**THE MIDNIGHT ECONOMIST**

A note from the author:

Many have concluded that the primary value of economics training lies in the consistent ability to apply its basic principles over a wide range of phenomena in an unavoidable complex world. Yet these basic insights are violated every day in academia, the media and government policy.

As his alter ego, the Midnight Economist (named for the radio time slot in which his commentaries were first delivered), UCLA economics professor Bill Allen, has, in well over 1,200 scripts, consistently demonstrated and explained to a lay audience the implications of the basic analytical principals of economics. This section presents a small sample of those commentaries, with added questions for thought and discussion.

This section is designed to complement *Exploring Economics* 7e, by Robert Sexton. It follows the order of the book, and is intended to be used to stimulate classroom discussions of the relevant material, to help train students to learn to apply economic principles for themselves. Each article is laid out on a single page (except for the introductory one, which is two pages), so that it can be copied (with or without the discussion questions) and handed out for use in the classroom.

**Introductory Concepts and Supply and Demand** (Chapters 1-9)

1. Introduction

2. Understanding Adam Smith and the Economy

3. Economic Order: Big Brother Versus Mutual Bribery

4. Needs and Preferences, Decrees and Market Bids

5. Property Rights, Conflict and Harmony

6. Unhappiness and Uncleared Markets

7. Scarcity, Shortage and Policy

8. The Moving Forces Behind Market Prices

9. The Law of Demand and the Message of the Market

10. Liquidity Crisis

11. How Do We Ration a Pie Too Small?

12. The Hurricane After Hugo

13. Safety Policies and Indirect Costs

14. Private Property and Pollution

15. Property Rights and Pollution

16. Congress, Ethics and Rules

17. Education, Sex and Character

**Microeconomics** (Chapters 10-17)

1. Tunnel Vision, Tunnel Use and Advance of Theory

2. Poets, Comedians, and Replacement Costs

3. Costs, Competition and Prices

4. Losses, Profits and Use of Resources

5. On Monopoly and Competition

6. Prices and Production

7. Competition and Efficiency, Innovation and Monopoly

8. The Sense of Auntie Trust

9. Small Firms, Opportunity, and Growth

10. Choices, Advertising and Freedom

11. Advertising and the Demand for Mouse Wash

12. Duopoly and “The Alehouse Rock”

13. OPEC and the Complications of Cartels

14. Dollars and Scholars, Cartels and Competition

15. Minimum Wages, Market Wages, Employment, and Income

16. Workers and Employers, Wages and Profits

17. The Plight of the Paycheck

18. Efficiency, Productivity and Wage Rates

19. Employment and Wages, Competition and Fairness

20. Sweatshops: Outrage and Analysis

21. Measuring Income Inequality

22. Sneaky Taxes

23. Medical Folks and Artichokes

24. Diseased Kidneys, Pure Hearts, and Dialysis for the Brain

**Macroeconomics** (Chapter 18-27)

1. The Causes of Unemployment

2. On Measurement and Interpretation: Glasses and Doughnuts

3. Diddling With Data

4 Public Works: The Oversold Solution to Unemployment

5. GDP: The Baby and the Bath Water

6. Determinants of Economic Growth

7. The Stock Market’s Anchor

8. Supply Side Silliness and Sense

9. Prices and Taxes

10. Budgets, Deficits, and Economic Performance

11. Inflation and the Cost-Push Mirage

12. Oil Shocks and a Long-Term Monetary Policy

13. Money, Non-Money and Reputation

14. Banks, Money and Policy

15. Money and Open Market Operations

16. Monetary Policy: Price Objective and Money Control

17. Monetary Policy: Living and Learning

18. Monetary Instability, Uncertainty and Productivity

19. A Target of Permanent Zero Inflation

20. Money and Mouse Work

21. “Highs” and “Lows” With Sugar and Money

22. Misleading Indicators

23. A New Friend and Familiar Foolishness

**International Trade and Finance** (Chapters 28-29)

1. Trade and Mutual Gain

2. The Trade Deficit and Cheap Foreign Labor

3. Foreign Lessons

4. Import Restrictions and Specialization

5. Price Control in the Foreign Exchange Market

***The Midnight Economist***

**for**

**Robert L. Sexton**

**Exploring Economics, 7e**

**Introductory Concepts and Supply and Demand**

(Chapters 1-9)

**1. Introduction The Midnight Economist**

According to a famous definition: "Economics is the science which studies human behavior as a relationship between ends and scarce means which have alternative uses."

Some may gag a bit over reference to economics as a science. And some may sense from the definition a lack of sex appeal, with economics appealing as a deadly dull, dry, and dreary field of arcane doodling and diddling. In actuality, there is, in good economics, muchof feel and flair, of instinct and intuition: economic analysis is not a purely mechanical exercise of grandly grinding out uninteresting answers to artificial problems. In any discipline of analytic application to important matters, elegant tools and rigorous techniques of thought must be supplemented with accumulated learning and developed wisdom in order to distinguish the profound from the superficial, the appropriate from the inapt and the inept, and the feasible from what cannot work well.

The foregoing definition of economics does suggest the core of the broad, versatile field of study and use. It all starts with scarcity: in this world of limitations, we cannot produce all we want. The fact of scarcity has implications of the most fundamental seriousness. Scarcity implies the necessity to pick and choose, for we will never fully satisfy all desires; choice-making implies cost-bearing, for cost is what we must give up in order to get the thing preferred. A world of scarcity and choices and costs is a world not only of dealing with stingy nature but of dealing with people; in dealing with other self-centered, aggressive, would-be autonomous people, we sometimes coordinate our efforts to mutual advantage, and we persistently compete in many ways as each tries to get a bigger slice of thefinite social pie.

A world of scarcity is inherently a hard world. But with some civility and sense, we can make our lives easier than they otherwise would be. How are we to organize ourselves as a community, what ground rules and institutions can we evolve and adopt which will enable people, with all their grasping grubbiness, to live together peacefully and productively?

By and large, people and their governmental leaders and masters have not answered that central question well. History is not an impressive story of progressive sophistication in formulating rules and procedures which enable the great bulk of the world's peopleto live without fear of oppression and want and with reasonable hope of personal fulfillment. But the human spirit is remarkable: people have been denied many options, their initiative has been severely curtailed, they have been abused and oppressed--and yet they have not only stubbornly survived, but commonly have shown much sense in adjusting and making do within the limited alternatives available to them.

People usually have done as well in their personal affairs as they have been permitted to do. How can they be permitted to do better? Much of what we do is “economic” in nature--what we do and how we do it, that is, in allocating “scarce meanswhich have alternative uses.” Much of our misery has stemmed from dumb economics--inefficient institutions, inappropriate property fights, wasteful processes, debilitating policies.

While people commonly are shrewd in handling their private business, they are not accomplished economists in the broader context where their expertise and; experience are necessarily limited. And they have been taught much mythology, including:

\* we could have enough of everything if we were fully to exploit our fantastic productive power;

\* economic efficiency is a matter only of technology and engineering;

\* agricultural and other surpluses stem from productivity outrunning demand;

\* property rights frequently conflict with human rights;

\* most business people are self centered and rapacious, while all government people are self-sacrificing and altruistic;

\* charging a higher price always increases the seller's profits;

\* the American economy is increasingly dominated by monopolists who arbitrarily set prices as high and wages as low as they please;

\* minimum wage laws are an effective tool that generally raises the income of the poor;

\* rent control improves and expands housing;

\* a government budget deficit reflects failure to tax enough to finance needed government services, and increasing tax collections will surely reduce a deficit;

\* inflation is caused by greedy domestic monopolists and irrational consumers, and disruptive international cartels;

\* the optimal size of various key measures is invariably *zero*, e.g., zero budget deficit, zero foreign trade balance, zero unemployment, zero pollution, zero crime, zero unwed mothers;

\* tariffs increase domestic employment and wages;

\* we cannot compete in a world in which most foreign wages are lower than wages paid domestic workers.

Mythology is a legitimate part of romantic and rational life, but it leads us astray--making us poorer and weaker and more troublesome in a stingy world--when it is made part of economic analysis and policy.

Good economics of description, diagnosis, and prescription will not solve all our problems. The best of achievable worlds will still be a world of scarcity--and thus a world of choices, costs, and competition. But good economics will help us to do best, even if not well, in a hard world.

Questions for Thought and Discussion:

1. Frank Knight, a famous economist, was well-known for saying “It ain’t ignorance that does the most damage; it's knowing so derned much that ain’t so.” If the myths listed above are not, in fact, true, what differences will it make in our understanding of public policy?

2. In a world of scarcity, can social problems be "solved" without causing problems elsewhere? Which problems are therefore worth solving?

3. How does the statement “incentives matter” result from the definition of economics given above? Why, therefore, might economists spend a great deal of energy on appropriately specifying the incentive structures facing the relevant decision makers in analyzing public policies?

**2. Understanding Adam Smith and the Economy The Midnight Economist**

Mouse Karl was in one of his sophisticated moods of insightful sneering. “You and Professor Allen,” he sneered to Mouse Adam in sophisticatedly insightful manner, “like to laud Adam Smith as the great father figure of modern economics. But Smith was either extraordinarily naive or a deliberate purveyor of capitalistic propaganda. And, in extolling Smith, you and Allen also are either innocent of sense or guilty of little integrity.”

“Well!” exclaimed the amiable Adam. “What inspired that outburst? Adam Smith was capable of error and inadequacy. Further, there have been giants in the history of economic analysis both before and after Smith. Still, his influence on serious economic thought has been enormous.”

“That has to be a misfortune,” snapped Karl, “for Smith basically misled us. He taught that we prosper most when we put ourselves into the grubby hands of business people, painting captains of commerce as paragons of prosperity and philanthropy. In actuality, capitalists are at least as greedy and self-centered as real people.”

“You may not be persuaded by Smith’s analyses of history, institutions and policies,” replied Adam with some impatience, “but do try to get straight what the man was saying. Smith certainly was *not* an apologist for the business community. He observed: ‘People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.’ He bitterly complained about the common propensities in the business world to try to monopolize and collude, to conspire against workers and the public, to seek governmental protection against competition. Does this suggest that Smith wanted the businessman, any more than the king and his bureaucrats, to be the autonomous master of mankind?”

“I confess that I am confused,” conceded Karl. “If businessmen are so grasping, so willing to exploit, how could Smith promote an arrangement of private property and open markets, thereby giving free play to the most unlovely characteristics of people?”

“Market processes, with efficient production and exchange,” answered Adam, “do not require that we like one another and are inspired by purity of heart to cooperate with one another. Market institutions and prices provide options and incentives to use our privately-owned resources well. Our intention is to benefit ourselves. But we individually prosper by supplying valuable goods and services to others, led as by 'an invisible hand' to coordinate our activities to the benefit of all.”

“I see,” said Karl contritely, “that there is more sense and subtlety in Smith than I had supposed. Smith understood that men are not angels. But with appropriate ground rules of the market, we can--quite amazingly--channel acquisitive instincts and aggressive inclinations to mutual advantage and the common good.”

Questions for Thought and Discussion:

1. If an analyst has made mistakes in one area, does that demonstrate whether his ideas in other areas are either correct or incorrect? Why do you think people so often attack the analyst rather than the analysis?

2. Is a system of private property rights and open markets better described as based on selfishness or as providing protections from the selfishness of others?

3. Why, in market systems, do people frequently voluntarily deal with others they may not like (e.g., sellers selling to buyers they may dislike)? How do market systems make discrimination against productive members of less popular groups costly?

**3. Economic Order: Big Brother Versus Mutual Bribery The Midnight Economist**

We dream of a world in which no one has to work, where nature lavishes on us all the goods we could desire. But this is not the kind of world in which we actually live. The means to satisfy wants are *scarce:* we want more than we can have.

Scarcity gives rise to *competition* and *conflict.* And yet in a viable society we must live together with coordinated activity. How can there be peaceful and efficient co-existence of acquisitive and uncooperative people in a stingy world?

The *motives* of people are essentially the same every place--to increase personal welfare. But *social arrangements,* including *economic systems,* differ greatly in the ways specific goals may be pursued. *Scarcity* exists in all societies; how *adaptation* to scarcity is made varies from community to community.

