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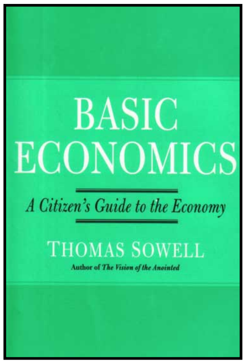

Basic Economics

A Citizen's Guide to the Economy

by Thomas Sowell
Basic Books © 2000
365 pages

Focus

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Take-Aways

- Free markets work better than other economic systems because they allow prices — not government bureaucrats — to allocate resources.
- Prices are like messengers that convey news to consumers and producers.
- Real prices reflect the ratio between the supply of a good and the demand for a good.
- Fluctuating prices provide incentives to manufacturers to produce or not to produce.
- Free markets harness people's tendency to work harder for themselves than they would for others.
- Companies in free markets are forced to adopt new and better ideas.
- Companies that fail to adapt to the market go under, and the resources that they were using shift to more efficient producers.
- This dynamic process creates efficiency and prosperity, but also painful dislocations for some members of society.
- Politicians and the media often portray economics as a zero-sum game: the only way for one group to get richer is for another group to get poorer.

Rating (10 is best)

Overall	Applicability	Innovation	Style
7	6	7	9

Relevance

What You Will Learn

In this Abstract, you will learn: 1) The concepts and terms that make up basic economics; 2) How basic economic principles guide and affect markets, societies and government policies; and 3) How politicians and the media distort and ignore economic fundamentals to advance their own agendas.

Recommendation

Anyone not familiar with the work of Thomas Sowell would be well advised to check out the blurbs on the back of the dust jacket of *Basic Economics*, where praise flows from conservative bastions like *The Wall Street Journal*, *The Washington Times* and the *American Enterprise Institute.* Take this as a warning that, even though Sowell's book does offer an excellent plain-English explanation of fundamental economics, its real mission is to explain how many societal catastrophes are caused by government policies he deems faulty. In so doing, he takes aim at minimum wage standards, rent control and, through his spirited defense of international trade, the anti-globalization crowd. But no matter which side of the ideological fence you occupy, *getAbstract.com* suggests reading this book for its insightful distillation of some of our most passionate political debates down to their economic essentials.

Abstract

What is Economics?

When the African countries of Ghana and Ivory Coast achieved independence in the 1960s, the presidents of neighboring nations made a bet about which nation would be more prosperous in the years to come. At the time, it seemed like a sucker's bet: Ghana was already richer than Ivory Coast and also had many more natural resources. But the president of Ivory Coast was confident his nation would prosper because it had embraced free markets while Ghana was committed to a government-run economy. By 1982, there was no doubt about who had won the wager: the poorest 20% of Ivory Coast's population had a higher real income than most of the people in Ghana.

"Bombing does more immediate damage to a city, but many cities have rapidly rebuilt in the post-war world. Rent control does more long-lasting damage because people do not understand the basic economics of it."

In country after country, free markets have delivered greater economic growth and prosperity than any other sort of system. How do free markets deliver this consistent performance? In government-controlled economies, politicians or bureaucrats decide the use of resources and determine who gets the goods that are ultimately produced. Free markets use a more reliable method to answer these questions: prices.

Prices

"Fights over which individuals and groups get how big a slice of the pie create the kinds of emotion and controversy on which the media and politicians thrive."

Prices are like messengers that convey news. The news that they deliver concerns the availability or scarcity of resources. Sometimes, as in the case of beachfront homes, the news is bad. Because there are not nearly enough beachfront homes in the world to house everyone who'd like to live in them, the prices of the homes are high. But the prices don't make beach houses scarce; the prices simply reflect the ratio of people who would like to live in beachfront homes to the number of beachfront homes. This ratio would not change if the government tomorrow placed a price cap on the houses, or even if it passed a law saying that beachfront houses will now be free to all Americans.

"Many apparently humanitarian policies have backfired throughout history because of a failure to understand the role of prices."

"Monopoly is the enemy of efficiency, whether under capitalism or socialism."

"Our social visions and our rhetoric are about 'the rich' and 'the poor,' as if we were talking about people who are born, live and die in poverty or luxury, while the reality is that most Americans do not stay in the same income quintile for as long as a decade."

