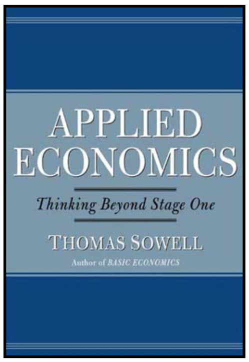

Applied Economics

Thinking Beyond Stage One

by Thomas Sowell
Basic Books © 2003
304 pages

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Take-Aways

- Economic thinking is long term and logical. Political thinking is short term and emotional.
- To understand the effect of policies, think through all of the consequences.
- Economic consequences may take years to happen but it is usually possible to predict them.
- Free individuals making their own decisions and allowing prices to determine and reflect supply and demand will collectively build the most efficient, just and reasonable economic systems.
- The price system is extremely effective at allocating scarce resources.
- Regulatory distortions of the price system usually have undesirable, unintended consequences.
- Rent control laws lead to housing shortages and more expensive rents.
- Drug price restrictions lead to less research and the discovery of fewer new drugs.
- Minimum wage laws result in fewer jobs and more unemployment.
- It is folly to establish economic rights — socialism means shared poverty.

Rating (10 is best)

Overall	Applicability	Innovation	Style
10	**8**	**7**	**10**

Relevance

What You Will Learn

In this Abstract, you will learn: 1) How to distinguish economic issues from political issues; and 2) How to think through economic issues logically.

Recommendation

This excellent, short, clear book should be part of everyone's reference library, particularly those who wish to understand standard conservative economic thought. The distinctions author Thomas Sowell draws between political and economic logic should become a valuable part of each voter's mental apparatus. Writing to educate the general reader, not to further instruct the sophisticated economist, the author advocates minimal government interference. He calls for as little regulation as possible, mainly because regulations have unintended and usually undesirable economic consequences when seen with a long-range perspective. Sowell's concise, easy-to-read style cuts through the jargon of most economic discussions to lay bare the underlying, plain heartwood. It is easy to quibble here and there. Sowell doesn't offer lots of statistics and back-up material. And, he seems to argue against individual economic decision making when he tilts a drug pricing discussion into a sermon against Americans buying medicine at low Canadian prices. However, *getAbstract.com* finds that his book stands on its merits nonetheless, as long as you understand that the author has a political — as well as an economic — point of view.

Abstract

Economic Thinking about Real World Issues

Knowing about economics is one thing, but applying economic thinking to real-world issues is something else again. Many people know the basic facts of economic life — for example, that when supply is low and demand is great, prices rise, and that when prices rise to a certain level, more supply enters the market and prices fall. It's clear to most people that there is a wage for which they won't work, a wage at which they will work, a wage at which it makes sense for them to hire help and a wage at which it doesn't make sense. But even though people may know that refusing to let prices rise will prevent new supply from coming into the market, and that keeping wages artificially high will result in fewer people getting hired, they often advocate policies that make little or no sense in the face of economic reality.

"Families, gangs, feudal warlords, insurance companies, partnerships, commodity speculators, and issuers of stocks and bonds are all in the business of reducing and transferring risk."

Well, perhaps it's not quite fair to say that these policies make no sense. They do make some sense, but only for a few people over the short term. For most people, they make no sense over the long term. For example, you may not be willing to make the sacrifices necessary to pay a doctor with your own money. But you may very well vote for state subsidized medical care that will pay your medical bills with someone else's money. If you have to pay a doctor out of pocket, you may try to stay in good physical shape and avoid going to the clinic except in an emergency. But if someone else is paying the bill, you might take life a little easier, think less about exercise and diet, and go to the doctor whenever you feel a twinge. The predictable result of subsidized medical care is that more people use more medical care and, perhaps, more people keep themselves in a poorer state of health because they have no economic incentive to stay healthy. Thus, what looks good for you in stage one — the state paying your medical bills — becomes bad for you down the line.

The reason that people — not only politicians but also the public — advocate nonsensical policies is simple. Economic logic and political logic have two different frames of reference. Political logic operates in the realm of things people wish were true or hope will be true. Thus, political logic looks at a program to lower the cost and risk of drug use as a desirable step toward easing the drug problem. Economic logic, by contrast, looks at the real facts of life. Thus, a program lowering the risk of drug use, in effect, makes drug use more economically desirable and will probably result in more, not fewer, drug addicts. Politics is about emotion and to some extent about fantasy. Economics is about the cold, hard facts of life. That's why they call it 'the dismal science.'

