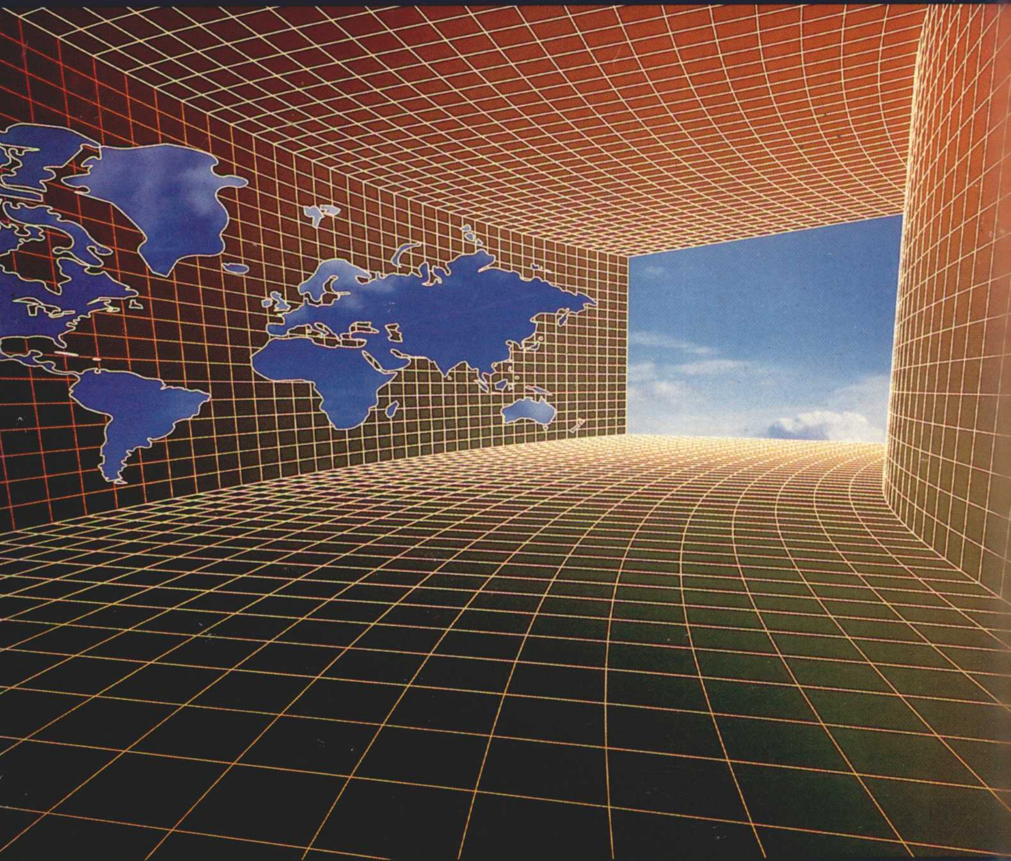

WHAT EVERYONE SHOULD KNOW ABOUT ECONOMICS AND PROSPERITY

James D. Gwartney and Richard L. Stroup

THE JAMES MADISON INSTITUTE

WHAT EVERYONE SHOULD KNOW ABOUT ECONOMICS AND PROSPERITY

■

James D. Gwartney and Richard L. Stroup

Photography Credits © 1993

Cover design: Kromhout & Kromhout Visual Design, Tallahassee, FL; cover photo: "World Map"—Uniphoto Picture Agency, Washington, DC; photo, p.10: "Robotics"—C.J. Howard, FPG International Corp., New York, NY; photos, p.16: "Farming"—1) John Colwell, Grant Heilman Photography Inc., Lititz, PA, 2) Grant Heilman, 3) Grant Heilman; photo, p.66: "Hong Kong Harbor"—Uniphoto Picture Agency. Special thanks to Amy Gwartney for the remaining photography.

Second printing 1996

Published by the James Madison Institute and other cooperating organizations, 1993. Nothing written herein should be construed as necessarily reflecting the views of the publishers or as an attempt to aid or hinder the passage of any legislation.

ISBN 0-9653054-0-6

Introduction

Why should you read this book?

We realize that your time is valuable. Most of you do not want to spend a lot of time learning new terms, memorizing formulas, or mastering details that are important only to professional economists. What you want are the insights of economics that really matter—those that will help you make better personal choices and enhance your understanding of our complex world. And you want those insights to be presented in a concise, organized, and readable manner, with a minimum of economics *jargon*. This short book attempts to meet both of these objectives.

