

Third Edition

Common Sense Economics

*What Everyone Should Know
About Wealth and Prosperity*

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past, present, and future*

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Introduction

Life is about choices, and economics is about how incentives affect those choices and shape our lives. Choices about our education, how we spend and invest, what we do in the workplace, and many other personal decisions will influence our well-being and quality of life. Moreover, the choices we make as voters and citizens affect the laws or “rules of the game,” and these rules exert an enormous impact on our freedom and prosperity. To choose intelligently, both for ourselves and for society generally, we must understand some basic principles about how people choose, what motivates their actions, and how their actions influence their personal welfare and that of others. Thus, economics is about human decision-making, the analysis of the forces underlying choice, and the implications for how societies work.

The economic way of thinking involves the integration of key concepts into your thought process. The following section presents twelve concepts that are crucial for the understanding of economics, and why some countries grow and achieve high income levels while others stagnate and remain poor. You will learn such things as the true meaning of costs, why prices matter, how trade furthers prosperity, and why production of things people value underpins our standard of living. In the

subsequent parts of the book, these concepts will be used to address other vitally important topics.

1. Incentives matter: Changes in benefits and costs will influence choices in a predictable manner.

All of economics rests on one simple principle: Changes in incentives influence human behavior in predictable ways. Both monetary and nonmonetary factors influence incentives. If something becomes more costly, people will be less likely to choose it. Correspondingly, when the benefits derived from an option increase, people will be more likely to choose it. This simple idea, sometimes called the basic postulate of economics, is a powerful tool because it applies to almost everything that we do.

People will be less likely to choose an option as it becomes more costly. Think about the implications of this proposition. When late for an appointment, a person will be less likely to take time to stop and visit with a friend. Fewer people will go picnicking on a cold and rainy day. Higher prices will reduce the number of units sold. Attendance in college classes will be below normal the day before spring break. In each case, the explanation is the same: As the option becomes more costly, less is chosen.

Similarly, when the payoff derived from a choice increases, people will be more likely to choose it. A person will be more likely to bend over and pick up a quarter than a penny. Students will attend and pay more attention in class when they know the material will be on the exam. Customers will buy more from stores that offer low prices, high-quality service, and a convenient location. Employees will work harder and more efficiently when they are rewarded for doing so. All of these outcomes are highly predictable and they merely reflect the “incentives matter” postulate of economics.

This basic postulate explains how changes in market prices alter incentives in a manner that works to coordinate the actions of buyers and sellers. If buyers want to purchase more of an item than producers are willing (or able) to sell, its price will soon rise. As the price increases, sellers will be more willing to provide the item while buyers purchase less, until the higher price brings the amount demanded and the amount supplied into balance. At that point the price stabilizes.

What happens if it starts out the other way: if sellers want to supply more than buyers are willing to purchase? If sellers cannot sell all of their goods at the current price, they will have to cut the price of the item. In turn, the lower price will encourage people to buy more—but will also discourage producers from producing as much, since it is less attractive to them to supply the product at the new, lower price. Again, the price change works to bring the amount demanded by consumers into balance with the amount produced by suppliers. At that point there is no further pressure for a price change.

Remember the record-high gas prices in the summer of 2008? While a lot of people felt the pain of higher prices at the pump, there was no panic in the streets or long lines at the gas pumps. Why? When the higher prices made it more costly to purchase gasoline, most consumers eliminated some less important trips. Others arranged more carpooling. With time, consumers also shifted to smaller, more fuel-efficient cars in order to reduce their gasoline bills.

Furthermore, as buyers reacted to higher gas prices, so did sellers. The oil companies supplying gasoline increased their drilling, developed new techniques such as fracking to recover more oil from existing wells, and intensified their search for new oil fields. The higher price helped to keep the quantity supplied in line with the quantity demanded. Eventually, the prices of both crude oil and gasoline fell as supply expanded.

Incentives also influence political choices. There is little reason to believe that a person making choices in the voting booth will behave

much differently than when making choices in the shopping mall. In most cases voters are likely to support political candidates and policies that they believe will provide them with the most personal benefits, net of their costs. They will tend to oppose political options when the personal costs are high compared to the benefits they expect to receive. For example, senior citizens have voted numerous times against candidates and proposals that would reduce their Medicare benefits. Similarly, polls indicate that students are strongly supportive of educational grants to college students.

There's no way to get around the importance of incentives. They are a part of human nature. Incentives matter just as much under socialism as under capitalism. In the former Soviet Union, managers and employees of glass plants were at one time rewarded according to the tons of sheet glass they produced. Because their revenues depended on the weight of the glass, most factories produced sheet glass so thick that you could hardly see through it. As a result, the rules were changed so that the managers were compensated according to the number of square meters of glass produced. Under these rules, Soviet firms made glass so thin that it broke easily.

Some people think that incentives matter only when people are greedy and selfish. This is untrue. People act for a variety of reasons, some selfish and some charitable. The choices of both the self-centered and altruistic will be influenced by changes in personal costs and benefits. For example, both the selfish and the altruistic will be more likely to attempt to rescue a child in a shallow swimming pool than in the rapid currents approaching Niagara Falls. And both are more likely to give a needy person their hand-me-downs rather than their best clothes.

Even though no one would have accused the late Mother Teresa of greediness, her self-interest caused her to respond to incentives, too. When Mother Teresa's organization, the Missionaries of Charity, attempted to open a shelter for the homeless in New York City, the city required ex-

pensive (but unneeded) alterations to its building. The organization abandoned the project. This decision did not reflect any change in Mother Teresa's commitment to the poor. Instead, it reflected a change in incentives. When the cost of helping the poor in New York went up, Mother Teresa decided that her resources would do more good in other areas.¹ Changes in incentives influence everyone's choices, regardless of the mix of greedy, materialistic goals on the one hand and compassionate, altruistic goals on the other, that drive a specific decision.

2. There is no such thing as a free lunch: Goods are scarce and therefore we have to make choices.

The reality of life on our planet is that productive **resources** are limited, while the human desire for goods and services is virtually unlimited. Would you like to have some new clothes, a luxury boat, or a vacation in the Swiss Alps? How about more time for leisure, recreation, and travel? Do you dream of driving your brand-new Porsche into the driveway of your oceanfront house? Most of us would like to have all of these things and many others! However, we are constrained by the **scarcity** of resources, including a limited availability of time.

Because we cannot have as much of everything as we would like, we are forced to choose among alternatives. There is "no free lunch." Doing one thing makes us sacrifice the opportunity to do something else we value. This is why economists refer to all costs as **opportunity costs**.

Many costs are measured in terms of money, but these too are opportunity costs. The money you spend on one purchase is money that is not available to spend on other things. The opportunity cost of your purchase is the value you place on the items that must now be given up because you spent the money on the initial purchase. But just because

1. Philip K. Howard, *The Death of Common Sense* (New York: Random House, 1994): 3-5.