

Common Sense Economics

*What Everyone Should Know
About Wealth and Prosperity*

Fourth Edition

JAMES D. GWARTNEY

FLORIDA STATE UNIVERSITY

DWIGHT R. LEE

UNIVERSITY OF GEORGIA

TAWNI HUNT FERRARINI

LINDENWOOD UNIVERSITY

JOSEPH P. CALHOUN

FLORIDA STATE UNIVERSITY

JANE SHAW STROUP

JAMES G. MARTIN CENTER FOR ACADEMIC RENEWAL



ST. MARTIN'S PRESS
NEW YORK

First published in the United States by St. Martin's Press, an imprint of St. Martin's Publishing Group

COMMON SENSE ECONOMICS: FOURTH EDITION. Copyright © 2005, 2010, 2016, 2024 by James D. Gwartney, Dwight R. Lee, Tawni Hunt Ferrarini, Joseph P. Calhoun, and Jane Shaw Stroup. All rights reserved. Printed in the United States of America. For information, address St. Martin's Publishing Group, 120 Broadway, New York, NY 10271.

www.stmartins.com

Library of Congress Cataloging-in-Publication Data

Names: Gwartney, James D., author. | Lee, Dwight R., author. | Ferrarini, Tawni Hunt, author. | Calhoun, Joseph P., author. | Shaw, Jane S., 1944- author.
Title: Common sense economics : what everyone should know about wealth and prosperity / James D. Gwartney, Florida State University, Dwight R. Lee, University Of Georgia, Tawni Hunt Ferrarini, Lindenwood University, Joseph P. Calhoun, Florida State University, Jane Shaw Stroup, James G. Martin Center for Academic Renewal.

Description: Fourth edition. | New York: St. Martin's Press, 2024. | Includes bibliographical references and index.

Identifiers: LCCN 2024003513 | ISBN 9781250292629 (hardcover) | ISBN 9781250292612 (ebook)

Subjects: LCSH: Free enterprise. | Wealth. | Economics. | Finance, Personal. | Saving and investment.

Classification: LCC HB95 .G9 2024 | DDC 339.2—dc23/eng/20240323

LC record available at <https://lccn.loc.gov/2024003513>

Our books may be purchased in bulk for promotional, educational, or business use. Please contact your local bookseller or the Macmillan Corporate and Premium Sales Department at 1-800-221-7945, extension 5442, or by email at MacmillanSpecialMarkets@macmillan.com.

Fourth Edition: 2024

10 9 8 7 6 5 4 3 2

Contents

Preface	1
Part 1: Twelve Key Elements of Economics	5
Part 2: Seven Major Sources of Economic Progress	51
Part 3: Ten Key Elements of the Economics of Government	115
Part 4: Twelve Key Elements of Practical Personal Finance	179
<i>Acknowledgments</i>	235
<i>Digital Assets, Supplemental Units, and Website</i>	237
<i>Suggested Additional Readings</i>	239
<i>Glossary</i>	241
<i>Index</i>	251

TWELVE KEY ELEMENTS OF ECONOMICS

1. Incentives matter: Changes in benefits and costs will influence choices in predictable ways.
2. All choices involve costs.
3. Decisions are made at the margin.
4. Voluntary trade promotes economic progress.
5. Transaction costs are obstacles to trade.
6. Prices bring the choices of buyers and sellers into balance.
7. Profits direct businesses toward productive activities that increase the value of resources, while losses direct them away from wasteful activities.
8. The “invisible hand” of market prices guides buyers and sellers toward activities promoting the general welfare.
9. Mistakes and misconceptions in economic analysis often occur because of failure to consider long-term consequences and secondary effects.

10. People earn income by providing others with what they value.

11. Production of goods and services that people value, not just jobs, provides the source of high living standards.

12. Economic progress comes primarily through voluntary trade, investment, stable capital markets, better ways of doing things, and sound economic institutions.

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, 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 integrating key concepts into your thought processes. This section presents twelve concepts that are crucial for the understanding of economics and will help you understand 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 enhances 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 predictable ways.

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 of 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 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 gas prices will reduce the number of gallons 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 change incentives in ways that work 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 will want to 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 a good at the current price, they will cut the price. In turn, the lower price will encourage people to buy more—but it 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.

Consider what happens when strong demand pushes a price up. Take gasoline, for example. The higher price will make it more costly to purchase gasoline. Consumers will respond by driving less, combining trips, and carpooling more often. In time, consumers will also shift to electric-powered and smaller, more fuel-efficient vehicles to reduce expenditures on gasoline. At the same time, the higher price will entice sellers to produce more. If not restricted, producers of gasoline will increase their drilling, develop new techniques such as fracking to recover more oil from existing wells, and intensify their search for new oil fields. This combination of forces will bring the amount demanded by consumers into balance with the amount supplied by producers. Over time, the larger supply will reverse the price increases. Price signals provide both buyers and sellers with incentives to make adjustments and bring their choices into harmony.

Just as incentives influence choices in the marketplace, they also influence political choices. Voters will be more likely to support those

candidates and policies they think will provide them with the most personal benefits, net of their costs. Voters will tend to oppose policies when the personal costs are high relative to the expected benefits. For example, senior citizens consistently vote against candidates and proposals that would reduce their Social Security or Medicare benefits. Similarly, polls indicate that students disproportionately support candidates promising loan forgiveness and “free” education. Producers in businesses ranging from sugarcane and beet farming to steel and lumber tend to support candidates that favor trade restrictions, pushing up the prices of the goods they sell and reducing foreign **competition**. As discussed later, social programs and trade policies can often be counterproductive once costs are compared to the benefits.

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 paid according to the tons of sheet glass produced. Because their revenues depended on the weight of the glass, sheet glass at some factories was so thick that you could hardly see through it. In response, the rules were changed so that compensation was based on the number of square meters of glass produced. Under these new rules, Soviet firms made glass so thin that it broke easily.¹

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. But the choices of both the self-centered and the altruistic will be influenced by changes in personal costs and benefits. For example, both the selfish and the altruistic person will be more likely to attempt to rescue a child in a shallow swimming pool than in the rapid currents approaching Niagara Falls. And

1. P. C. Roberts and K. L. Follette, *Meltdown: Inside the Soviet Economy* (Washington, DC: Cato Institute, 1990).

both are more likely to give a needy person their gently used clothes rather than their best ones.

Even though no one would have accused the late Mother Teresa of greediness, her self-interest caused her to respond to incentives, too. Consider Mother Teresa's organization, the Missionaries of Charity. It attempted to open a shelter for the homeless in New York City, but the city government required expensive (and, in Mother Teresa's view, 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 increased, Mother Teresa searched for alternative locations where her **resources** could do more good compared to costs.² Changes in incentives influence everyone's choices and drive decisions, regardless of the mix of greedy, materialistic goals on the one hand and compassionate, altruistic goals on the other.

2. All choices involve costs.

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 new smartphone? How about more time for leisure, recreation, and travel? Do you dream of driving your brand-new electric sports car into the driveway of your home? 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.

In the late nineteenth century, many taverns offered a "free lunch"

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