We think you can profit from this book regardless of your current knowledge of economics. If you are a beginner, this book will introduce you to a few basic economic principles that to a large degree merely reflect common sense. These concepts, however, are powerful tools. When making decisions, they will help you develop your thoughts logically and view the central issues more clearly. They will also enhance your ability to differentiate between sound arguments and economic nonsense.

If you are a student of economics or business, this book will help you pull together the "big picture." After 30 years of teaching college economics, the authors are painfully aware of two points: (1) students often miss important points because they are busy with extraneous graphs, formulas, and mathematical details and (2) they do not retain much of what is taught in their college economics courses. The information encapsulated in this book will challenge college students to think more seriously about the really important implications of economics—knowledge that will make a difference long after their final exam in economics is a faded memory.

Finally, even if you are a business executive or a policymaker, we believe you will find this book informative. However experienced you may be in your particular area, you may not fully appreciate how all the pieces of the economic puzzle fit together. This is often the case with people in both business and government. They know their job, but they have not thought very seriously about how political rules and policies influence the broader economic health of people and nations.

Studies indicate that we are a nation of economic illiterates. In a democratic setting, the consequences of economic illiteracy can be disastrous. People who do not understand the sources of economic prosperity are susceptible to schemes that conflict with the attainment of that prosperity. A nation of economic illiterates is unlikely to remain prosperous for very long. The basic principles explained in this book will help you better understand what types of economic arrangements work and why some nations prosper while others stagnate or even regress. As a result, you will be able to make wiser choices and become a better citizen.

Acknowledgements

The authors would like to thank the following people for helpful comments on earlier drafts of this book: Ljubisa Adamovic', Terry Anderson, John W. Cooper, Jack Fay, Randall Holcombe, Tom Palmer, Judd W. Patton, Scott W. Rasmussen, Ronald H. Salter, Jane S. Shaw, Russell S. Sobel, Carol Strauss, and Sharon Watson. They would also like to express their appreciation to the Philip M. McKenna Foundation and the Earhart Foundation for funding which facilitated the project and to Valerie N. Colvin for her excellent work on both word-processing and the design.

TABLE OF CONTENTS

PART I:

Ten Key Elements of Economics

TEN KEY ELEMENTS OF ECONOMICS

1. Incentives Matter.

2. There is No Such Thing as a Free Lunch.

3. Voluntary Exchange Promotes Economic Progress.

4. Transaction Costs are an Obstacle to Exchange; Reducing This Obstacle Will Help Promote Economic Progress.

5. Increases in Real Income are Dependent Upon Increases in Real Output.

6. The Four Sources of Income Growth are (a) Improvements in Worker Skills, (b) Capital Formation, (c) Technological Advancements, and (d) Better Economic Organization.

7. Income is Compensation Derived from the Provision of Services to Others. People Earn Income by Helping Others.

8. Profits Direct Businesses Toward Activities that Increase Wealth.

9. The "Invisible Hand" Principle—Market Prices Bring Personal Self-interest and the General Welfare into Harmony.

10. Ignoring Secondary Effects and Long-term Consequences is the Most Common Source of Error in Economics.

1. Incentives Matter.

All economic theory is based on the postulate that changes in incentives influence human behavior in a predictable manner. Personal benefits and costs influence our choices. If the benefits derived from an option increase, people will be more likely to choose it. Conversely, if the personal costs of an option increase, people will be less likely to choose it.

This basic postulate of economics is a powerful tool because its application is so widespread. Incentives affect behavior in virtually all aspects of our lives, ranging from market activities to household decision-making to political choices.

In the marketplace, the basic postulate indicates that, if the price of a good increases, consumers will buy less of it; producers, on the other hand, will supply more of it since the price increase makes it more profitable to produce the good. Both buyers and sellers respond to incentives. Market prices will bring their actions into harmony. If the quantity buyers want to purchase exceeds the quantity sellers are willing to provide, price will rise. The higher price will discourage consumption and encourage production of the good or service, bringing amount demanded and amount supplied into balance. Alternatively, if consumers are unwilling to purchase the current output of a good, inventories will accumulate and there will be downward pressure on price. In turn, the lower price will encourage consumption and retard production until the amount demanded by consumers is once again in balance with production of the good. Markets work because both buyers and sellers alter their behavior in response to changes in incentives.

