

MAN, MARKET, & ECONOMY

ECONOMY?



ECONOMY?



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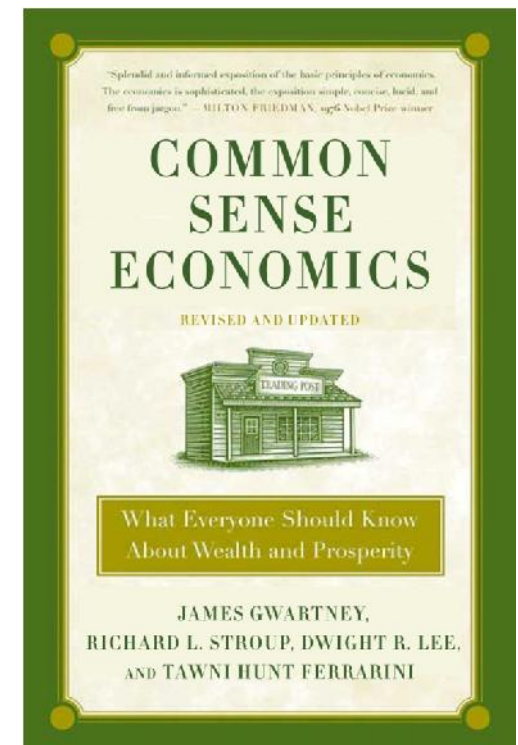


COMMON SENSE ECONOMICS ~ WHAT EVERYONE SHOULD KNOW ABOUT WEALTH AND PROSPERITY 2010

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ECONOMY?

- *“It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest.*

We address ourselves, not to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages..”

Adam Smith

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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.

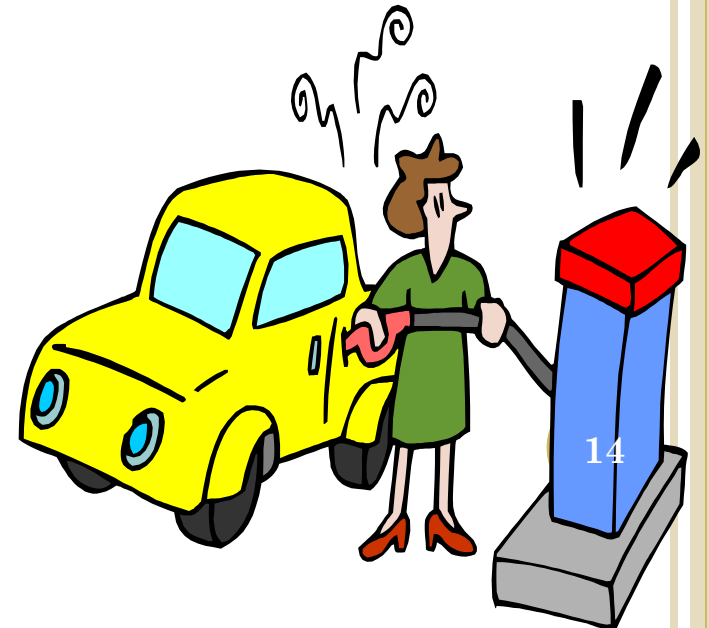
ELEMENT 1. INCENTIVES MATTER.

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.
- 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

In short-run..

- Consumers of gas to cut down on driving, car-pool, take mass transit or walk,
- Producers of gas to increase production,

In long-run..