Prices sometimes deliver good news. Suppose for example, that a vast new supply of iron ore was discovered. Only a tiny minority of the population would even be aware that such a discovery had occurred. But the rest of us would soon see the effects of the discovery as the prices on steel products fell. Even though we know nothing about iron reserves or the steel-making process, the end result of the new discovery would quickly be conveyed to us through changes in prices. These adjustments are automatic — they don't require consumers to know anything about the resources themselves.

Prices in Action

It's a generally accepted axiom that people buy more of any good at a low price and less at a high price. Conversely, manufacturers produce more of a good when they can sell it at a high price than they will when prices are at rock bottom. Through the intersection of these two rules, the free market determines the real prices of any good.

By providing incentives, freely fluctuating prices harness people's tendency to do more for themselves than they are willing to do for others. If prices suddenly rise on a commodity, producers will be drawn to that market. For example, if a tomato crop fails in a given region, farmers from other areas will rush to supply that market to take advantage of the unusually high prices caused by the regional tomato shortage. In this way, the tomato importers make an extra profit and the tomato supply is restored.

In many cases, governments attempt to direct prices by imposing controls, such as setting a floor or a ceiling on prices in response to crises. Experience has shown, however, that price ceilings lead to shortages and price floors lead to surpluses. For example, some cities and countries implemented rent controls to address housing crises. But in New York and San Francisco, and in all of Sweden, England and France, the market distortions created by price controls resulted in increased demand for apartments, sharply increased prices for apartments not covered by the laws and a rapid deterioration in apartment upkeep and maintenance.

The Rise and Fall of Business

In an era when Sears and Montgomery Ward were the unchallenged giants of U.S. retailing, James Cash Penney had some new ideas about how to run a chain store. Years later, a J.C. Penney clerk named Sam Walton set off with his own ideas about the retail industry and created the Wal-Mart chain, which now has sales larger than Sears and J.C. Penney combined. Because Walton was living in a free economy, he didn't have to convince politicians, bureaucrats or managers at Sears and J.C. Penney that he had a better way of doing business. All he had to do was deliver merchandise to consumers at a lower price. Once he accomplished that task, the other stores were forced to adopt his new ideas to protect their own profits. Companies that can't or won't adapt to new conditions go under, and the resources they were using shift to more efficient producers.

Since prices are determined by the market, not by individual producers, the easiest — and often the only — way to increase profits is to decrease production costs. As Henry Ford proved, one sure-fire way to cut production costs is to make more of whatever it is that you're producing. This is what economists mean when they talk about economies of scale.

Unfortunately, Ford, like all manufacturers, also encountered diseconomies of scale. Simply put, there comes a point at which the cost of producing more cars stops falling and starts climbing. There are many reasons for this phenomenon, but the simplest explanation is that companies just get too big to operate efficiently. The chief executive of AT&T put it best back when his company was the world's largest corporation: "AT&T

is so big today that when you give it a kick in the behind, it takes two years before the head says, 'Ouch!'"

"It does not matter that a law or policy proclaims its goal to be 'affordable housing,' 'fair trade,' or 'a living wage.'" What matters is what incentives are created by the specifics of these laws and how people react to such incentives."

Work and Pay

Wages and salaries determine how much money consumers have to purchase goods. A consumer's level of earnings defines his or her place in society. Because wages determine an individual's standard of living and societal status, they are always at the center of heated political debate. Unfortunately, much of this debate is misleading. Statistics divide society into categories of top income earners and bottom income earners. Because of the prevalence of these figures, many see monetary earnings as a zero-sum game: if some people are getting more, it must mean that others are getting less. Politicians and the media make their living arguing about who is getting the largest slice of the pie.

This thinking ignores the truth that the pie is always getting bigger. Earnings are dynamic because they reflect changes in society and in the economy. New technologies and methods of organization create new demand — and higher wages — for some workers, while making other jobs obsolete. Efforts to halt this process and "save jobs" or to "eliminate discrepancies in pay" result in lower standards of living overall by interrupting the adaptation of new advances.

"Periods of crisis often generate emotions which seek outlets by blaming personal and intentional causes, rather than systemic causes, which provide no such emotional release for the public or moral melodrama for the media and politicians."