Use of *violence* is one way of resolving conflicts. Thomas Hobbes, the English 17th century political theorist, explained the problem of order when people seek to satisfy diverse desires with scarce resources. “...if any two men desire the same thing, which nevertheless they cannot both enjoy,” he says, “they become enemies.” And in the anarchical state of nature, “the life of man [is] solitary, poor, nasty, brutish and short.”

Hobbes resolves the problem of order by introducing a ruler to whom each man shall “give up [his] Right of Governing [him]self.” People are to enter into a social contract with an absolute sovereign, Hobbes tells us, “to keep them in awe, and to direct their actions to the Common Benefit.”

One may reject violence as a mode of interpersonal relations and still be dissatisfied with the Hobbesian resolution of the problem. Instead of state-imposed order, how about *mutual bribery?* We tend to class as immoral all bribery. But is it immoral to *induce* people to do what you wish by making them better off? Let Adam Smith, the Scottish thinker of the 18th century, explain:

Man has almost constant occasion for the help of his brethren, and it is in vain for him to expect it from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favor, and show them that it is for their own advantage to do for him what he requires... Give me that which I want, and you shall have this which you want...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.

We *are* confronted by scarcity. And so conflict *does* exist. Are we to adapt through giving up our individual freedom and responsibility to Hobbesian central control or adapt through mutually beneficial coordination of self-interested actions in a market system?

Questions for Thought and Discussion:

1. Are character traits, like honesty and compassion, scarce, in much the way that iron ore and arable land are scarce? How does this scarcity affect how we organize society?

2. Why does the Midnight Economist find “mutual bribery” a more reliable form of beneficial social coordination than benevolence?

3. Why is violence not normally the form of resource allocation favored by society? Could war be viewed as a form or resource allocation by violence? Who would find war in their self-interest?

4. If government is used to prevent citizens from using violence against one another, does that also expose citizens to the threat of violence from their government?

**4. Needs and Preferences, Decrees and Market Bids The Midnight Economist**

Marxists and poets speak of “needs.” But, in economics, “need” is a non-word. Economics can say much which is useful about *desires, preferences,* and *demands.* But *“*need” presumably is a moral, psychological, or physical imperative which brooks no compromise or adjustment--or analysis. If we “need” something, we *must* have it: There is literally no alternative of either substitution or abstinence.

But the assertion of absolute economic “need”--in contrast to desire, preference, and demand--is nonsense. What do we do if I “need” a certain amount of something and you also “need” a particular minimum amount and both our “needs” cannot be satisfied? It actually is the condition of this world of scarcity that we have conflicting claims which must be somehow resolved. It does no good for each of us stubbornly to stamp a foot, spit downwind, and proclaim inalienable “needs” which in the aggregate *cannot* be fully satisfied. Scarcity, by its nature, gives rise to competition, to conflict, to the necessity of *rationing* in some manner the things we desire.

Do we ration goods among competing claimants through fighting and force? That is suicidal anarchy. Do we ration through governmental directives? That is stultifying repression. Do we ration through market processes? That is efficient freedom.

But the message of efficient freedom is unattractive for some. If one advocates allocation through a market procedure which makes relative preferences manifest and effective, there will be a clergyman who will ask, “where in your analysis is the variable representing gentle compassion,” and there will be a journalist who will protest that you lack humane values.

If distribution by central authority for the purpose of better satisfying “needs” were desirable in the case of medical care or concert tickets, it is difficult to see why the same system should not be used in distributing the *entire* social output, regardless of differing productivities of workers and differing preferences of consumers. Few of our self-styled benefactors go that far (Nor did the Russians ever go that far in practice). While they enthusiastically champion it case-by-case, even the naive and the vicious recognize it in the aggregate as in some sense ridiculous--both unfeasible and unappealing.

Obviously, the world is complicated and frustrating. To make do well, we must analyze cogently and act effectively on the basis of the analysis. We must have intellectual guidance--an analytical orientation, a set of criteria and techniques of deduction and of testing, in short, a theory. Otherwise, everything is a special case, and we are directed by whim and instinct and emotion, not by coherent principle. And the conflicts of competition, stemming inevitably from our condition of scarcity, are resolved by decrees from a ruling bureaucracy, not through individual marketplace bidding on the basis of personal preferences.

Questions for Thought and Discussion:

1. Why is talking in terms of needs not useful in analyzing people’s behavior? Why does marginal analysis require analytical terms such as preferences and demands rather than “needs”?

2. If I argue that the government should provide me with something because I “need” it, is that analytically any different from saying “I want it, but I don’t want to pay for it”?

3. If I shouldn’t be forced to pay for something I “need,” who should have to pay for it?

4. In areas of greatest need--in the sense of being the most difficult to do without, such as basic food, clothing and shelter--does it become more or less important to allocate resources by a process that most effectively communicates people’s desires to producers? Does your answer imply such goods should be allocated by the market system or through government?

**5. Property Rights, Conflict, and Harmony The Midnight Economist**

It is doubtful that Adam and Eve could have had a full measure of comprehension of the implications of their indiscretion. The consequences have been more dire than they should have been, for succeeding generations have not always adjusted shrewdly to the condition of scarcity which was seductively introduced into the Garden.

How is a society to deal with the competitions and conflicts inevitably associated with scarcity? We are forever cursed with sweaty brows in obtaining our daily bread and it behooves us to minimize the costs and discomforts.

In our best adaptation to a lousy world, we want people to know of alternatives, to be able to communicate bids and offers and to obtain goods and to bear costs in accordance with relative preferences. There is information to be acquired, and there are assessments and comparisons to be made and negotiations to be conducted.

In all this, we obviously are competing with each other. But there are ways and ways to compete. The competition can take place through mechanisms of the market, which yield civilized coordination, with people pursuing individual gain in a manner which yields mutual benefits. Or the competition can take place through machinations determined by decrees of Big Brother which spawn belligerent confrontation in which one person’s gain is his enemy’s loss.

These different approaches to living together in a stingy world are illustrated by administration of large blocs of valuable land. As recounted by economists John Baden, Richard Stroup and Dwight Lee, the Audubon Society owns the Rainey Wildlife Sanctuary in Louisiana. The Sanctuary not only is home for much wildlife, it also contains natural gas deposits.

If the territory were owned by *government--*as is two-fifths of this nation--the Audubon Society and the energy companies would be natural enemies. Each party, in single-minded self-interest, would seek the jugular of the other through wielding political influence. But with private ownership of the land, there is room and incentive for mutually useful negotiation. The Audubon Society has found it advantageous to sell limited rights of gas drilling: in its own interest, the Society takes into account the preferences of the companies. By the same token, the companies are induced to acknowledge and adapt to the concerns of the Society.

This negotiated harmony is *not* a matter of metamorphosing greedy natures into brotherly love. Rather, it is mutually beneficial accommodation through voluntary market exchange. It is, thus, a matter of rights to use of property. When those rights rest with a governmental third-party dispenser of privileges, the Society and the firms inevitably fight and resources are badly used as alternatives are restricted and costs are ignored. But when those property rights are privately owned, market negotiations replace grabs for politically exercised power and persuasion is used through appeals to the interests of the other party.

The choice between such alternative arrangements is not difficult.

Questions for Thought and Discussion:

1. Was anything scarce in the Garden of Eden story? What?

2. Why would the Audubon Society develop natural gas deposits on its own wildlife sanctuary, yet oppose similar development on government-owned land?

3. How can natural gas development in the Rainey Wildlife Sanctuary improve or expand the extent of wildlife habitat?

4. Why do those who have already built houses on their property so often then try to restrict others’ ability to develop the remaining undeveloped land? Would they do that if they owned all the still-undeveloped land in the area?

**6. Unhappiness and Uncleared Markets The Midnight Economist**

If Karl had been a chicken instead of a mouse, he would have been in a fowl mood. “I’m sick of hearing you economist types talk about market equilibrium,” he snarled at his fellow mouse, Adam. “You seem to want equilibrium at any price and suppose that that will solve all our problems.”

“I’m sorry to learn of your sickness,” soothed Adam. “But you may be sick for wrong reasons. We don’t want equilibrium at any price; rather we want a price at which there is equilibrium. And we want an equilibrium price, not because that will solve all problems, but because it generally avoids making a hard life stilI harder.”

“It certainly is a hard life,” snapped Karl, “and we mice of sensitivity and compassion want the government to make things better. One way is to stipulate fair prices.”

“I suppose everyone prefers prices which are fair instead of unfair,” murmured Adam. “But your notion, or the government’s notion, of fairness may not be the same as mine. Everyone would like to sell at higher prices at least as much as he now sells, and everyone would like to buy at lower prices at least as much as he now buys. But we can’t both raise and lower a price at the same time; if a seller charges more, a buyer cannot pay less. And if government starts to diddle with prices, the market will not be cleared.”

“Oh,” groaned Karl, “you are making my head hurt. Of course, we can’t move a price up and down simultaneously. But we should move it to where it ought to be. Who cares if the market is cleared--whatever that means.”

“A price which is market-clearing is at an equilibrium level,” Adam explained. “At that unique price, the amount of the good demanders are willing to buy is just equal to the amount suppliers are willing to sell, and the price stays where it is. No one is frustrated because he cannot buy or sell more at that price. Avoiding that particular frustration is not everything, to be sure. Whatever is the market mechanism or the bureaucratic procedure of determining prices, it will still be a world of scarcity.”

Questions for Thought and Discussion:

1. Is the quantity traded at the equilibrium price greater or less than if the government imposed a higher minimum price or a lower maximum price?

2. Can a good be in surplus and still be scarce?

3. How is the cost to society of a price ceiling below the equilibrium price similar to the cost to society of monopoly output restrictions or tariffs on imported goods?

4. If the government wanted to decrease the price of a good to help consumers, would a subsidy or a price ceiling be more effective at helping those consumers?

**7. Scarcity, Shortage, and Policy The Midnight Economist**

Ever since the serpent seduced Eve and Eve seduced Adam, we have been cursed with scarcity. No matter how much, how hard, and how well we work, we cannot produce all of everything we want. It is not likely that grubby people will soon stop wanting so much; it is no more likely that the supply of manna from heaven will appreciably increase. So it behooves us to be efficient, squeezing as much as possible of those things we want most out of the limited resources we have available.

When the objective is efficiency in using resources, the mind of man has not conceived, and the machinations of man have not evolved, a better arrangement than a private property, price-directed economy. Much of the world is belatedly learning this lesson. But many of our politicians and journalists, and even some business people, do not really accept the market economy. For them, “free men in free markets” is only a romantic notion, too fragile and too inequitable to rely upon when major difficulties arise.

Curtailment of oil can be a major difficulty. With current and prospective oil supplies reduced, it is not surprising that the valuation of oil would rise. There is nothing nefarious or subversive in gasoline prices going up when supply goes down.

But an increase in the price of a commodity as conspicuous as gasoline brings out the demagogic craziness of Senator Snort and his little friends, who love to snarl darkly about “gouging” by Daddy Warbucks. Even when the boys try to be terribly analytic, they make hash of good sense. A single story in the *Los Angeles Times* refers ten--count them, ten--times to oil and fuel *shortages* when what was meant was simply *reduced supply.*

If supply of oil is reduced, of course price rises. And the rise of price serves a purpose: the higher price leads people to *want* to cut consumption to the amount available--the higher price *rations* the reduced supply. But if people are not induced to curtail the amount demanded when supply falls, then we have a *shortage.* At a price too low, people demand too much. *Scarcity* is inflicted on us by a stingy world*; shortage* is inflicted on us by our adoption of price control.

Confusing shortage with scarcity is far more than a mere matter of formal terminology. Failure to understand the nature of the problem can lead us into bad policy which perpetuates and aggravates the difficulty. Faced with incipient shortage as supply falls, we bitch about evils of rising prices; we combat “gouging” by suppressing prices, and we then try to ration and allocate in costly patchwork ways. But holding down prices when the market can be cleared only by their going up intensifies the shortage.

Clumsy language leads to clumsy thought, which leads to clumsy policy, which leads to clumsy use of resources.

Questions for Thought and Discussion:

1. Does a dramatic reduction in the supply of a product result in a shortage? Does a dramatic increase in the supply of a product result in a surplus?