"Political thinking tends to conceive of policies, institutions or programs in terms of their hoped-for results — 'drug prevention' programs, 'profit-making' enterprise, 'public-interest' law firms, 'gun control' laws, and so forth."

Economics does not ask what you hope will happen. It asks what will actually happen. And what will happen next, and next. Economics understands that every political decision has consequences. Every policy establishes some set of incentives and disincentives. People will respond positively to the incentives and negatively to the disincentives. A policy to control the price of drugs will result in fewer new drugs — companies will invest less in researching new drugs because their return on investment is lower than it might be in a free market.

Why do politicians advocate policies that will undermine their constituents in the long run? The answer is simple. Economic consequences take years to work through the system. Suppose a state decides to raise education funds by taxing corporations. Most companies do not leave and the state raises more money. That's stage one. Within a year or two, businesses at the edge of profitability go bust because they can't afford their taxes. As taxes go up, more firms fail. That's stage two. Meanwhile, as other businesses consider alternatives to operating in a high-tax region, some move away. Other businesses that might have come to the state decide not to, because of high taxes. That's stage three. At that point, the state suffers an employment problem and a revenue shortfall because too few companies are hiring. By now, the politicians who voted on the first tax increase are long gone. With the state facing an employment and budgetary problem, what do their successors propose? Experience shows that in such circumstances, politicians often propose a tax increase to balance the budget.

"For purposes of economic analysis, what matters is not what goals are being sought but what incentives and constraints are being created in pursuit of those goals."

Solutions That Hurt

Politicians often offer solutions that make economic problems worse. In India and other developing countries, politicians have offered subsidized grain and other relatively costly services and goods to gain votes. The result almost invariably is a fiscal crisis, unemployment and consequent economic difficulties for the entire population.

"As markets replaced politically managed economic decision-making, China experienced one of the highest economic growth rates in the world."

The problem isn't limited to developing countries. In the early years of the new millennium, California's politicians decided that electric bills were getting too high and decided to solve the problem by regulating electricity prices. In fact, prices were getting high, but for sound economic reasons. Reduced rainfall meant less water flowed through the hydropower plants and, consequently, less power came out — but the cost of operating the plant remained the same. Hydrocarbon prices were also rising, which meant it cost more to generate power in coal and oil-fueled power plants. California's politicians trolled for votes by regulating the prices that electric utilities could charge for power, but did nothing to ease cost pressures on the utilities. As a result, utilities paid 15 cents a kilowatt-hour for electricity they could only sell for a maximum of seven cents a kilowatt-hour. Within a relatively short period of time, California experienced blackouts, bankrupt public utilities and a power shortage. The state stepped in to buy electricity from the power generators because the public utilities had such bad credit ratings that the generators would not sell to them. Californians ended up paying much

"The advantages of a free labor market benefit not only the worker but also the economy."

more for electricity than they would have if politicians had not meddled with the price mechanism. They paid on their utility bills, on their tax bills and in the form of lost economic opportunity because of the businesses that relocated or failed because California's electric grid became so unreliable.

"Given the low educational levels of many who become career criminals, crime may well be their best-paying option."

Some Burning Issues

That is, roughly speaking, how economic logic works. It goes well beyond stage one — the stage at which politicians congratulate each other about a new piece of legislation that fixes an alleged problem. Politicians are usually wrong about the existence and severity of a problem. In a free market system, people can make up their own minds about whether or not a problem exists, and they can pay for the solution that makes the most sense to them, given the price of the solution and the severity of the problem. Maybe the solution to California's energy crisis was to leave the price system alone. Eventually prices might have risen to a point at which Californians would have adopted conservation measures. Maybe someone would have built a new power plant or two. Maybe voters would have considered new energy sources — even nuclear power — in economic rather than emotional terms. But economic logic never had a chance to work. The political distortion of the price system turned a relatively minor inconvenience, rising electricity prices, into a statewide disaster. This sort of thing happens over and over. By thinking in relentlessly economic terms, you can foretell the future of almost any policy. The following sections offer a few examples.

"A given individual's value as a free worker was likely to be greater than that same person's value as a slave, because of the constraints inherent in keeping someone in bondage."

Free Labor

Aside from the moral issues, slavery sounds like a good deal for slave-owners. Own a slave and get free labor. So why is it that the regions where slavery was most widespread are even now relatively poor compared to regions where slavery was scarce in recent history? Under slavery, people are not free to choose the jobs they can fill best or to demand the wages the market will pay. As a result, human capital remains undeveloped. Slave owners have little or no incentive to engage in more productive or efficient forms of economic enterprise, because their economic eyes dazzle at the mirage of free labor. Slavery is a very inefficient foundation for an economic system, and most slave-owning regimes were self-destructive.

