Changes in incentives alter the behavior of people.
- Incentives operate on all levels personal, familial, industrial and societal levels.

#### CHANGES IN PRICES

• Lead to changes in behavior.

• Remember the record high nominal gas prices in the summer of 2008?

• Why was there no panic in the streets or lines at the gas pumps?

• Incentives matter, that is why!

# ADJUSTMENT ILLUSTRATES WHY INCENTIVES MATTER

Higher gas prices led

- Consumers of gas to cut down on driving, car-pool, take mass transit or walk,
- Producers of gas to maintain low inventories and increase production, and still
- Others to innovate and invent alternative fuels and energy sources

### WHAT'S THE DIFFERENCE BETWEEN SHORT-RUN CHANGES AND LONG-RUN CHANGES IN BEHAVIOR?

- Consumers eliminate unnecessary trips, walk or car-pool in the short-run, and
- They buy more fuel efficient vehicles in the long-run.
- Producers increase production in the shortrun, and
- They discover new energy sources in the long-run.

#### POLITICS

- Incentives affect political as well as market choices.
- Voters will consider how the expected actions of candidates will affect their personal well-being.
- Politicians will consider how their positions will affect their chances of being elected (and re-elected).
- Why do people run for office? Make political contributions? Volunteer for political campaigns?

#### SEAT BELTS SAVE LIVES...

- Does wearing a seat belt affect incentives?
- Why do people get in more accidents now that cars are safer?

# ELEMENT 2. THERE IS NO SUCH THING AS A FREE LUNCH.

#### **SCARCITY**

- Our resources are limited...but our desire for goods and services is virtually unlimited.
- When production costs are high, it is because the resource in question is desired for other purposes as well.
- A resource is scarce if *it has alternative* uses.

#### To Choose is to Refuse

- Because we are constantly faced with scarcity, we must make **choices**.
- Every time we choose one thing (material or not) we refuse something else.
- We constantly make **trade-offs** in our decisions.

### BUT, BUT, BUT...

- What if someone buys your lunch?
- This is merely a *shift* in the cost of lunch. It is not an *elimination*.
- And is it *really* free to you?
- How else could you have spent your time if you had not gone to lunch?



# ELEMENT 3. DECISIONS ARE MADE AT THE MARGIN.

#### Marginalism...

- Few, if any, decisions are "all-or-nothing."
- Marginal means *additional*...
- Marginalism is seldom ignored in our personal decisions, but frequently in our conversations and in politics.
- To get the most out of our resources, we should only take an action when the marginal benefits are greater than the marginal costs.

#### CONSIDER THE FOLLOWING SITUATION.

Maria wishes to buy gasoline and have her car washed. She finds that if she buys 9 gallons of gasoline at \$2.50 per gallon, the car wash costs \$2, but if she buys 10 gallons of gasoline, the car wash is free. For Maria, the marginal cost of the tenth gallon of gasoline is

- a. zero
- b. 50 cents
- c. \$2.00
- d. \$2.50

Answer: 50 cents (=\$2.50 - \$2.00)

# EXAMPLES OF MARGINAL DECISION-MAKING

- How clean is your house?
  - Do you clean 100% of the dirt away?
- How about when company is coming?
- How about when selling your house?

 In each case, you clean to the point where the <u>marginal costs outweigh</u> <u>the expected marginal</u> benefits!



# ELEMENT 4. TRADE PROMOTES ECONOMIC PROGRESS.

#### WHY DO PEOPLE ENGAGE IN TRADE?

- Why do you buy things from others rather than producing them yourself?
- Would you be better off if you purchased fewer items from others and produced more of what you consume?
- Would Americans be better off if we produced more items domestically and purchased fewer from foreigners?

#### Sources of gains from trade ...

- Trade moves goods from people who value them less to people who value them more.
- Trade makes larger outputs and higher consumption possible as the result of specialization.
- Trade makes larger outputs possible because it facilitates the use of mass production methods.

#### TRADE EXISTS AT MANY LEVELS...

- Enrolling in this class
- Shopping at a grocery store
- Having a garage sale
- Taking a vacation
- Buying imports from China and Mexico



# ELEMENT 5. TRANSACTION COSTS ARE AN OBSTACLE TO TRADE.

#### TRANSACTION COSTS

### Are resources spent on

- Searching out trading partners
- Searching out product information
- Negotiating terms of trade
- Closing sales

### WHY DO WE EXPERIENCE TRANSACTION COSTS?

- Physical objects ~ Can't get there from here!
- Lack of information ~ Finding sellers and best deals
- Political obstacles ~ Taxes, tariffs, licensing requirements, regulations, etc.

#### WHAT IS THE ROLE OF MIDDLEMEN

• Does he or she increase or decrease transaction costs? Explain.

#### WHY DO TRANSACTION COSTS MATTER?

- They reduce the volume of trade and the gains it generates.
- Economic progress is helped by relatively low transaction costs.