2. If there is a sharp reduction in the supply of a good, how does imposing a price ceiling cause the output available to fall even more than it would have otherwise?

3. If prices aren’t allowed to ration goods because of price controls, how will they be rationed instead?

4. Can a good be scarce at the same time there is a surplus of it at current prices?

**8. The Moving Forces Behind Market Prices The Midnight Economist**

Some economic fallacies don't die easily. Take the belief that the only determinant of a market price is the cost of producing the particular good. When a price rises or falls, it is commonly assumed that the item's cost of production must have gone up or down. And there is a tendency to condemn price increases which are not apparently due to higher production costs.

But market prices are not mere reflectors of production costs. To see the real driving force behind market prices, consider rental rates on trucks between Houston and Detroit. The *Wall Street Journal* reported that one year the Detroit-to-Houston charge for a twenty-four-foot U-Haul van was about $1,800 plus gasoline. U-Haul's *costs* for the reverse trip from Houston to Detroit were no different, yet the *fee* for the same van northbound was only $300 plus fuel. The truck rental fee varied six-fold, depending simply on which way one was traveling.

That difference seems unjustified to one who clings to the old wives’ tale that only production costs determine prices. What does determine truck rental fees and all other markets is *competition* among consumers for the available supply. An increased demand would cause the price to be bid up. A smaller available quantity would further intensify consumer’s bidding. Conversely, a diminished demand or an increased supply would weaken consumers’ competition and cause the price to fall.

There are thus two factors which determine a market price: consumers’ demand and the available supply. Either or both can change without any change in the cost of production. The early 1980s decline in the auto industry induced more people to migrate from Detroit to other areas, such as Houston. The demand for rental trucks in Detroit jumped. Inventories dropped. Rental rates soared in order to apportion existing truck supplies among competing renters. Someone who wanted to move from Detroit to Houston, therefore, had to pay a higher rental fee because increased consumer demand and consequent dwindling inventories made rental trucks scarcer in Detroit. Meanwhile, in Houston, competition for trucks was much smaller, and the available supply of trucks increased as people arrived from depressed areas, such as Detroit. Both factors--a smaller demand and a larger supply--kept rental rates in Houston much lower.

The lesson is clear. Prices move up or down in order to ration the existing supply among those who demand it. And market-clearing prices can be very different for the same good at different times or in different locations--even though production costs are identical. So long-distance calls are cheaper at night; matinees are cheaper than evening performances; early-bird restaurant specials are less expensive; and U-Haul trucks from Detroit to Houston were much higher priced than the same trucks from Houston to Detroit.

Production costs do influence market prices*,* but only to the extent that these costs affect the available supply. Supply and demand are the real moving forces behind market prices.

Questions for Thought and Discussion:

I. What happens to the opportunity cost of renting a truck, an apartment, etc., when more people want it than before? When fewer people want it than before?

2. If costs borne in producing an item determines its value, should smarter students get lower grades if they learned the material more quickly or easily? Should shorter people get more points if they make a shot in basketball?

3. How does the idea that production costs determine value lead to support for rent controls on apartments when the demand for living in an area increases? Why doesn’t this myth get invoked to hold up prices when demand for living in an area decreases?

4. If production costs are the determinants of value, how could you determine the value of a factory built in 1960? If a retailer acquired his inventory of a good at varying prices over time, would the value of one item be higher than another because it was bought at a higher price?

**9. The Law of Demand and the Message of the Market The Midnight Economist**

Occasionally, I have occasion to go from here to there. With time constraints which are severe, I go by big, iron bird, despite the fact that travel in the cattle-car section of the plane is pretty primitive.

The head of a major airline has made a statement which does not assuage my distaste for commercial flying. On the matter of pricing, he said, anyone who has to get to Detroit will fly there, whether the fare is $150 or $250 or $350. The remark is reminiscent of the old Robber Baron motto: “The public be damned.” And aside from it being a public relations *faux pas,* it is lousy economics.

*For some* people in *some* circumstances, the amount of travel to Detroit will not be affected by price within the range of $150 to $350. But for *most* people in *most* circumstances, the amount of travel demanded will be determined largely by price within that range. And *for everyone--*and for every *commodity--*the amount demanded will be reduced by a *sufficiently* higher price.

The Law of Demand says that the *price* of a good and the *amount* people are willing to buy are inversely related. Starting with today’s price, the price can be raised enough to induce people to buy less; and price can be lowered enough to increase the amount demanded.

The Law of Demand holds for labor services as well as for airline travel. Does anyone really suppose that employers will hire as many workers at a higher wage per hour as they would at a lower wage? Surely not. And yet, a majority of Congress voted to increase the minimum wage, with the President’s support, while insisting that employment would not be affected.

The Law of Demand holds for gasoline. During the OPEC cartel shenanigans of the 1970's, many people with a public forum asserted that letting gas prices rise would not induce the community to cut consumption to match available supplies. They were wrong, of course, as events eventually demonstrated what reason predicted.

The Law of Demand holds for apartments and water and medical care. With all these products, a market-determined price will clear the market, equating amounts demanded with amounts available. A market-clearing price next year may be higher than today’s market-clearing price. And if government controls prevent price from rising, then we will have imposed upon ourselves a shortage. At the old, frozen price, people will continue to demand as much as before, while the market is telling us to demand less.

In their own interests, people will listen to the market, and adjust to it, if government does not block the message. The Law of Demand is bigger than all of us: there are no exceptions to the law, and we cannot repeal it. But with price controls, we can frustrate its beneficial operation--and with bad pricing policies, which ignore the law, business firms can lose wealth.

Questions for Thought and Discussion:

1. If you choose “cattle-car” airline seating on a flight to save $200, what does that indicate about the added value to you of “better” seats?

2. Why must we be careful not to generalize from the statement “I would not fly to Detroit more often at a price of $150 than at a price of $350” to the statement “people will not fly to Detroit more often at a price of $150 than at a price of $350”?

3. What would have to be true about the alternatives to buying a good for its quantity demanded to not change with price? Can you think of any goods for which that is true?

4. When the fines for speeding in an area are raised, does that reflect the belief by law enforcement authorities that there is a downward sloping demand for speeding? Does the 20% of their bill many health insurance plans require members to pay imply they believe there is a downward sloping demand for medical care?

**10. Liquidity Crisis The Midnight Economist**

Water is a liquid asset. And it is scarce: we don’t have all we want. For many*, scarcity* means *shortage.* So we are told that we must now act appropriately or gasoline shortages of yesteryear will pale in comparison with future shortages of water. rought, population growth, industrial expansion, pollution, increasingly thirsty appliances--all supposedly are disastrously gulping our limited fresh water.

A common bureaucratic approach to scarcity is to wonder simply how to get more. We might try to salvage more of the river water which now runs off into the sea, but those concerned with fisheries and environment fear the consequences of still heavier tampering with nature. e might invest more in desalination plants to produce fresh water from the ocean, but such water costs perhaps 10 times as much as current supplies. And importing water from places as distant as Canada would be even more expensive.

If we are not to go far in increasing water *supply,* perhaps we can cut water *consumption* and improve the efficiency of *use* of the water we have. Some want water police to implement controls and decrees, prohibiting ornamental and golf course use of water, unrequested serving of water in restaurants, use of hoses in cleaning driveways and automobiles, and dampening construction sites to keep down dust.

We need not surrender to officious officials the right to choose acceptable uses of water. Freedom of individual choice is compatible with--and, indeed, required for--socially efficient use of a scarce resource, with people paying and receiving market-clearing prices. If water becomes scarcer, its *market-clearing* price will rise; individuals would then use less water. But they would decide for themselves the extent to which water uses are not worth the higher price, and the quantity of water demanded would fall to equal the supply available.

A “shortage” of *anything* occurs *only* because people demand more than is available at the *existing price.* With market-clearing prices, water can be put to its best uses and rationed in accordance with community valuations. This will entail correcting the current massive subsidization of agriculture, which consumes over 90 percent of California’s fresh water while producing less than five percent of the state’s income. Urban residents pay some 200 times as high a price for water as do irrigation districts. We cannot afford to continue to make it economically feasible to grow monsoon crops in a virtual desert. We cannot afford federal and local laws which make it illegal for some areas to sell excess water to other areas which want to buy it. We cannot afford, in short, to perpetuate a staggering subsidization of waste.

“If California's farmers used just 10 percent less water, enough additional water would be available to everyone else,” says *The New York Times, “*for decades of urban growth with some left over to restore the plundered salmon streams and wetlands.”

The problem of sensible water use is more economic than technological, but economics is commonly omitted from both diagnosis and prescription. The major, most fundamental water problem in California is not inadequate water. We can prosper with what we have. The problem is that we do not distribute and use what we have as well as we could if we were to make our water decisions through the devices and procedures of a freely flowing water market.

Questions for Thought and Discussion:

1. Why don’t more farms in hot weather climates water at night, when evaporation is less, use more water-saving drip watering systems or switch to less water intensive crops?

2. If there was a water market, why wouldn’t the current large difference in what agricultural users and urban users pay for water persist?

3. If it was efficient to develop new sources of fresh water, would a competitive market for water tend to lead to new sources being developed?

**11. How Do We Ration a Pie Too Small? The Midnight Economist**

We have a rationing problem. We have had a rationing problem ever since a disgusted Deity sent Adam and Eve packing. All of the currently produced pie of aggregate output is divided among the members of the community, but everyone would like a bigger slice.

If the markets for the many goods are cleared, everyone can buy as much as he is willing to buy at going prices. But we all still want more. So how about forcing down prices? However, if we decree lower prices, we induce greater quantities demanded of the various goods and smaller quantities supplied of most of them. Inflicting shortages through price controls will not magically return us to the Garden of Eden.

Under the best of circumstances, we are confronted with scarcity. We must--somehow, through some procedures, by some criteria--ration most of what we consume. Since we do not have enough of most things to make everyone fully content, inevitably we compete. In an open market, we compete through offering money, bidding up prices to levels where those still in the bidding will wish to buy no more than is available.

In a purported spirit of “fairness” and a striving for “equity,” we sometimes stipulate maximum prices, making it illegal to buy or sell an item above the ceiling price. Such stipulation does not eliminate scarcity. It does not eliminate competition. Rather, it simply curtails one form of competition, so alternative forms must now be used.

One perfectly splendid way is to wait in line: first-come-first-served--with those at the end of the line not served at all. So the relatively small money expenditure must be supplemented with time and aggravation.

Or the artificially suppressed price may be administered with ration coupons, as with meat and gasoline during World War II. The essence of that scheme is that everyone gets to buy the same amount of the good despite their different demands.

Or there can be tie-in deals. You get the apartment in competition with ten others because you are willing to pay heavily for a pile of sticks which the landlord calls a Steinway piano.

Or you may pay under the table, with no pretense of buying a piano. Irrational, inefficient laws tempt us to cope through cheating and lying.

Or a government bureaucracy may allocate the good on various inspired grounds: age, occupation, geographical location, political loyalty, old-boy connections.

Perhaps the most pernicious basis of rationing is personality and appearance. If not everyone can get the apartment or the loan or the meat, those left out will be those with the wrong skin color, the wrong gender, the wrong age, the wrong religion, or who talk funny.

There is much to be said for the impersonality of the open market. Money is simply money, and mine is no better than yours.

Questions for Thought and Discussion:

I. How can price ceilings, designed to ease the burden of scarcity in terms of money prices, make goods still more scarce and costly?

2. Why is it in the joint interest of both buyers and sellers to convert non-money costs into money prices?

3. Are ways to get around price ceilings, such as tie-in sales, efficient? Should they be encouraged or outlawed?

4. If we imposed price floors (e.g. minimum wages) to ease the constraint of scarcity on sellers of a product, instead of price ceilings, would we get the same types of non-price rationing?

5. Why would one expect price controls to result in increased discrimination in society?

**12. The Hurricane After Hugo The Midnight Economist**

“It’s disgraceful how some mice take advantage of others’ misfortune," complained Mouse KarI. “After hurricane Hugo smashed the east coast, sellers increased prices of ice, plywood, chain saws and other goods. Fortunately, government blocked the gouging by making it unlawful to raise prices after the hurricane.”