The National Economy

Whenever someone starts throwing around statistics that are supposed to "prove" something about the national economy, watch out. The national economy is so large and complex that it is difficult for economists to agree on even basic measurements, such as the Gross National Product and Gross Domestic Product, which total the goods and services produced each year. This complexity makes setting government policy difficult. Many policies, for example, are based on the cost of living or inflation, which is the tendency of prices to rise as additional money comes into circulation. But when the government calculates inflation rates, it can't add up the prices of everything. Instead, economists create a basket of commonly used goods. Problems arise, however, because prices determine which goods consumers commonly use.

Many of us can remember when televisions, air conditioners and portable computers were so expensive that only the very rich could afford them. At the time, these items were not included in the basket of goods used to measure inflation. As years passed, however, prices on these items fell. They are now found in many homes. National inflation statistics missed this huge drop in prices, and in retrospect, inflation estimates for the period likely were too high.

"Treating the cause of higher prices and higher interest rates in low-income neighborhoods as being personal greed and trying to remedy it by imposing price controls and interest-rate ceilings only ensures that even less will be supplied to low-income neighborhoods."

Government policies also fall prey to the fallacy of composition, which means thinking that because something is true for one group, it is true for the entire economy. Politicians love to come to the rescue of particular industries, classes or racial and ethnic groups. Consider the steel industry. For the past 20 or so years, stories about the loss of jobs in the U.S. steel industry have been a newspaper staple. Politicians have tried to protect these jobs by restricting steel imports. But these policies are the result of fallacy. In reality, import restrictions increase the price of steel, which increases the price of other American-made goods, which means fewer sales of U.S. goods and fewer jobs for everyone in the long run.

International Trade

International trade is not a zero-sum game. It allows goods and services to be produced cheaper and better than they would be if every country had a closed economy. It benefits consumers while decreasing profits and employment among those who produce costly or obsolete products. Protecting less efficient producers makes no sense internationally or domestically, because the jobs saved come at the expense of other workers and consumers, who will pay more for worse products. When an obsolete industry goes belly up, the resources that it was using shift to newer, more efficient uses and overall productivity increases.

"The Hippocratic Oath taken by doctors begins: 'First, do no harm.' Under tanding the distinction between systemic causation and intentional causation is one way to do less harm with economic policies."

International trade benefits both wealthy and poor nations because of the concept of comparative advantage. Even if one country can produce all goods and services cheaper than another country (what economists call absolute advantage), it still benefits from trade. Why? Because even the most efficient country will produce one thing better than another. For example, the U.S. might be better than Canada at producing both cars and corn. But if the U.S. is better at producing cars than corn (comparative advantage), it will operate most efficiently by producing as many cars as possible and outsourcing corn production to Canada. In the end, the world has more cars and more corn, so both countries come out ahead.

"We have seen some of those great human costs — people going hungry in Russia, despite some of the richest farmland on the continent of Europe; people sleeping on cold sidewalks on winter nights in Manhattan, despite far more boarded-up housing units than it would take to shelter them all."

The rapid flows of wealth through the international economy, often decried by critics as a cause of third-world poverty, actually force governments to behave more responsibly. For centuries, governments have transferred wealth from the people to themselves through the simple process of issuing new money to pay for whatever the governments want. With the free and nearly instantaneous movement of funds through the international economy, money and resources will flee from any country that is being mismanaged. Many governments don't like these new restrictions on their trade freedom, so they denounce international trade.

Basic Economics

Even though economic fundamentals seem obvious, they are often forgotten in heated political debates over issues like rent control and minimum wages. Politicians promise such things as "affordable housing," "fair trade" and "a living wage" without considering the incentives that their policies create. Basic economics provides tools for evaluating policies' logical implications based on empirical evidence. If you are prepared to sacrifice prosperity for stability, so be it. All economics can do is make you aware of the consequences.

About The Author

Thomas Sowell is the Rose and Milton Friedman Senior Fellow on Public Policy at the Hoover Institution, Stanford University. He has taught economics at colleges and universities across the country and has published articles and books on economics in the United States and overseas.

Buzz-Words

Absolute advantage / **C**omparative advantage / **D**iseconomies of scale / **E**conomies of scale / **F**allacy of composition / **I**ncentives / **I**nflation / **Z**ero-sum game