### HOW HAVE THE FOLLOWING INFLUENCED THE VOLUME OF TRADE:

- The internet?
- The interstate highway system?
- Tariffs on goods purchased from sellers in other countries?

### ELEMENT 6. PRICES BRING THE CHOICES OF BUYERS AND SELLERS INTO BALANCE.

### IN A MARKET, THERE IS A BUYER AND SELLER.

• Both the buyer and the seller, not one or the other, are made better off as the result of any voluntary market exchange.

#### LAW OF DEMAND

- When a rise in the price of a good or service makes it more expensive for buyers to purchase it, they will normally choose to buy fewer units.
- The opposite is true when a price falls.
- Thus, there is an inverse relationship between the price of a good and the amount buyers will purchase. This is the law of demand.

#### LAW OF SUPPLY

- Higher prices will make it more attractive for sellers to provide the good or service.
- The opposite is true if prices fall.
- Thus, there is a positive relationship between the price of a good or service and the quantity sellers will be willing to supply. This is the law of supply.

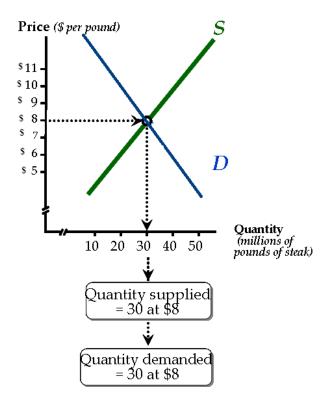
### **EQUILIBRIUM**

- Equilibrium occurs at the price where the amount demanded by consumers is just equal to the amount sellers are willing to supply.
- In equilibrium, all mutually advantageous exchanges will occur.

#### SUPPLY AND DEMAND

- Economists often use graphics to illustrate the relationships among price, quantity demanded, and quantity supplied.
- Identify equilibrium price and quantity where "X" marks the spot in the graph.

#### Supply, Demand and Equilibrium Price



### IN A MARKET ECONOMY, FIRMS WILL:

- Search for those opportunities where market conditions are such that they are able to generate revenue sufficient to cover their costs.
- Continue to produce a good or service only if consumers value it enough to pay prices sufficient to cover per unit costs.

# WE LIVE IN A DYNAMIC WORLD AND CONDITIONS CHANGE.

- Consider the impact of each event on demand and/or supply and the market equilibrium price and quantity.
  - How will an increase in the income levels in China impact the market for tourism in the U.S.?
  - How will an increase in the tax on gas impact the market for fuel efficient cars?
  - How will political uncertainty, social unrest and unsound legal institutions impact markets in Afghanistan?

### IN A MARKET ECONOMY,

- Buyers and sellers are motivated to
  - coordinate their actions,
  - cooperate with each other, and
  - work together harmoniously.
- The potential gains from trade are maximized.

# ELEMENT 7. PROFITS DIRECT BUSINESS TOWARD ACTIVITIES THAT INCREASE WEALTH.

# WHY PROFITS AND LOSSES ARE OUR FRIEND...

- People of a nation are better off if their resources produce highly valued goods and services.
- Less productive use of resources will be discouraged.
- This is the function of profits and losses.

# WHAT IS THE FUNCTION OF PROFIT AND LOSS IN A MARKET ECONOMY?

- Profit is a reward for transforming resources into something of greater value.
- Losses are just as important! They impose discipline on people, businesses and organizations that are not producing valuable goods and services. Consider the following example.

# TO PRODUCE OR NOT PRODUCE? THAT IS THE QUESTION.

- T-shirt factory
  - A T-shirt factory has total production costs of \$20,000.
  - Wealth has been created for the producer and consumer when the value of the t-shirts purchased are worth more to consumers than to producers who committed valuable resources to their production.
- What is the profit or loss if 1000 shirts can be sold for \$22 each?
- What is the profit or loss if 1000 shirts can be sold for \$18 each?
- In which situation, should the t-shirt factory produce?
- In which situation are the t-shirts worth more to consumers than to the producers who committed the resources required to supply them?
- In which situation are they worth less?

# ELEMENT 8. PEOPLE EARN INCOME BY HELPING OTHERS.

### EARNING INCOME BY HELPING OTHERS

- People are different in many ways. We have different specialties or comparative advantages...They are our greatest assets!
- Differences in income arise because our differences affect the value of goods and services we help create and supply.
- There is a direct link (ceteris paribus) between helping others in ways that they value and the income we earn.
- If you want a high income job, figure out how to help others in ways they value!!!

## INCENTIVES MATTER, AGAIN.

- The direct link between providing others with things they value and our personal earnings provides each of us with a strong incentive to develop our talents and skills.
  - College students are rewarded for improving their knowledge and skills.
  - Star athletes and entertainers are rewarded for their special skills.
  - Entrepreneurs are rewarded for their strategic risk-taking.

