



# Common Sense Economics: What Everyone Should Know About Wealth and Prosperity

By James D. Gwartney, Richard L. Stroup, Dwight R. Lee, Tawni Hunt Ferrarini

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"The authors tell us what everyone should know about economics in language we can all understand. It's refreshing when four of the best in the profession avoid the all-too-common practice of writing in a code that only other economists can comprehend." ---Robert McTeer, former president of the Federal Reserve Bank of Dallas

With the global economy recovering from a steep recession, those who fail to grasp basic economic principles such as gains from trade, the role of profit and loss, and the secondary effects of government spending, taxes, and borrowing risk falling behind in their professional careers--even their personal lives. *Common Sense Economics* discusses key principles and uses them to show how to make wise personal and policy choices.

This new edition of a classic from James D. Gwartney, Richard L. Stroup, Dwight R. Lee, and Tawni H. Ferrarini, with reflections on the recent recession and the policy response to it, illuminates our world and what might be done to make it better.

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## **Editorial Review**

### Review

“Economic Journalism is often based on slipshod analysis; scientific treatises are analytically coherent but unintelligible. This book is an effort to bridge the awesome gap between these levels of discourse. It is solid economic analysis, simply presented.” ?Nobel Laureate James Buchanan

“If this book had been written a century ago the wasteful experiments with command economies might have been avoided. After my college-age children read this new edition, their understanding of how markets create social cooperation and wealth and how they can personally be guided in their finances sharply advanced.”  
?Gary M. Walton, *Professor of Economics, University of California, Davis and President of the Foundation for Teaching Economics*

“I gave a copy of *Common Sense Economics* to one of my colleagues who teaches accounting here. He read it this weekend and thought it was so good that he is considering paying his students (half the cost) to read it. We both think the lessons are perfect.” ?Kelly Hunter Markson, *Ph.D., Instructor of Economics, Wake Technical Community College*

“My high school students really enjoy this book. It is easy for them to understand and it presents important economic concepts in plain language using clear, often clever, examples. They read the whole book, and we discuss it page by page during class discussion. I believe they get more out of it than their regular text.”  
?David Gardner, *Principal and Teacher, Frederica Academy (Georgia)*

“*Common Sense Economics* is about both personal prosperity and the wealth of nations. It explains how and why ordinary people are able to accomplish extraordinary things when they are economically free and when the policies and institutions of their government are supportive of that freedom.” ?Wayne Angell, *Member, Board of Governors of the Federal Reserve System (1986–1994)*

“*Common Sense Economics* makes economic principles as obvious and simple as they can be. By weaving careful reasoning with memorable examples and clear writing, the authors explain how economies grow (or don't grow); how prices coordinate economic activity; and how governments promote or deter economic progress. This is an extraordinary contribution to economic education.” ?Kenneth G. Elzinga, *Robert C. Taylor Professor of Economics, University of Virginia*

“Economics is not only fun and exciting, it's mostly plain common sense. The authors have done a yeoman's job in proving just that. *Common Sense Economics* is not only a fun, readable read but can serve as a handy and important reference for students, teachers, businessmen, members of the media, politicians, and trained economists.” ?Walter E. Williams, *John M. Olin Distinguished Professor of Economics, George Mason University*

“*Common Sense Economics* takes the economic way of thinking to the next level. If every high school graduate understood the principles in this book, people would make wiser choices as consumers, producers, and citizens and the United States would be more prosperous.” ?John Morton, *former Vice President for Program Development, National Council on Economic Education*

“In a time when public policy is being influenced primarily by need, greed, and compassion, this text sets out, in laymen's terms, the most basic understanding of how the economy really works. *Common Sense*

*Economics* is a must-read for anyone interested in the truth about wealth creation and effective public policy.” *J. R. Clark, Probasco Chair, The University of Tennessee and Executive Director, Association of Private Enterprise Education*

About the Author

**James D. Gwartney** holds the Gus A. Stavros Eminent Scholar Chair at Florida State University and is the director of the Stavros Center for the Advancement of Free Enterprise and Economic Education.

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Introduction

Life is about choices, and economics is about how incentives affect those choices and shape our lives. Choices about 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 with regard to how societies work.

The following section introduces twelve key concepts that are crucial to the understanding of how our economy works. The reader 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 a fraction of the time devoted to Economics 101, you can pick up most of its important lessons. In subsequent sections you will use these concepts to address other vitally important topics.

### 1. Incentives Matter.

All of economics rests on one simple principle: Changes in incentives influence human behavior in predictable ways. Both monetary and non-monetary factors influence incentives. If something becomes more costly, people will be less likely to choose it. Correspondingly, when an option becomes more attractive, 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 the material is covered extensively on exams. 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 fewer, 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 an item’s price is too high, suppliers will have to lower the price in order to sell it. The lower price will encourage people to buy more—but it will also discourage producers from producing as much, since at the new, lower price it will be less profitable to supply the product. 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 nominal 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 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. As buyers reacted to higher gas prices, so did sellers. The oil companies supplying gasoline increased their drilling, adopted new techniques 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 over time.

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 more 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, polls indicated that nonunion members were overwhelmingly opposed to exempting union members from health care taxes that non-members and others were required to pay. Similarly, senior citizens have voted numerous times against candidates and proposals that would reduce their Medicare benefits.

There’s no way to get around the importance of incentives. It’s a part of human nature. Interestingly, 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. The rules were changed so that the managers were compensated according to the number of square meters of glass they could produce. 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. That’s not true. 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 expensive (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 uses.<sup>1</sup> 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.

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 you don't have to spend money to do something does not mean the action is costless. You don't have to spend money to take a walk and enjoy a beautiful sunset, but there is an opportunity cost to the walk. The time you spend walking could have been used to do something else you value, like visiting a sick friend or reading a book.

We often hear it said that some things are so important that we should do them without considering the cost. Making such a statement may sound reasonable at first thought, and may be an effective way to encourage government to spend more money on things that you value and would like others to help pay for. But the unreasonableness of ignoring cost becomes obvious once we recognize that costs are the value of forgone alternatives. Saying that we do something without considering the cost just says that we should do it without considering the alternatives.

The choices of both consumers and producers involve costs. For consumers, the cost of a good, as reflected in its price, helps us compare our desire for a product against our desire for alternative products that we could purchase inst...

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