“But the hurricane did temporarily increase the scarcity of many products,” answered Mouse Adam. “Supplies of many items fell at the same time demands for them rose. There were not enough products to satisfy all of every mouse’s increased wants, so somehow these items had to be rationed. How could mice most efficiently adapt to the disaster, making the best of a tragic situation? Unfortunately, government controls--which are costly to enforce--prevented higher prices from rationing the products to those willing and able to pay, so *shortages* resulted. The goods were then rationed by *waiting in line.*”

“A good thing, too,” responded Karl, “for it is cruel to imply that a poor, unemployed mouse cannot receive immediate relief for her family because she does not have as much as a rich family.”

“But price controls are not an effective means for helping the poor,” admonished Adam. “Remember, price controls create shortages and cause rationing by waiting in line. Is it not cruel to imply that a poor, elderly mouse in ill health cannot receive immediate relief because she does not have as much endurance as others to wait in line?”

“Rationing by waiting in line does not guarantee poor mice a greater share of the pie,” continued Adam. “Indeed, many mice will pay others to wait for them. If public officials were sensibly concerned about assuring the poor minimal access to goods in the marketplace, they would give the poor cash to supplement their buying power. Then, the entire community--not just suppliers of the purchased goods--would bear the cost of the subsidy.”

“Well, government price controls do keep goods cheaper during the emergency,” remarked Karl.

“They don’t even do that,” answered Adam. “The real price of obtaining a good is its money price *plus* the value of time spent waiting in line. The price control keeps the money price lower. But by increasing the waiting time, it often raises the time cost by a greater amount. So when money *and* time are considered, the good is more costly than it would be if its money price could rise to its market level.”

“Moreover,” Adam continued, “price controls make goods more expensive by reducing their availability. Without price controls, mice would have more incentive to transport greatly desired products into the devastated area.”

“Self-interest isn’t the only permissible reaction to the adversity,” snapped Karl. “What about all those caring mice over the country who donate food and other valuable commodities?”

“That is noble behavior which ought to be praised and encouraged,” answered Adam. “But it doesn’t make sense to undo this charity by enacting price controls which further reduce already scarce supplies, make goods even more costly and divert time from cleaning up to waiting in line.”

Questions for Thought and Discussion:

1. How can price ceilings hold down prices of goods but increase their opportunity cost?

2. Why will price ceilings make disaster recovery slower than it would otherwise have been?

3. Why would giving the poor cash be a more effective way of seeing to their “needs” after a disaster than imposing price ceilings on the products they wish to buy?

4. Are the arguments against price ceilings after disasters also applicable to rent control?

**13. Safety Policies and Indirect Costs The Midnight Economist**

Sometimes things are not what they seem. And sometimes the illusion is more satisfying than the reality. That is why cosmetics and foundation garments sell so well. But in the world of economics, being led astray can be costly. And we often mislead ourselves. We can easily mislead ourselves by stopping the thought process too quickly, noting only immediate characteristics of problems and effects of policies, overlooking indirect implications and consequences.

Safety is good. Granted, some extraordinarily silly things have been said in support of *zero* tolerance of risk in a world of substantial inherent risk. But it can be prudent to promote reduction of risk at reasonable cost.

So there is effort to impose a requirement that every airline passenger--including very young passengers--have his own seat. Currently, children up to two years can be held by an adult. But in heavy turbulence or a crash, surely the child would be safer buckled into his own seat rather than held. True, purchasing the separate seat, even at reduced fare, would increase costs of family travel. Indeed, with increased total demand for seats, prices of all seats might be higher-- and airlines could be very brave about a substantial increase in revenue. But who would contend that the safety of children does not warrant greater expenses of travel?

Now, is that the appropriate end of the analysis? We like safety; infant safety seats can be protective; so we should make such seats mandatory. Economists Richard B. McKenzie and Dwight R. Lee suggest that we go further.

First, note the very modest gain in safety which would be achieved. Research in the Department of Transportation indicates that mandatory safety seats could have prevented just *one* infant death in the 12 years 1978-90. There were additional child fatalities in that period, to be sure, but they occurred in sections of planes where *no one* survived.

Second, demanders respond to changes in prices. If the expenses of airline travel rise, there will be less airline travel. Some of these who are then priced out of flying will stay home. But many will travel by automobile, instead. And automobile travel is much more dangerous than airline travel.

What orders of magnitude are involved? Using very conservative estimates of key variables, professors McKenzie and Lee calculate that the increase in expenses in airline travel could result in a shift to automobile travel which would yield five additional deaths per year--along with injuries and destruction of property. Five deaths a year for twelve years is 60 car fatalities, offset by only *one* life saved in an airliner crash.

The analysts reasonably conclude that government “should not be in the business of creating a travel safety problem (on the highways) that is bigger than the one they are trying to alleviate (in the skies).”

Questions for Thought and Discussion:

1. Could mandating $5000 of added safety equipment on all new cars result in more automobile deaths and injuries than would otherwise have occurred? (hint: how long would you keep your old car?)

2. How can making cars safer increase the number of pedestrian deaths from car accidents?

3. How could child safety caps have increased the number of accidental drug poisonings of young children at first? (hint: they were harder for older people to take off, as well.)

4. How could a national 55 mph speed limit to save lives have increased the number of automobile deaths in Wyoming and Montana?

**14. Private Property and Pollution The Midnight Economist**

Everyone who is sensitive, cultured and very anxious to do good knows that the free-market economists have sold out to Big Business, and that Big Business, in turn, delights in pillaging and raping the landscape, the seascape, and the atmosphere in its frenetic search for an extra buck. But Professor Dwight Lee provides quite a different--and vastly more sophisticated--picture.

The problem of environmental pollution, Professor Lee explains, is fundamentally an economic problem, that is, a problem of scarcity. Pollution is a cost of living and producing; reduced production is a cost of cleaner and more attractive environment. There is an unavoidable trade-off between man-made goods and environmental purity. How much of the one are we to sacrifice at the margin to obtain more of the other? Whatis the optimal combination of production and pollution?

The role of conveying accurate information and efficiently coordinating activities of self-interested individuals is performed splendidly by open markets to the extent that *private property* prevails. For well-defined and enforced ownership rights in resources make possible mutually beneficial *exchange*:you can sell only what you own and buy only what is owned by someone else. And uncoerced exchange will be conducted at market-clearing prices, which reflect the worth of goods not only to their owners, but also to others in the market.

Automobiles are private property, as are the gasoline and maintenance services which keep them rolling. People rationally buy and sell such assets. But operating a car creates pollutants which are emptied into the air--and air is not privately owned. Small wonder that we accept the gains of automobile transportation but ignore the pollution costs. We weigh the costs of the car, the gas and the maintenance against their benefit, but we do not have to buy the air, so we treat pollution as being free.

In the absence of saleable property rights, there are no markets and no prices to induce and guide efficient use of resources. The costs of pollution aren’t fully weighed, and individually rational activity in a defective institutional arrangement results in excessive pollution.

Questions for Thought and Discussion:

1. Would it be possible to have zero pollution by any means?

2. Why is the optimal amount of pollution likely to vary across societies? Would real per capita income differences have a predictable effect?

3. What is the un-owned good that leads to excessive congestion on urban freeways? How could a rush hour toll mimic a market solution to that un-owned good?

4. Why is there less graffiti in your bathroom than in a public restroom?

**15. Property Rights and Pollution The Midnight Economist**

“A sell-out to big business!” fumed Mouse Karl.

“What’s raising your blood pressure now?” wondered Mouse Adam.

“A proposal to grant rights to pollute,” gasped Karl. “In Southern California, the Air Quality Management District is considering a plan to trash its regulatory procedures for curbing smog. Instead, the agency would set an overall level of allowable air pollution, divide the total allowance into shares, and then distribute the shares among local firms. The total allowance would decline each year, but businesses could trade the shares they receive.”

“Sounds reasonable,” said Adam reasonably.

“Ridiculous!” jeered Karl. “The plan would grant businesses the right to pollute. A company needing less than its allowance could sell its pollution rights to another needing more. Businesses could then profit by selling shares in poison!”

“But the reason air pollution is a problem,” explained Adam, “is because property rights to air have not been established. Unlike private resources, air has no owners whose personal wealth is at stake in managing and monitoring its use. And without private owners to charge mice for its use, fresh air has no market price. No wonder we fill the air with excess pollution.”

“As a remedy,” countered Karl, “governments have regulatory standards.”

“True,” agreed Adam. “But even regulations give individuals and businesses rights to pollute. Eliminating all pollution would mean prohibitive sacrifices by the community. So government regulation, like the proposal you scorn, gives mice the right to put some dirt and toxins into the air.”

“Maybe,” conceded Karl. “But at least regulation doesn’t let mice profit by selling their right to pollute. With old-fashioned regulation, government just orders businesses to limit pollution by telling them how to change their activities and technologies.”

“That’s the problem,” answered Adam. “Compared to owners and managers of businesses, government officials have little knowledge of the complex processes they regulate. Their mandated methods of reducing pollution usually are inefficient and clumsy. So the community wastefully uses too many resources to reduce pollution to an allowable level. And regulation provides no incentive for firms to cut pollution beyond required levels or to develop new methods and technologies to clean the air.”

“All these shortcomings are overcome,” continued Adam, “if regulation is replaced by marketable rights to pollute. Then, companies with lower costs of reducing pollution have an incentive to exploit their competence in keeping the air clean. They can profitably sell their rights to other companies whose costs of curbing pollution are higher. Greater efficiency in limiting pollution benefits the community, which gives up less income, production and employment to clean the air.”

Questions for Thought and Discussion:

1. Why do current pollution standards amount to rights to pollute?

2. Why would tradable pollution rights tend to lower the costs of a given degree of pollution reduction?

3. Why would tradable pollution rights raise the profitability of developing less costly pollution abatement approaches, particularly ones that can be used by a large number of polluters?

4. If someone was willing to bear the cost of additional pollution reductions, could they achieve that by buying up pollution rights and retiring (not using) them? Couldn’t even non-polluters help clean up the air further in this manner, if they chose?

**16. Congress, Ethics, and Rules The Midnight Economist**

“The rich are very different from you and me.” “Yes,” wrote Ernest Hemingway, “they have more money.”

But what of public officials? Are they different from you and me? Many believe government types, unlike the rest of us, should always put the community's interest before their own.

So when government representatives do not act altruistically, a lack of ethics is often blamed. Ethical behavior is no less important in personal and commercial relationships than in government. Honesty, tolerance, dependability, responsibility--such ethical attributes facilitate interaction of individuals in directing competitive behavior to productive ends.

But even if all were always ethical, individuals would still have to face scarcity, make choices and bear costs. And when doing so, they would not selflessly sacrifice themselves to help others or, at the other extreme, selfishly promote their interests by destroying others. Neither full-blown altruism or greed would dominate activity in a world of high ethics. Here, individuals act with a regard for both others and themselves. By following legitimate self-interest, they utilize their productive resources to promote best the well-being of others.

In effect, that is what the marketplace does well. Its rules of conduct direct individuals to promote others' interests--in order to promote their own. To obtain more, one efficiently produces what others want.

But people are not angels. Unethical behavior stains the marketplace, as it blemishes personal relationships and government. Compared with the marketplace, however, government lacks effective rules of the game to direct self-interest to the common benefit.

These rules are absent or weak for a number of reasons. First, government officials are often unable to *identify* community preferences. The community cannot easily communicate to government. Most voters rationally remain ignorant about particular issues, for becoming well informed is a costly process with only the small benefit of casting a vote more intelligently--and the vote is for a candidate who represents a large package of diverse issues.

Second, government people typically lack effective *incentive to* satisfy community preferences, for, unlike producers in the market, they do not increase their own wealth by efficiently investing resources they control.

And third, government officials predictably give disproportionate weight to *special interest groups* that lobby forcefully for actions which bestow handsome benefits on them but spread costs inconspicuously among the community.

So even if officials were always ethical, they would still indulge vigorous special interests at the expense of nebulous community preferences. The fundamental problem of government is not so much inadequate ethics as of deficient rules, which provide inadequate information, faulty guidance and ineffectual constraints for government.