Of course, this process does not work instanteously. It will take time for buyers to respond fully to a change in price. Similarly, it will take time for producers to build an additional plant in response to a price increase or reduce production if price declines. Nonetheless, the implications are clear—market prices will coordinate the actions of both buyers and sellers and bring them into harmony.

The response of buyers and sellers to the higher gasoline prices of the 1970s illustrates the importance of incentives. As gasoline prices rose, consumers eliminated less essential trips and did more car pooling. Gradually, they shifted to smaller, more fuel-efficient cars in order to reduce their gasoline consumption still further. At the same time, petroleum suppliers in the United States increased their drilling, used a water flooding technique to recover more oil from existing wells, and searched more intensely for new oil fields. By the early 1980s, this combination of factors was placing downward pressure on the price of crude oil.

Incentives also influence political choices. The person who shops in the supermarket is the same person who shops among political alternatives. In most cases, voters are more likely to support political candidates and policies that provide them with net personal benefits. Conversely, they will tend to oppose political options when the personal costs are high relative to the benefits provided.

The basic postulate of economics—that incentives matter—is just as applicable under socialism as it is under capitalism. For example, in the former Soviet Union, managers and employees of glass plants were at one time rewarded according to the tons of sheet glass produced. Not surprisingly, most plants produced sheet glass so thick that one could hardly see through it. The rules were changed so that the managers were rewarded according to the square meters of glass produced. The results were predictable. Under the new rules, Soviet firms produced glass so thin that it was easily broken. Changes in incentives influence actions under all forms of economic organization.

Some critics have charged that economic analysis only helps explain the actions of self-centered, greedy materialists. This view is false. People act for a variety of reasons, some selfish and some humanitarian. The basic postulate of economics applies to both the altruist and egotist. The choices of both will be influenced by changes in personal costs and benefits. For example, both the altruist and the egotist will be more likely to attempt the rescue of a small child in a three-foot swimming pool than in the rapid currents approaching Niagara Falls. Similarly, both are more likely to give a needy person their hand-me-downs rather than their best clothes. Incentives influence the choices of both.

2. There is No Such Thing as a Free Lunch.

Scarcity constrains us. The reality of life on our planet is that productive resources are limited, while human desires for goods and services are virtually unlimited. Since we cannot have as much of everything as we would like, we are forced to choose among alternatives.

When resources are used to produce good A, say a shopping center, the action diverts resources away from the production of other goods that are also desired. The cost of the shopping center is the highest valued bundle of other goods that could have been produced and consumed, but now must be sacrificed, because the required resources were used instead to produce the shopping center. The use of resources to produce one thing reduces their availability to produce other things. Thus, the use of scarce resources always involves a cost; there is no such thing as a free lunch.

Costs play a vitally important function: they help us balance our desire for more of a good against our desire for more of *other* goods that could be produced instead. If we do not consider these costs, we will end up using scarce resources to produce the wrong things—goods that we do not value as much as other things that we might have produced.

In a market economy, consumer demand and producer costs perform this balancing function. In essence, the demand for a product is the voice of consumers instructing firms to produce a good. In order to produce the good, however, resources must be bid away from their alternative uses—primarily the production of other goods. Producers incur costs when they bid resources away from the production of other goods. These costs of production represent the voice of consumers saying that *other goods* that could be produced with the resources are also desired.

Producers have a strong incentive to supply those goods that can be sold for as much or more than their production costs. This is another way of saying that producers will tend to supply those goods that consumers value most relative to their production costs.

Of course, a good can be provided free to an individual or group if others foot the bill. But this merely shifts the costs; it does not reduce them. Politicians often speak of "free education," "free medical care," or "free housing". This terminology is deceptive. None of these things are free. Scarce resources are required to produce each of them. For example, the buildings, labor, and other resources used to produce schooling could be used instead to produce more food, recreation, entertainment, or other goods. The cost of the schooling is the value of those goods that must now be given up because the resources required for their production were instead used to produce schooling. Governments may be able to shift costs, but they cannot avoid them. The "scarce resources have a cost" concept applies to all.

With the passage of time, of course, we may be able to discover better ways of doing things and improve our knowledge about how to transform scarce resources into desired goods and services. Clearly, this has been the case. During the last 250 years, we have been able to relax the grip of scarcity and improve our quality of life. However, this does not change the fundamental point—we still confront the reality of scarcity. The use of more labor, machines, and natural resources to produce one good forces us to give up other goods that might otherwise have been produced.