- Others to innovate and invent alternative fuels and energy sources

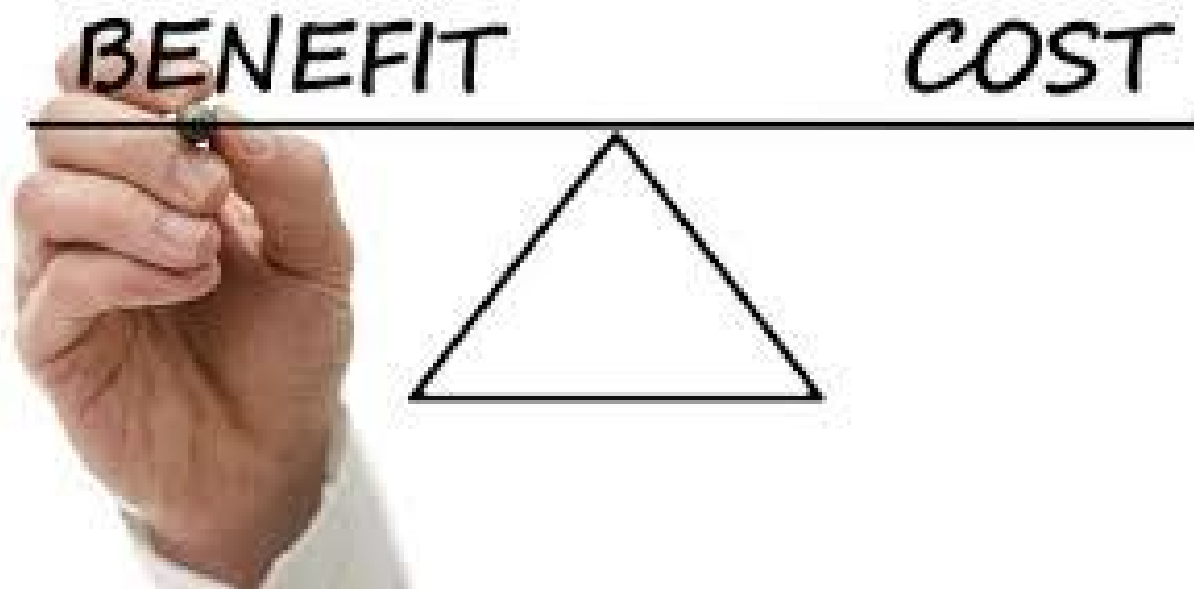
POLITICS

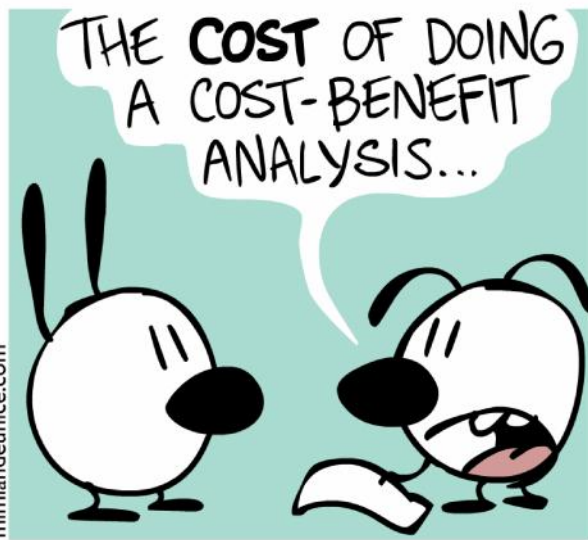
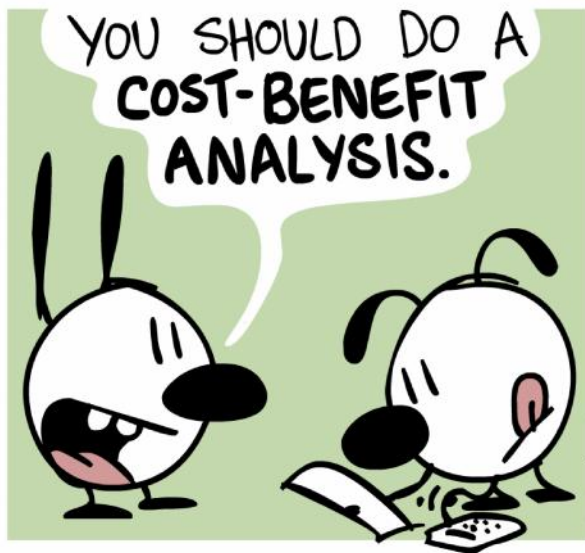
- Incentives affect political as well as market choices.
- Voters will consider how the expected actions of candidates will affect their personal well-being.
- Politicians will consider how their positions will affect their chances of being elected (and re-elected).

POLITICS

- How about the National Council for Peace and Order(NCPO)??







**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?



BUT, BUT, BUT...

- 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?







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**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

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 marginal costs outweigh the expected marginal 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
- Taking a vacation
- Buying imports from China and Mexico



**ELEMENT 5. 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?

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- 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.

ELEMENT 6. 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?

**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.

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.

ELEMENT 7. 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.”

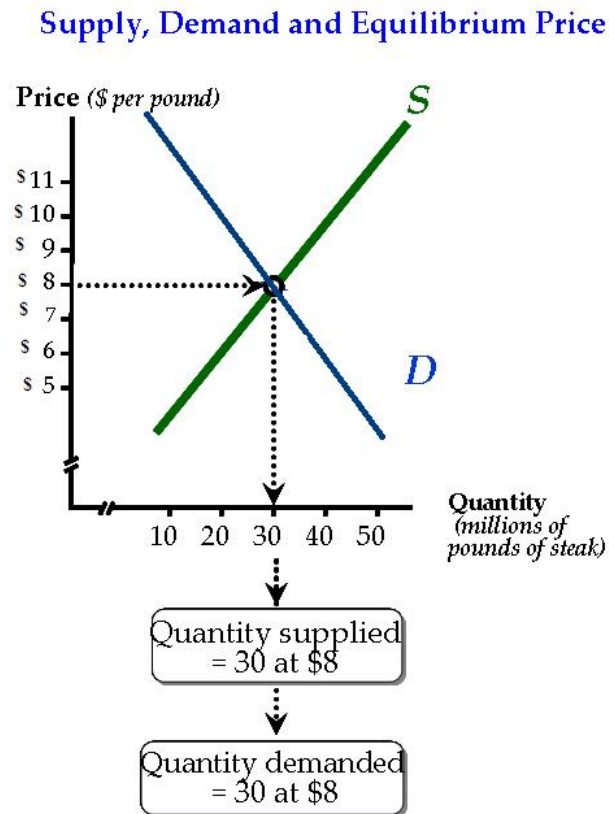
**PRICES BRING THE CHOICES OF BUYERS
AND SELLERS INTO BALANCE.**

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.

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.



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.

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.

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 8. 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.

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 9. 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 10. 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.

PAYING FOR PENCIL STUBS IN THE 2ND 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.

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