Questions for Thought and Discussion:

1. Does a rich person have more or less power to harm you than a congressman?

2. In a market system, if someone, whether rich or poor, wants to get richer, will he help or hurt others in the process? Does someone who wants to get richer through government activity help or hurt others in the process?

3. Why is it rational for most citizens to be relatively uninformed about political issues? How does this give power to special interests in politics?

4. Why is it harder for citizens to communicate what kind of aircraft carriers they would like the government to build than for customers to communicate what kind of computer they want computer makers to build?

**17. Education, Sex, and Character The Midnight Economist**

We do not live in a gentle and genteel age. Typically, behavior is neither decorous nor disciplined. Conduct evinces general lack of pride and common rejection of erstwhile conventional proprieties. And irresponsibility has its costs.

Jacqueline R. Kasun, professor of economics at Humboldt State University, has investigated the elemental economics--the logic and the evidence--of sex education. Her analysis has sobering and perhaps generally unwelcome implications for public policy

Studies conducted by Dr. Kasun indicate two consequences of sex education. On the one hand, such instruction seems to increase the probability of *premarital sexual activity* by 14-, 15-, and 16-year-olds. On the other hand, it appears to increase the use of *contraceptives.* With regard to *pregnancy,* it is likely that the first effect predominates. The pregnancy data are not conclusive, but evidently the number of abortions has been seriously understated, so the probable net result of more sexual activity along with more contraception has been more pregnancy. This likelihood is consistent with the fact that states which have spent most in providing contraceptives and abortions have had the highest rates of premarital teenage pregnancy.

Sexual activity is not a function of sex education alone. Such activity is reduced by family stability, represented by both parents being in the home. It is reduced even more by frequent church attendance.

But probably the most important determinant of premarital sexual activity is *price,* that is, the terms on which the activity is available. The price includes the readiness of access to contraceptives and abortions. And the lower the price, the greater the amount demanded.

As a no-nonsense economist, Dr. Kasun observes: “A youngster who is given free contraceptives by her high school birth control clinic without her parents’ knowledge and with the promise of a free and confidential abortion in case of pregnancy faces a low price for premarital sex activity. She can be expected to consume more of it than a girl with less easy access to contraceptives and abortion...The notion that teenagers can be deterred from becoming pregnant by more and easier access to contraceptives and abortions is like expecting people who are given free gasoline to reduce their driving.”

Economics can contribute critically to analysis of teenage promiscuity and pregnancy and to policy implications. Still, the problem is ultimately one of character and cultivation and commitment. When social opprobrium of loutish behavior is severely diluted, when the community has largely succumbed to coarseness, there can be no very satisfying and effective answers. The best we can do in our degenerate condition is to fight a losing rearguard action in trying simply to minimize losses and delay final disaster.

Questions for Thought and Discussion:

1. Do you think that sex education is designed to increase teenagers “tastes” for premarital sex? How could it act to increase those “tastes”?

2. Why could the two consequences of sex education discussed above either raise or lower the number of teenage pregnancies that result?

3. If cars were made safer for passengers in accidents, how could that lead to an increase in the number of injuries due to car accidents?

4. Why is this analysis an example of an elasticity question?

***The Midnight Economist***

**for**

**Robert L. Sexton**

**Exploring Economics, 7e**

**Microeconomics**

(Chapters 10-17)

**1. Tunnel Vision, Tunnel Use, and Advance of Theory The Midnight Economis**t

The notions of demand and supply, when appropriately used, can help in explaining the world. But they are not perfectly self-evident notions and their fruitful use is not perfectly simple.

Consider what have been called two “laws" of demand. The first law says that, at a given moment, less of a good will be bought at sufficiently higher prices than at lower prices. The second law says that the full impact of, or the total adjustment to, a higher price takes time.

No economist denies the validity of the first Law: right now, when you must pay more for gasoline, you will choose to buy less gas.

The second law of demand seems to be a straightforward extension of the first. Adjustments are involved in reducing the amount demanded of a good in the face of a price increase and not all adjustments are fully made instantaneously. When gas prices rose sharply in the 1970’s, people cut back consumption in various ways, but some ways took more time than others. Shorter but less scenic routes had to be discovered; car pools had to be organized; shopping schedules had to be rearranged; travel habits had to shift from private automobiles to buses and motor scooters; more fuel-efficient cars had to be designed, built and sold.

Is the so-called second law of demand really a “law,” being invariably true? It is abstractly plausible and consistent with much evidence. But Timothy Hau, of the University of Hong Kong, may have found an exceptional case.

When the toll for private car and taxi use of a Hong Kong tunnel was doubled in mid-1984, automobile use of the tunnel immediately fell appreciably, and at the end of 1986, it remained smaller than it had been before the toll increase. This is consistent with the first law. But all of the reduction in purchase of tunnel use took place in the first month; after that, use of the tunnel gradually crept up. And this does not support the second law.

Perhaps it turned out that knowledge was initially so inadequate that the first step of adjustment to the toll increase was quickly deemed to be exaggerated. In particular, use of the harbor ferry, which immediately rose greatly and then trended back down, turned out to be less attractive than originally anticipated. So proper statement of the law must specify an adequate degree of knowledge of alternatives, lest the process of adjustment to the price increase be aborted and partially reversed.

Or perhaps the second “law” cannot be reasonably salvaged. It may not be a “law” it all, but only a suggestive first approximation. But a generalization can have less than perfect predictive power and still be useful.

At any rate, all this suggests the way of analytic progress. Analysis requires theory. But the theory must perform: it must pay off in helping to explain phenomena. If the applied theory does not well enough account for the thing to be explained, the world will go on, but the theory is to be adjusted.

Questions for Thought and Discussion:

1. Why does the second law of demand, often stated by saying that demand curves are more elastic in the long run than in the short run, generally make sense?

2. Why could being over-optimistic at first about how good the substitutes for a particular good were lead to a violation of the second law of demand?

3. Does how much more elastic demand curves become over longer time periods depend on the speed with which new information and adaptations can be discovered?

4. Can you think of other examples that violate the second law of demand?

**2. Poets, Comedians, and Replacement Costs The Midnight Economist**

If you would understand how the world works economically, put not your faith in journalists or politicians.

When the dictator of Iraq decided to take civilization to the oligarchies of Kuwait, the rate of increase in oil prices rose abruptly in fears of curtailed supplies. But why should a motorist have to pay a higher price on Tuesday for gas which was sold to the filling station on Monday at a low, pre-invasion price? Shouldn't yesterday’s low cost to the retailer mean a Iow price to today’s customer?

The august *New York Times* provided--in the words of one of its own columnists—“one of those fuller-explanation stories that make *The Times* indispensable to people who would...know what’s going on...” The story accounted for the quick jump in gas prices essentially on grounds that “psychology...is in charge,” abetted by instantaneous electronic communications. Although “physical fundamentals” of the oil industry had not yet changed, “people expect the price to rise,” a petroleum researcher was quoted, “so the price rises.”

And, of course, psychology conjures visions of corruption, and SenatorSnort quickly made noises about “greed,” “collusion,” and “war-profiteering.”

Well, prices are generated through activities and anticipations of people in markets. And where there are people, activity and anticipations, there is necessarily involved some “psychology.” But more than simple-minded psychology is entailed. When a firm--whether Colossal Oil Company or a neighborhood outlet--searches for the best price to charge, there are certain objective conditions to satisfy. Most basically, if a firm’s receipts do not cover its expenditures, the firmwill not be long for this world.

A firm sells an asset this morning; it uses proceeds of the sale to replenish inventory this afternoon in order to make another sale tomorrow. If the firm is to survive, it must sell assets at prices high enough to replace those assets. The relevant expenditure of the firm is the *replacement* cost of the asset *today,* not the *historical* cost in acquiring the asset *yesterday.*

You sell a house to buy another house. The price you charge now had better reflect today's market valuation if you hope to replace it. The fact that you bought the house for less--or perhaps acquired it at a zero price through inheritance--has nothing to do with its present value.

A savings institution acquired loanable funds last year when interest rates were low. Now, rates are higher and the institution charges high interest on today’s loans, for it will have to pay depositors high rates. in order to replenish its loanable funds inventory.

Similarly, a seller of gas and oil and must charge today’s high prices in order to cover replacement costs, even if the product sold today was bought yesterday at a lower price.

Poets of the press and comedians of Congress should try real hard to comprehend that past prices are not pertinent for present operations: today’s values are provided by today’s perceptions.

Questions for Thought and Discussion:

1. Is there any way prices cannot reflect anticipations about the future?

2. Is the opportunity cost of an item in your inventory correctly measured by what you paid for it in the past? hat difference does it make whether you intend to replace that item in your inventory?

3. If you sold an asset for more than you paid for it but less than it will cost to replace, did you earn a profit on the sale?

4. Why do you think businesses use “going out of business” sales as a technique to make customers think prices will be lower as a result?

**3. Costs Competition, and Prices The Midnight Economist**

A reader has written bitterly to the consumer editor of a newspaper, “What kind of rip-off are the airlines pulling,” he asks, “when the fare from Los Angeles to Indianapolis is more than twice that from Los Angeles to New York?”

The editor agrees that such pricing “gouges” Indianapolis customers. After all, the airline costs of flying to Indianapolis are smaller than the costs of a New York flight, so the Indianapolis fare should be smaller. Everyone knows that.

Well, many *believe* that costs determine--or, in a nice world, “should” determine--prices. But is it somehow wasteful, unfair or otherwise wrong that matinee tickets are cheaper than those for evening performances?

Obviously, prices of goods are *not* always in the same relation as their costs of production. Then, how *do* we account for prices? How can a relatively short airline trip be priced higher than a longer trip?

The editor turned to an airlines analyst of a brokerage house for guidance. The analyst polluted the air by proclaiming that “the Indianapolis passenger is subsidizing the New York passenger.” But the fare to Indianapolis is not high because the fare to New York is low; nor is the New York fare low because the Indianapolis fare is high. In a market free of government decree, airlines will not long continue routes which do not pay: they will not use net revenue from good routes to underwrite persistently bad routes. The carriers will try to set profit-making prices on each route independently.

The brokerage analyst finally--and grudgingly--lets the cat largely out of the bag. “Unfortunately,” he observes, “price is a product of competition, and the competition between Los Angeles to New York is fierce, while the competition for traffic between Los Angeles and Indianapolis is nil.”

So the direct basis of the fares is not respective costs; nor is it mysteriously a matter of discriminatory subsidization. Rather, it is a matter of *competition in supply* and the *amount of demand.* How many suppliers seek the favor of how many demanders?

Curiously, many more people want to travel to New York than to Indianapolis. If there were only one airline to New York and no imposed price control, the profit-maximizing fare and the amount of profit would be very considerable. But these profit possibilities have attracted many carriers. And that competition has driven down the price--and the profits.

Thelower New York price on all airlines is not made *feasible* through subsidization by the relatively few people going to Indianapolis on *some* airlines or by a willingness of *any* airline to lose money on the route to New York.

The New York fare is low because of *competition* of many airlines which seek to survive in that market. And the New York fare would be no higher if every airline decided not to fly to Indianapolis.

Questions for Thought and Discussion:

1. Is the opportunity cost of providing a hotel room today determined by the cost to construct, maintain and operate it or by what someone else would be willing to pay for that room today?

2. Why would profit-seeking airlines not find it in their interest to use earnings from profitable routes to subsidize unprofitable routes?

3. If Los Angeles to Indianapolis passengers were being unfairly gouged by air fares, wouldn’t you expect other airlines to begin flying such a remunerative route?

4. How can differences in competition on routes lead to it being cheaper to fly from Los Angeles to Pittsburgh by booking a Los Angeles to New York flight with a stopover in Pittsburgh, than to book a direct flight from Los Angeles to Pittsburgh (the hidden city strategy)?

**4. Losses, Profits, and Use of Resources The Midnight Economist**

“I try to be tolerant,” said mouse Karl quite intolerantly, “of the open, competitive market. But one thing wrong with it is that it doesn’t work very well. If widget output is greatly increased, widget prices crash and profits turn into losses. In a world of scarcity, it is a ridiculous economy in which great output means disaster for producers.”