"Paying less and getting less — whether less is defined quantitatively or qualitatively — is no bargain, least of all in the case of medical care."

The free movement of labor benefits workers and, thus, benefits the whole economy. Nowadays, slavery is dead, except in a few backward regions. But labor is no longer free to move. Minimum wage laws require employers to pay every worker a certain amount. The flip side of the minimum wage law is that it prohibits unskilled workers from taking sub-minimum wage jobs even if they might get valuable training. Some of the greatest fortunes in the U.S. were earned by people who started working for pennies or even for free, including Andrew Carnegie, Henry Ford and F.W. Woolworth. If minimum wage laws had been in force when these entrepreneurs began their careers, they might never have gotten a start.

"As far as the practical effect on patients is concerned, advertising is as much of an ingredient in the drug's benefits as any of the pharmaceutical components themselves."

Socialized Medicine

Does everyone have a "right" to good medical care? Think past stage one before you answer. Worldwide, governments have established such a "right" by subsidizing medical care. The result is predictable. Price controls or subsidies on medical care mean that people demand more of it, because the price is artificially low. Because there's not much money in providing care, less supply enters the market. High demand and low supply means that somehow or other the price has to rise — and it does, several ways. Because providers have many patients and patients have no alternatives, quality falls and health care consumers get less for their money. Often a parallel health services market develops in countries with nationalized health care. In such systems, consumers may choose to patronize doctors outside the system and pay out of their own pockets. In other cases, consumers may pay quite a bit extra to get a truly competent, qualified doctor to provide high quality care within the system. The pricing of medical care can be distorted many ways. In the U.S., one of the most egregious is the tort system. Juries award hefty malpractice verdicts to plaintiffs, often based on very unsound logic. The result is to increase the cost of medical care. In some jurisdictions, the cost has risen so high that providers have withdrawn, leading to news reports of pregnant women who are unable to find local obstetricians.

"Although rent control is often thought of as a way to protect the poor from unaffordable housing, only the poor who initially occupied the rent-controlled housing benefit."

Housing

Politicians have distorted the housing market many ways, almost always with deleterious results. One early effort was slum clearance in big cities. Appalled to see so many Jewish and Italian immigrants crowded into slums, reformers demanded that the slums be cleared. As a result, immigrants had to pay more for housing and could not afford to send money back to their kin or to help relatives escape famine, disease and persecution and come to America.

The reformers may have made their cities more attractive, but they did no favors for the immigrants and their relatives. More recent political initiatives in housing, especially in big cities, have included rent control. Rent control limits what landlords can charge. Thus, it artificially lowers the price of apartments, with predictable results, including housing shortages, homelessness and exorbitant rents once the landlords find loopholes or ways around the regulations. Of course, such loopholes and work-arounds always exist. Other such political meddling includes land use restrictions. Limiting the height of apartment buildings means fewer units of housing can occupy a given amount of land, resulting in relatively higher prices for the units that get built. Zoning restrictions that prevent housing construction have a similar result.

"More pedestrians and motorists are likely to suffer injuries or death because more high-risk drivers can afford to be on the roads and highways than could do so if auto insurance rates were allowed to rise to the very high rates required to compensate for the damage done by reckless drivers."

Risks and Benefits

One often hears charges of discrimination leveled against financial institutions that refuse to lend in certain areas or stores that charge higher prices in particular neighborhoods. Almost always, the decision is not a consequence of racial discrimination, but a rational economic response to the risks of doing business in those areas. Measures that force prices down or force financial institutions to lend distort the pricing system and make it impossible for businesses to act on a true assessment of risks and rewards. Distortion of risk also underlies the growth of so-called "public interest" law. Public interest lawyers raise money to advance their causes by suing and winning cases. Often, they win by distorting the truth about risks and benefits. Whether the issue is nuclear power or auto safety, the question of risk should always be "Risk to whom, and what was the alternative?"

No matter what the issue may be, a ruthless economic logic that goes beyond political rhetoric to examine actual consequences is the only reasonable test of any policy. Policies have a way of generating unintended, though not unforeseeable, consequences.

About The Author

Thomas Sowell is the Rose and Milton Friedman Senior Fellow on Public Policy at the Hoover Institution at Stanford University. He has written for *Forbes*, *Fortune*, *Newsweek*, *TIME* and other publications. His previous books include *Basic Economics*, *Knowledge and Decisions*, *Ethnic America*, *Race and Culture* and *The Vision of the Anointed*, among others.