#### HIGHER INCOME AND LIVING STANDARDS

- Income and living standards cannot increase without an increase in the availability of goods and services that people value.
- Question: Can you think of anyone with substantial earnings who is not providing a good or service that others value highly?

ELEMENT 9. PRODUCTION OF GOODS AND SERVICES PEOPLE VALUE, NOT JUST JOBS, PROVIDES THE SOURCE OF HIGH LIVING STANDARDS.

Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to only so far as it may be necessary for promoting that of the consumer.

—ADAM SMITH (1776)

# IT IS PRODUCTION OF VALUE THAT REALLY MATTERS, NOT JOBS.

- If jobs were the key to high incomes, we could easily create as many as we wanted.
  - All of us could work one day digging holes and the next day filling them up.
  - We would all be employed, but we would also be exceedingly poor because such jobs would not generate goods and services that people value.

# DO SPENDING PROGRAMS CREATE JOBS OF VALUE?

- Politicians and proponents of government spending projects are fond of bragging about the jobs created by their spending programs and they exaggerate program benefits. Consider the following:
  - Agricultural Adjustment Act (AAA) of 1933
  - 2009 "Cash for Clunkers" Program
  - Government Support for Ethanol Fuel Production

### WHEN THE GOVERNMENT "CREATES" JOBS

- Government pays for these jobs either through taxes or borrowing.
- It crowds out private sector jobs and spending.
- There is nothing like profit and loss that will direct funding toward productive projects in government. That is, there is nothing in government that directs resources toward projects that are valued more than cost.

### JOBS OF VALUE MATTER!

• It is not simply more jobs that improve our economic well-being but jobs that produce goods and services people value and are willing to pay for. When that elementary fact is forgotten, people are often misled into acceptance of programs that reduce net wealth rather than create it.

# QUESTION FOR THOUGHT:

• When governments become heavily involved in subsidizing and granting favors to some businesses at the expense of others, how will this incentive structure influence the efficiency of resource allocation?

ELEMENT 10. ECONOMIC PROGRESS COMES PRIMARILY THROUGH TRADE, INVESTMENT, BETTER WAYS OF DOING THINGS, AND SOUND ECONOMIC INSTITUTIONS.

### WHAT IS ECONOMIC PROGRESS?

- Americans produce and earn **THIRTY TIMES** as much as they did in 1750.
- Why are Americans so much more productive today than they were 250 years ago?
- Why is economic progress important?

### Sources of Economic Growth

- Investments in productive assets and discovery and development of resources
  - Tools, machines, "human capital", minerals
- Improvements in technology
  - Internal combustion engine, electricity, computers, by-pass surgeries, etc.
- Improvements in economic organization
  - Legal system, competitive markets, etc.

ELEMENT 11. THE "INVISIBLE HAND" OF MARKET PRICES DIRECTS BUYERS AND SELLERS TOWARD ACTIVITIES THAT PROMOTE THE GENERAL WELFARE.

### WHAT IS THE "INVISIBLE HAND?"

• Adam Smith, *The Wealth of Nations* (1776) claims the following: "It is his own advantage, indeed, and not that of society which he has in his view. But the study of his own advantage naturally, or rather necessarily, leads him to prefer that employment which is most advantageous to society...He 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 not part of his intention."

# MARKETS PROVIDE INFORMATION.

- Friedrich Hayek(1899-1992) stressed:
  - The primary function of markets is to provide information (both to buyers and sellers).



### CONSIDER THE PRICE OF APPLES...

- Price is indicative of what consumers are willing and able to pay.
- Price also incorporates the costs of production and the costs of bringing the apples to market in light of other production options.

#### SPONTANEOUS ORDER

- Things constantly happen spontaneously to make both consumer and producers better off through exchange.
- When guided by market prices, self-interested individuals will move toward activities that will promote the general welfare.
- This occurs without any central planning.

ELEMENT 12. TOO OFTEN THE LONG-TERM CONSEQUENCES, OR THE SECONDARY EFFECTS, OF AN ACTION ARE IGNORED.

### WHAT ARE SECONDARY EFFECTS?

- Why is the failure to consider the unintended secondary effects often a major source of economic error?
- Policy changes often generate unintended secondary effects. Consider the following examples.

### RENT CONTROLS

- Intended purpose: Cheaper rental housing.
- Unintended secondary affects: less investment in rental housing, fewer rental units available in the future, decline in the maintenance and quality of rental units, more difficult to find rental housing.

# TARIFFS AND QUOTAS INTENDED TO PROTECT DOMESTIC INDUSTRIES

- Intended purpose: protect struggling industries and their employees negatively impacted by global competition
- Unintended consequence: hurt consumers of the taxed or restricted goods, e.g. sugar industry

# PAYING FOR PENCIL STUBS IN THE 2<sup>ND</sup> GRADE CLASS

- Intended purpose: give students incentive to hold onto their pencils
- Unintended consequence: students quickly sharpened their pencils down to the stubs to get the 10 cents.