Mouse Adam tried to tolerate the intolerance. “Losses for widget producers,” he said gently, “are evidence of bad use of the community’s resources and incentive to shift some of those resources to better uses.”

Karl was offended. “Look,” he snarled, “we want more goods, producers produce goods, so producers should not be penalized when they produce more.”

“Losses certainly are misfortunes for producers,” Adam agreed. “But we should recognize what they reflect and what they imply from the standpoint of the economy.”

“A loss,” snapped Karl, “means simply that some unlucky character is losing his shirt because his costs are greater than his receipts.”

“But what do the costs and the receipts measure?” asked Adam. “Business receipts are a measure of the worth of the product in the eyes of the buyers. Anyone paying two dollars for a widget is saying that he prefers the widget to two dollars worth of any other good.”

“Obviously,” said Karl, “people pay two dollars for widgets only because they consider the widget to be worth the money. But what do costs reflect?”

“Costs,” replied Adam, “reflect the value of *other* goods which *could* have been produced by the resources embodied in the widgets. To produce widgets, labor and other inputs must be bid away from other uses. Inputs derive their value from the value of the outputs they produce. The price which must be paid for inputs is a measure of the most valuable alternative good which is *not* produced when we make widgets.”

Karl’s beady little eyes sparkled with comprehension. “So,” he said, “if business receipts indicate the value of our product and business costs indicate the value of the best alternative product, and if receipts are smaller than costs, then the community prefers that the resources we are using here be used elsewhere. They consider some other good to be worth more at the margin, so widget production should be cut and the output of the other good increased.”

“You are a pretty smart mouse,” commended Adam. “A loss is a sign that the resources of the community are misallocated. We would be better off by shifting inputs from widgets to something of greater value. And, in an adaptable market, that will happen. Widget producers, with their losses, will not find it feasible to compete for the previous amount of inputs against profit-making competitive producers. And owners of inputs will have incentive to sell their services to the highest bidder. So--with no five-year plan decreed by an economic czar--resources will shift to where the community values them most.”

“I conclude,” said a now wiser Karl, “that the market works.”

Questions for Thought and Discussion:

1. When would an increase in widget production increase the total revenues of widget producers and when would it decrease their total revenues?

2. Even though we want more goods in a world of scarcity, why are losses and consequent output reductions an important part of an efficient economy?

3. What would be required to guarantee that no decision-maker ever made losses?

4. Without profits or losses to guide him, how would a central planner know which industries to expand and which industries to contract?

**5. On Monopoly and Competition The Midnight Economist**

Mouse Karl was customarily belligerent but uncharacteristically somber. He turned to the characteristically composed mouse Adam.

“If you really are concerned with the efficiency of the economy,” said Karl, “you would try to do something about monopolies. The community in general is at the mercy of big businesses, who decide by whim what and how much to produce and what prices to charge.”

“Curious,” mused a composed Adam. “Nearly everywhere you look, you see autonomous, impervious monopolists. Nearly everywhere I look, I see dependent, adaptable competitors.”

Now Karl was more excited than somber. “Businesses are dependent and adaptable?” lie shrieked. “Don't make me laugh,” he laughed.

“Businesses which survive, much less prosper,” Adam elaborated, “recognize that they function in a highly interrelated world, usually buying inputs from many suppliers, organizing those various inputs in production and selling output to many buyers. There are many options, so there must be many decisions. Managers of even big businesses must satisfy customers while containing costs. And those decisions are not made once-and-for-all, because the input and output markets and production technology are incessantly changing. A firm has wealth today because of wise decisions and good work yesterday, but it will be wealthy tomorrow only if it operates well today.”

“Pure theory,” sniffed Karl, “otherwise known as mythology.”

“On the contrary,” replied Adam quite sternly. “I am speaking of the uncertain real world of blood, sweat and tears. In a single recent issue of the *Wall Street Journal,* there were at least half a dozen stories of various sorts of enterprises--sizable and small, sophisticated and simple-- fighting for their lives in hard, changing markets.”

“One story,” Adam went on, “dealt with the gambles and experiments of magazines who are suffering from a long slump in advertising income. Another recounts the difficulties and possible strategies and tactics of a struggling metropolitan newspaper. There are the various retailers who are obliged to modify merchandizing techniques in the face of shifting shopping mannerisms and characteristics of the community. More than a dozen fast-food restaurants are challenging the increasingly elaborate giants by going back to the sort of simple hamburger shops of the 1950s. Financial advisers are struggling with the new specifications of optimum portfolios in light of new tax provisions. And in hard-hit ‘rust belt’ states, there is a surge of garage-shop, blue-collar entrepreneurs who, after losing their jobs with big manufacturers, are staking all they have in small outfits of their own.”

“I infer,” said a somber but no longer belligerent Karl, “that not every business person is an unassailable fat cat.”

Questions for Thought and Discussion:

1. Is a “big business” necessarily a large part of its market? Does it necessarily have a large amount of market power?

2. Why are competitors typically far more likely to accuse firms of monopolization than customers?

3. If you were the only newspaper in town, would that guarantee you large profits?

4. Can you think of any once-dominant firms who have lost their large market share?

**6. Prices and Production The Midnight Economist**

Prices are important. Prices are critical in determining how much of different goods is demanded and how much is produced. Market-determined prices reflect preferences, anticipations and costs. People, both consumers and producers, make decisions in light of prices of some goods relative to prices of other goods and prices of goods today relative to prices expected tomorrow and prices of outputs relative to prices of inputs.

The world is a changing place. Jungle instinct alone is enough to suggest that some sorts of changes best lead to price changes if we are to keep demands and resource allocations in proper alignment.

Some of the underlying changes are cyclical, following a well-defined path over the hours of a day or the seasons of a year. And so prices of goods can appropriately rise and fall over a cycle even when production costs per unit vary little.

Thus, ski-resort, cruise-ship, airline, telephone, restaurant, and theater prices often vary greatly, depending on the month or the hour. Demands for evening plays are greater than for matinees, while more telephone calls are made during the day than in the night. The optimal price to charge for the product varies with changing demand. To put the matter differently, the product itself is defined not only by its physical characteristics but also by the time of its supply and consumption: an evening performance at the theater is not the same commodity as an afternoon performance of the same play with the same actors.

Some electric power companies, reports *The New York Times,* are belatedly learning what theater and telephone company managers have long understood: The demand for their product is cyclical, and the price can best reflect the rising and falling demand.

A flat “average equilibrium” price per unit of electricity over the daily and seasonal cycles will be too low for peak periods (it will encourage still more to be demanded when usage already is naturally great) and too high for slack times (it will further curtail the quantity demanded when usage is naturally small). If production capacity is made great enough to handle peak demand, there will be much idle plant the rest of the time; if there is lesser capacity, there will be peak-period shortages.

Problems are compounded if production expenses are higher in peak periods because of utilization of equipment with higher operating costs, requiring, say, use of an oil-fired plant to supplement a hydroelectric dam.

Raising peak-load prices and lowering slack-period prices may leave total electricity consumption unchanged. But it would go some way to even-out consumption over the cycle. And that, in turn, would reduce both immediate operating expenses and the costs of producing more plant to satisfy peak demands. Smoothing the consumption cycle means making fuller and better use of smaller plant investment.

Questions for Thought and Discussion:

1. Is charging lower prices for matinees than for evening movies price discrimination--charging different customers different prices for the same good--or are matinees and evening movie viewings different goods?

2. How could higher electrical prices in peak demand periods and lower prices in low demand periods lower overall production costs, even if it did not change total electrical usage over the entire cycle?

3. What would be the result of a government requirement that restaurants change the same prices at lunch as at dinner or that hotel room charges must be the same for every day of the year?

**7. Competition and Efficiency, Innovation and Monopoly The Midnight Economist**

One of my wise friends warned me of the worth and the limitations of mathematical doodling in economics. “The blackboard can be a very useful device,” he said, “but do not confuse it with the real world.”

Economic theory--and the curve bending and equation solving in which it is often exposited--is highly useful when used well. It helps to identify key variables and their functional interrelations in the problem at hand. It heIps to turn general wonderment into coherent thought, to convert unstructured conjecture into consistent deduction, to provide systematic speculation amenable to real-world examination.

But not all possibly pregnant wonderment, conjecture and speculation can be readily reduced to neat, self-contained models. Not everything worth concern and consideration can be measured to the fourth decimal place. One need not denigrate formal rigor and manipulative elegance to note the need for imagination, erudition and wisdom. Esoteric technique cannot well substitute for sophisticated sense.

A model which serves well in its own proper province may require considerable adaptation for other proper questions and purposes. The economic theory of “perfect competition” is a case in point. It typifies much of economic thought of the past century. Many modem economists have worried much about how to make the most efficient use of resources now available to the community.

The theory of perfect competition tells us the conditions--conditions of costs and production, price and purchase--which must be satisfied in a market of many sellers and many buyers if efficiency is to be attained. But it is a theory of a particular kind of market in a context that is largely static, not to process and evolution over a substantial period of time.

A major economist of the twentieth century, Joseph Schumpeter, tried to push out the boundaries of our concern. The real world is one of change, and the life of the market is one of flux and adjustment stemming, in part, from *innovations.* Innovations may involve a new product, a new method of production, a new market, a new source of supplies, a new organization.

Being first--first in lowering cost, first in merchandising--establishes a degree of monopoly. Monopoly power tends to be quickly diluted. Still, progress calls for innovation, and the innovating entrepreneur is trying to get a monopolistic edge which generates profit. Some degree of seeming short-term inefficiency may be a necessary but tolerable cost of greater long-term productivity-- although it is not convenient to incorporate such insightfulness into mechanical models.

Does this mean that Professor Schumpeter favored monopoly for its own sake? Does his picture of market activity wholly vitiate the competitive model? No. But short-term static efficiency is not everything. The competitive model, while answering some important questions, does not well explain the actual world dynamics of innovation. Let the model fit the world.

Questions for Thought and Discussion:

1. If you could not have a monopoly for a period of time on a substantial new innovation, would there be more or fewer innovations as a result?

2. If a completely new product is created by an innovator, does the consumer welfare cost of monopoly output restriction accurately reflect the change in consumer welfare that results?

3. Why might one be more favorable to a monopoly arising from a new innovation than one created by government restrictions on entry to an industry?

4. Why might one oppose permanent monopoly protection for a new innovation?

5. Might efficiency over time require some inefficiency at a given point in time?

**8. The Sense of Auntie Trust The Midnight Economist**

“It’s wonderful to have Auntie visit us,” Mouse Karl squeaked to his mouse friend Adam.

“Yes, indeed,” affirmed Adam. “Tell us, Auntie Trust, about your work as the government’s top guardian against monopoly.”

“You must have your whiskers full,” suggested Karl, “trying to wiggle a little competition into the marketplace.”

“Not exactly,” Auntie Trust answered. “I have more difficulty opposing sellers who want to use my authority to *restrict* competition.”

“I don't understand,” puzzled Karl. “Don’t you prevent businesses from monopolizing the marketplace? I thought the Sherman Act, the Clayton Act and other important laws empowered your office to stop monopolists from picking the pockets of mouse consumers.”

“That’s what most mice suppose,” replied Auntie Trust. “But often it’s the other way around. Many mice oppose a particular merger of firms because they believe its success will encourage more mergers in the industry. The result would then be fewer competitors.”

“Correct!” chortled Karl. “Less competition. Don’t you outlaw monopolistic mergers.”

“Hold on,” said Auntie Trust. “Neither the number nor the size of businesses in a given market is a good indicator of the degree of ‘monopoly power.’ A smaller number of larger firms can be more efficient, and that means lower prices for consumers. If a merger would create a more efficient enterprise, other firms in the industry would have to become more competitive to survive. Rather than confronting increased competition with greater efficiency of their own, the firms often try to use my authority to block the merger in the first place--and they do so in the name of protecting competition.”

“But what about ‘predatory’ pricing?” asked Karl. “History seems full of examples, such as John D. Rockefeller’s Standard Oil Company, when big, wealthy businesses cut prices below costs and drove out competitors. Don’t you have to use government power to prevent monopolistic price wars?”