3. Voluntary Exchange Promotes Economic Progress.

Mutual gain is the foundation of trade. Parties agree to an exchange because they anticipate that it will improve their well-being. The motivation for market exchange is summed up in the phrase, "If you do something good for me, I will do something good for you." Trade is productive; it permits each of the trading partners to get more of what they want.

There are three major reasons why trade is productive—why it increases the wealth of people. *First, trade channels goods and services to those who value them most.* A good or service does not have value just because it exists. Material things are not wealth until they are in the hands of someone who values them. The preferences, knowledge, and goals of people vary widely. Thus, a good that is virtually worthless to one may be a precious gem to another. For example, a highly technical book on electronics that is of no value to an art collector may be worth hundreds of dollars to an engineer. Similarly, a painting that is unappreciated by an engineer may be an object of great value to an art collector. Therefore, a voluntary exchange that moves the electronics book to the engineer and the painting to the art collector will increase the value of both goods. Simultaneously, the exchange will increase the wealth of both trading partners and the nation because it moves goods from people who value them less to people who value them more.

Second, exchange permits trading partners to gain from specializing in the production of those things they do best. Specialization allows us to expand total output. A group of individuals, regions, or nations will be able to produce a larger output when each specializes in the production of goods and services it can provide at a low cost, and uses its sales revenue to trade for desired goods it can provide only at a high cost. Economists refer to this principle as the law of comparative advantage.

In many ways, gains from trade and specialization are common sense. Examples abound. Trade permits a skilled carpenter to specialize in the production of frame housing while trading the earnings from housing sales to purchase food, clothing, automobiles, and thousands of other goods that the carpenter is not so skilled at producing. Similarly, trade allows Canadian farmers to specialize in the production of wheat and use the revenue from wheat sales to buy Brazilian coffee, a commodity that the Canadians could produce only at a high cost. Simultaneously, it is cheaper for Brazilians to use their resources to grow coffee and trade the revenues for Canadian wheat. Total output is enlarged and both trading partners gain.

Third, voluntary exchange permits us to realize gains derived from cooperative effort, division of labor, and the adoption of large-scale production methods. In the absence of exchange, productive activity would be limited to the individual household. Self-sufficiency and small-scale production would be the rule. Exchange permits us to have a much wider market for our output, and thus enables us to separate production processes into a series of specific operations in order to plan for large production runs—actions which often lead to enormous increases in output per worker.

Adam Smith, the "father of economics," stressed the importance of gains from the division of labor more than 200 years ago. Observing the operation of a pin manufacturer, Smith noted that the production of the pins was broken into "about eighteen distinct operations," each performed by specific workers. When the workers each specialized in a productive function, they were able to

Modern production of a good like a pencil or an automobile often involves specialization, division of labor, large-scale production methods, and the cooperation of literally tens of thousands of people. Gains from these sources are dependent upon exchange.

produce 4,800 pins *per worker* each day. Without specialization and division of labor, Smith doubted an individual worker would have been able to produce even 20 pins per day.

Specialization permits individuals to take advantage of the diversity in their abilities and skills. It also enables employers to assign tasks to the workers who are more able to accomplish them. Even more importantly, the division of labor lets us adopt complex, large-scale production techniques unthinkable for an individual household. Without exchange, however, these gains would be lost.

4. Transaction Costs are an Obstacle to Exchange; Reducing This Obstacle Will Help Promote Economic Progress.

Voluntary exchange is productive because it promotes social cooperation and helps us get more of what we want. However, exchange is also costly. The time, effort, and other resources necessary to search out, negotiate, and conclude an exchange are called transaction costs. Transaction costs are an obstacle to the creation of wealth. They limit both our productive capacity and the realization of gains from mutually advantageous trades.

Transaction costs are sometimes high because of physical obstacles, such as oceans, rivers, marshes, and mountains. In these cases, investment in roads and improvements in transportation and communications can reduce them. In other instances, transaction costs may be high because of man-made obstacles, such as taxes, licensing requirements, government regulations, price controls, tariffs, or quotas. But regardless of whether the roadblocks are physical or man-made, high transaction costs reduce the potential gains from trade. Conversely, reductions in transaction costs increase the gains from trade and thereby promote economic progress.

People who provide trading partners with information and services that help them arrange trades and make better choices are providing something valuable. Such specialists or middlemen include real estate agents, stockbrokers, automobile dealers, publishers of classified ads, and a wide variety of merchants.

Often, people believe that middlemen are unnecessary—that they merely increase the price of goods without providing benefits to either the buyer or the seller. Once we recognize that transaction costs are an obstacle to