“Predatory pricing is more myth than reality,” responded Auntie Trust.”Rockefeller did *not* use costly price wars to drive rivals out of business. No matter how big or wealthy, no business would long find it worthwhile to sell appreciably below its cost in an uncertain attempt to put a competitor out of business. One company may *purchase* another, as Standard Oil bought other oil companies, but that strategy takes us back to evaluating the effects of mergers.”

“Then why do many who complain about predatory pricing ask you to restrain price cutting in the name of competition?” asked Karl.

“Mostly because they want to prevent a more efficient company from underselling them,” replied Auntie Trust. “It may seem as though these complainants are trying to *preserve* competition, but actually they are trying to *restrict* it. What they want is *not competition,* but *protection from competitors.* In the world of your dear old Auntie Trust, what seemingly is, often actually isn’t.”

Questions for Thought and Discussion:

1. When would consumers oppose mergers of suppliers? Would rival producers oppose those same mergers?

2. Would the fact that more than 90% of antitrust suits are brought by rivals tend to make you think their primary effect is to encourage or discourage competition?

3. Why do you think trying to drive rivals out of business by selling below cost would be an unprofitable strategy?

4. If there is little evidence of actual predatory pricing, why do firms charge others with doing it?

**9. Small Firms, Opportunity and Growth The Midnight Economist**

“In numbers there is strength,” and “the more, the better,” it is often said. Well, perhaps not always--as with wives and children. But many and much can be promising in some categories and circumstances.

This may be the case in the context of “market structure.” Producing and transporting and selling are done mainly through business firms. Business firms are born and organized and directed through the coordinated efforts of innovators and investors and managers. Resources are committed to such endeavors at considerable risk, in the hope of adequate returns. Those firms will prosper most who best employ productive inputs in responding to preferences of consumers. And consumers, in turn, delight in market options, in many suppliers vying with energy and imagination and boldness to please buyers.

The existence of many firms contributes to much consumer-pleasing competition. And the increasing number of firms is a response to high and expanding consumer demand. The rapid forming of firms both reflects and contributes to the robustness of the economy.

A flourishing economy is one of eager exploitation of expanding economic opportunity. By that critical criterion, the American economy is flourishing.

It generally takes much time and always takes much success for a firm to grow to great size. Most firms are born small. The vitality of the economy is reflected largely in the rate of birth and growth of small firms. And small companies are proliferating.

From 1970 to 1983, corporations expanded impressively in number, receipts, and assets. In numbers and receipts, at least, the picture is dominated by firms with assets no more than one million dollars. Such firms doubled in *number* over the thirteen year period, accounting for more than 99 percent of the increase in all corporations; in 1983, they were over 91 percent of the total. And in *sales*, the proportion of corporations with less than one million dollars increased from three out of four to five out of six.

Large corporations are *not* disappearing dinosaurs. But the wave of the future may not be characterized so conspicuously by “bigness.” Liquidity and mobility of resources may be more important that economies of scale in manufacturing.

We cannot *know* the future. We best *shape* the future not with concrete five-year plans of centralized direction, but by general fostering of economic opportunity. One manifestation of economic health is the vigorous formation of small firms.

Questions for Thought and Discussion

1. Why would the number of new firms being formed be a useful indicator of economic opportunity?

2. How did firms that started as proprietorships and partnerships become some of the largest corporations today?

3. If the proportion of output produced by large firms increased, would it make a difference in analyzing the consequences whether that resulted from more small firms growing to become large forms or from the same large firms increasing their share of total output?

4. Do economies of scale favor large or small firms in their competition for consumers’ favor? Why? What advantages do smaller firms have in that competition?

**10. Choices, Advertising, and Freedom The Midnight Economist**

It is sometimes said that the private-property, free-market economy is subject to “consumer sovereignty”--consumers reveal their preferences by “voting” with their dollars for what they want.

There is no dominating consumer sovereignty, economist Harold Demsetz points out. Exchanges will be made when they appear advantageous to all parties involved. Neither producer nor consumer, neither one trader nor another, imposes his will on the other. *Each* hasonly the right to offer for sale or to purchase. Exchange is not coercion; it is not imposed on others. No trade takes place if consumers are unwilling to bid prices deemed adequate by potential sellers. Similarly, producers make no sales if they are unwilling to sell at prices as low as those offered by potential buyers. Buyers who demand Cadillacs at a price of $1 will be disappointed; so will suppliers who ask $1 million. Neither buyer not seller is sovereign.

But professor J.K. Galbraith discards the notion of consumer sovereignty on the grounds that consumer wants have been molded by advertising. This results in something approaching *producer* sovereignty: producers supposedly make what they happen to please and convince consumers that that is what consumers want.

Now, at any given moment, people are characterized by certain preferences. And we can have some interest in how those wants came into being.

Wants are shaped--but by many forces in addition to advertising. Not only Madison Avenue, but also Washington, D.C., the Church, Mother, schools and Galbraith himself are among the forces which form wants. Our beliefs and tastes *are* to a large extent learned: civilization itself is, in considerable measure, a matter of teaching and learning beliefs and tastes. But it is *not* clear that *business firms* have a unique advantage in want-creating activity. Washington enjoys free press and TV coverage and is immune from anti-fraud laws. Professors are protected by academic freedom. Clergymen can offer, with impunity, everlasting life. Most of what I know I learned at my mother’s knee and other low joints. But *business* people are constrained by innumerable provisions of law.

Galbraith fears that people are persuaded of their supposed wants. And we are to ignore these wants because they are not “natural” or “inborn.”

But freedom surely means more than the right to exercise only the elemental instincts of untutored “noble savages.” Freedom must mean the right to *choose* among offerings. If choice is to be meaningful, a free society must rely on a free flow of communication--information and persuasion--from those who *compete* for the favor of adults. There must be *competition* to provide *alternatives.*

Give me options--and then stand aside while I make my own choices.

Questions for Thought and Discussion:

1. Why might “mutual sovereignty” be a better term to describe market results than “consumer sovereignty”?

2. Would it be more accurate to say that consumers are sovereign over what goods are produced in a market system or that consumers are sovereign over which of the goods will continue to be produced and which producers survive to continue in production?

3. Say that there are 10 different producers of laundry detergent. an all of them exercise “producer sovereignty” over a purchaser of detergent at the same time?

4. What are some of the ways in which competing business firms are more constrained in trying to change your preferences than are government officials?

**11. Advertising and the Demand for Mouse Wash The Midnight Economist**

Adam and Karl, were arguing the merits of advertising. Adam had returned from shopping and surprised Karl, who was nibbling on a piece of honey wheat berry bread, his favorite food.

“Look at what I bought,” said Adam excitedly as he reached into a bag of mouseries and pulled out a red bottle of mysterious fluid.

“What nonsense is it this time?” questioned Karl in a patronizing tone.

“It's a bottle of mouse wash,” answered Adam. “It’s that new product advertised on television. A capful in the morning bath will eliminate offensive mouse odors all day.”

“Superfluous junk,” railed Karl. “Another victim of advertising. You’ve confirmed my belief that advertising should be banned in the public interest.”

“That’s ridiculous,” responded Adam. “Advertising gives me a lot of information: it tells me about new products, their prices and where they can be bought.”

“That's just it,” said Karl angrily. “Advertising makes you want things you would never have wanted on your own. Producers don’t make what consumers want; advertising makes consumers want what producers make.”

“Nobody *forced* me to buy the mouse wash,” retorted Adam. “It was my money; it was my choice; and now it is my mouse wash.”

“But don’t you see,” persisted Karl, “that your desire for mouse wash is a *contrived* want--a want which would never have existed without the persuasion of advertising. It’s a shame that so few of your wants originated with you and not with advertising.”

“Poppycock,” snapped Adam. “Is your preference for honey wheat berry bread wholly an ‘original’ want? Mice do not live by bread alone. Just about everything we want is learned to some extent. We were not born with our present preferences for the kinds of food we cat, the clothes we wear, the music we listen to, or the literature we read. All these wants, and many more, were learned--and continuously relearned as our tastes have been molded through our lives. There are all kinds of persuasive elements in society--parents, teachers, clergymen, politicians, girl friends--telling us to do this and not to do that, to admire some things and shun others. Advertising is but one of those many elements.”

“Preposterous!” said Karl. “Look at all the unimportant, nonessential goods mice now buy but would not buy without advertising. They are silly, contrived wants.”

“That's the point,” Adam said calmly. “You can say that all wants have been contrived in the sense that we learned them. But that does not make them imaginary or any less important. Just because you don’t agree that mouse wash is a useful good doesn't mean that it is unreal or unimportant to me. Because you can't understand why other mice could possibly want things you do not, you suppose they must be dupes of advertising. Wouldn’t you say you are being an elitist?"

Questions for Thought and Discussion:

1. Do you think there would be as much of honey wheat berry bread or other higher quality products available for sale if advertising was not allowed?

2. If all our preferences and situations were very similar and stable, would advertising be more or less valuable than if our preferences and situations were very different and changed often?

3. Is TV advertising for a product you know you would never buy a waste of resources?

4. Is local advertising of more value to person who has lived in a town his whole life or to someone who just moved into town?

5. How many of your wants originate completely with yourself?

**12. Duopoly and “The Alehouse Rock” The Midnight Economist**

If Parker Brothers had designed its game so that two people always won, it would have been called “Duopoly” instead of “Monopoly.” Critics of the Justice Department's antitrust policy argue that its anti-merger antics are helping to create a duopoly in the beer industry.

The Justice Department may have prohibited mergers which would have *increased* beer competition. The department's restrictive policy is to forbid mergers within an industry when those mergers would meaningfully add to the industry’s concentrationa measure of how much of total sales is accounted for by just a few firms. A duopoly would have a high degree of concentration, for all of the industry’s sales would be made by only two companies.

Higher levelsof industry *concentration* are naively presumed to lead inevitably to less *competition* among the firms of the industry. Since more concentration means fewer rivals, it is supposed that price-fixing is more likely to occur. But as put by Yale Brozen, of the University of Chicago, “Sure, there’s a temptation to fix prices, but it isn’t as strong as the urge to put one over on your competitors.”

The *desire* to collude and thereby to raise prices must be distinguished from the *ability* to do so. Not only is it difficult for rival companies to agree on the production cuts each must make in order to force up price, but it is difficult to prevent each company from undercutting the others in order to increase its sales. It is unlikely that, without--and sometimes even with--government support, firms will long curb their rivalry--even in industries with high levels of concentration.

The beer industry has become more concentrated: the number of breweries has dropped sharply, and ten of them now account for over 95 percent of all beer sold. The combined shares of the two biggest breweries, Anheuser-Busch and Miller, have also foamed sharply upward in recent years. This growth does not necessarily mean that competition is being eroded or that beer consumers are being harmed. Instead, it may reflect basically the community’s reward to those companies for their efficient, consumer-satisfying activity.

Still, competition requires competitors, and government antitrust policy has been blamed for helping, not restraining, the relative growth of the two biggest breweries. It has done so by preventing merger of smaller companies, such as Heileman and Schlitz. But instead of resulting in excessive concentration, such a merger could have created a healthy, robust rival. A business publication called it “...the single acquisition that might have significantly slowed Anheuser’s growth and made the industry more competitive.” But thanks to the Justice Department, consumers will not have the opportunity to vote in the market in order to reward or punish this new challenger. In the name of fostering competition, the birth of a consequential competitor has been aborted. The two biggest breweries have reason to rejoice at the department’s protective ruling.

Questions for Thought and Discussion:

1. How can a merger, which decreases the number of competitors in an industry, increase competition? How does your answer relate to economics of scale in production?

2. Suppose Anheuser-Busch and Miller grew to sell the majority of the beer in America by spending megabucks on advertising and promotion. If rivals also had access to advertising and promotion on the same terms, would there be any reason to term the results “unfair” or not in consumers’ interests?

3. How does the ease of new entry into a market affect how competitive a market is, for a given number of existing competitors?

4. What would you conclude about the effects of a proposed merger of smaller brewers on competition in the beer industry if Anheuser-Busch and Miller opposed it? What if they favored it?

**13. OPEC and the Complications of Cartels The Midnight Economist**

The course has never been wholly smooth among the nations of OPEC. Still, the cartel, with its price and production-control maneuvers, was a mighty force in the 1970s.

OPEC is not dead, but it is now a Samson with a crew cut. Its difficulties have steadily grown since 1979. It now reacts to rather than dictates to the world petroleum market. And the reactions are not entirely peacefully orchestrated within the family. Each member would like to maintain sales at high prices; it has become apparent that either sales or prices will have to be reduced; but the members differ on how *much* to adjust sales or price and on how to *distribute* the adjustment costs among themselves.

It is not surprising that the power of OPEC would be diluted over time. The rest of the world has curtailed consumption, developed alternative supplies and accumulated strategic reserves. And it is not surprising that, with the dilution, members of the group would break ranks on how to make disagreeable adjustments to deteriorating circumstances.

In broad outline, the rise and decline of OPEC is consistent with the troubled history of cartels. Contrary to common mythology, cartels have *not* been readily formed and highly effective over prolonged periods, and the world of commerce is not dominated by beady-eyed, cigar-chomping, rapacious cartelists.

It is not easy to organize a cartel, melding highly autonomous organizations into a monopolistic facsimile. There are markets to divide, prices to set, and production quotas to assign. Successful operation is even harder than initial organization. embers must remain persuaded that they enjoy net benefits from collusion compared to acting as independent agents. The more profitable the collusive efforts, the greater the incentive for outsiders to seek admission or to organize their own club or individually to compete. The more numerous the participants and the more lucrative the tightening of the screws on consumers, the greater the temptation for individual members to cheat--and the greater the fear of each that some *other* member will cheat.

Long-term survival of the cartel has two fundamental requirements: first, cheating by a member on the stipulated prices, outputs and markets must be detectable; second, detected cheating must be adequately punishable without leading to a break-up of the cartel. Because of competition--overt competition from outside or *sub rosa* competition within--effective cartels cannot expect a long life.

OPEC has cracked its big whip longer than have most. Many initially doubted that it would last as long as a decade. The longevity may be attributed largely to the cartelists being governments rather than corporations, to the tribal emotionalism which stoked stubborn ambitions and to inept responses by oil-importing countries. But even OPEC has found competition of the market to be a formidable foe of collusion.

Questions for Thought and Discussion:

I. Would government-sponsored or legal cartels be more effective than ones that aren’t?

2. Why will even successful cartels tend to break down over time? Why might they break down more in hard times than in good?

3. How can government agricultural price supports and production restrictions generate results like an agriculture cartel?

4. Why would countries with far larger oil reserves and current outputs be less likely to cheat on OPEC and more likely to be pricing “moderates” than smaller members with more limited reserves?

5. How did domestic policies, such as crude oil price ceilings, that held down U.S. oil output, help OPEC?

**14. Dollars and Scholars, Cartels and Competition The Midnight Economis**t

Especially in “higher” activities--including education--some are pleased to pronounce standards of refinement and punish transgressors. Sometimes they believe their haughty foolishness.

Consider, with economists Armen Alchian of UCLA and William Meckling of the University ofRochester, intercollegiate athletics andtheir supervision by the National Collegiate Athletic Association.

The wholesome competition of the gladiators camouflages collusion of the schools, with the NCAA being the enforcement agency of organized exploitation of the athletic employees. The athletes are paid, of course. So are students who work in the library, the bookstore, the dormitories, the labs. But maximum payments to athletes are specified by the national collegiate cartel. Why the discrimination against athletes?

Successful athletic programs can generate enormous revenues, so the players are very valuable. And those revenues directly and indirectly aid the financing of the entire school, not just the athleticdepartment. There is, then, the incentive to curtail wages of the athletes in order to maximize net income to the school.

A given school could not long compete--and generate that massive income--if it *uniquely* paid below-market wages to its athletes. Any school not meeting the labor market competition would have inferior teams and small gate receipts. But employee exploitation not practicable for an *individual school is* feasible when done by *all* schools under enforced agreement.

The cartel agreement does have to be enforced. For there is temptation to cheat by surreptitiously paying players something closer to their free-market worth. Correspondingly, there is incentive for schools to squeal on each other when they see rules being broken by competing institutions. Finally, authority of the endorsing agent--the NCAA--is great, for flagrant cheaters would lose academic accreditation, which would cost the school more in lost government and philanthropic subsidies than even the potential athletic profits.

One might justify prohibition of intercollegiate athletics, now packaged and promoted by colleges for sale to the community, for such activities could be construed as diluting the purposes and diverting the activities of higher education. And one might justify non-cartelized, non-exploitative athletics, with each school determining how and to what extent it will participate in open competition of the market.

But it is surely unseemly to play the game (pardon the expression) of cartel monopolization and exploitation in the name of genteel cooperation and protection of purity, the game of subterfuge and inconsistency in the name of academic honor and intellectual sophistication.

Questions for Thought and Discussion:

1. Who are most exploited by the NCAA’s “maximum wage” for student athletes? Why does this make college recruiting so important to athletic success and so subject to abuse?

2. Do the NCAA restrictions help explain why college coaches are so concerned that star athletes “complete their education,” while sometimes being far less concerned about how much they learn from that education?

3. Are rookie salary caps in various major leagues similar in effect to the NCAA restrictions on compensation for star players?

4. How can the NCAA enforce its cartel without the explicit power of the government behind it? How can the major leagues enforce their caps?

**15. Minimum Wages, Market Wages, Employment, and Income The Midnight Economist**

“I'm so ticked off,” cried Mouse Karl.

“Sorry to hear of you” tick and flee problem,” responded Mouse Adam. “What is the cruel cause of your current crisis?"

“Poverty!” shouted Karl. “There is too much of it and it could be so easily eliminated, but the callous fat-cat members of the community don’t care”

“There *is* poverty,” said Adam soberly, “even in this land of relative milk and honey. But I had not supposed that it could be easily and quickly corrected simpIy by civilized concern.”

“Sometimes you seem innately inane,” snarled Karl. “People are poor because of low income; most income is received as wages; higher wages thus mean greater income; so we can get rid of poverty by sufficiently raising the legal minimum wage.”

“You do make it all seem pretty simple-minded,” replied Adam. “Just what is a ‘sufficient’ increase in wages?”

“Be bold," boldly suggested Karl. “Make the minimum hourly wage higher”.

“Bold?” asked Adam. “Make it $45 or $450 an hour!”

Karl twitched his tail nervously. “We have to be realistic,"”he grudgingly suggested. “Not many would be hired at wages that high.

“Precisely,” confirmed Adam. “What is income to the worker is cost to the employer. It is not good for one’s economic health--whether he be a consumer or a supplier--to pay more for something than it is worth.

The market value of labor services is determined by what the worker does, how well and attractively he does it and how many other workers are available to do the same thing. Unhappily, some people are not in a position to offer labor services which the community values very highly. If government then makes it illegal for those people to sell their services at low market prices, the services will not be bought. Pegging wages above market levels reduces the already limited competitive powers of people who are young, untrained, inexperienced or otherwise disadvantaged. Pricing workers out of the labor market--denying them both income and work experience--is a pretty peculiar anti-poverty program.”

Karl was crestfallen but no longer so confused. “Well,” he sighed, “if there is to be employment only at market-determined wages and if market wages reflect economic productivity, then evidently the only way to raise wages is to increase productivity. We will live better only if we produce more. And we *can* become more productive. But that will require much sense and commitment and investment--and time. No politician’s quickie gimmick of market subversion will make us wealthy.”

Questions for Thought and Discussion:

1. Is the claim that raising the minimum wage to $10 or $15 andhour won’t reduce low-skill employment consistent with the claim that an even higher minimum wage would reduce low-skill employment?

2. Why are the very lowest skilled workers the ones most likely to be harmed by an increase in the minimum wage?

3. How could raising the minimum wage reduce on-the-job training for minimum wage workers, slowing the growth in their wages over time?

4. Why might higher-paid, more skilled workers find a higher minimum wage for low-skill workers in the same field in their own self-interest?

**16. Workers and Employers, Wages and Profits The Midnight Economist**

The labor market is, indeed, a market, where something is bought and sold at a price. How much is exchanged on what terms?

As a supplier of labor services, what do you have to offer? What talents, skills and mannerisms do you have; what can you mentally and socially do? How unique is your product? In light of what you can do and of how many others can do it, how attractive are you to potential buyers? And what are your alternatives either in competing for a variety of jobs or in getting by without working at all?

There are considerations from the demanders’ side, as well. A buyer will buy, as a seller will sell, only if he anticipates gaining from the transaction. And a buyer will pay a price no higher, as a seller will accept a price no lower, than seems to him sensible, given his objective and alternatives.

As in other markets, activity is guided and results are generated by forces of supply and demand in a context of competition.

But the real competition is not all workers against all employers. When I seek a job, I compete with those *other workers* who are trying to get that job. If you get the job I wanted, you were more attractive to the employer than I was, either because you were judged to be physically more productive or because you were willing to accept a wage low enough to offset my superior productivity.

I do *not* Iike fellow workers competing with me. The competition I *do* like is among employers. The wage one employer is obliged to pay for labor is affected mightily by how much other employers are offering and it is a happy situation for me when rival employers bid against each other for my services.

So competing workers offering labor lower my wage and competing employers bidding for labor raise my wage.

Organizing workers into unions does not change the fundamentals. A union may raise particular wages--and thereby reduce the number employed in that line of work. Those displaced workers then increase labor supply elsewhere, reducing wage rates there. Unions redistribute wages *among* workers rather than raise all wages.

Even in principle, wages cannot be increased perceptibly by further reduction of profits. Wages already account for some 75 percent of domestic income and after-tax profits only a small fraction of that. Aggregate wages can rise only if national output is increased. Output will be raised, not simply by working harder, but by saving and investing more, managing better and innovating with greater boldness. But resources will not be used more effectively by destroying the profits which provide much of the motivating engine and the guiding rudder of the economy.

Questions for Thought and Discussion:

1. Why will developing skills of value to others as well as to your current employer tend to increase your wages faster than just developing skills valuable to your current employer?

2. Do unions make workers better able to compete with employers, or do they restrict other workers’ ability to compete with current employees for their jobs?

3. What is the predictable result of unionization on wages in the non-union sector?

4. What does opening a new competitive sports league tend to do the salaries in the original league?

5. Why would a large new employer who hired only men coming to a town tend to raise women’s wages?

**17. The Plight of the Paycheck The Midnight Economist**

Are real wages falling? The answer depends on how they are measured.

If the rate of pay fails to include noncash benefits like medical insurance, then one measure of the average real wage has fallen for more than two decades. But fringe benefits are part of wages. And for years Americans have been substituting more benefits for cash. Total hourly compensation, including benefits and adjusted for inflation, tell a far different--far more optimistic--story.

Still, this broader measure began growing more slowly after the late 1960s. Why? Might paychecks be leaner in the future?

The answer begins with productivity of labor. Higher real pay comes from baking a bigger economic pie, not from somehow grabbing a bigger slice of an existing one, perhaps by stealing from profits. Indeed, labor compensation already represents about 75 percent of the nation’s total income. In contrast, corporations’ before-tax profits are only some six percent. So workers must produce more per hour if their average hourly wage is to rise.

Rising labor productivity generally has lifted real wages throughout our history. Yet, about twenty-five years ago, productivity growth began to slow. Predictably, decline in growth in real wages soon followed.

Why, then, did productivity grow more slowly? We have no simple answer. But we know that labor productivity rises because people have more tools and better technology to use. And we know that new tools and technology come from businesses making risky investments.

Investments are risky because businesses will lose wealth if consumers don’t buy what the new investments produce. The risks are not taken mainly by customers, employees or creditors. They are borne most directly by business owners--the proprietors, partners and stockholders who bet their personal wealth that they can well anticipate and efficiently satisfy consumers’ preferences.

Business owners bet their wealth on new investments only when they anticipate personal gain. Yet, the profitability of new investments has fallen since the 1960s, reports the Survey of Current Business. In 1965, before-tax profits for nonfinancial corporations represented almost 14 percent of their invested capital. By 1990, the rate of return had fallen to only 5 percent. The rate of return and the growth of productivity and of real wages all show a sharp decline since the mid-1960s.

The lower rate of return has depressed growth of real wages. For when business owners earn smaller rewards for risking their wealth, they make fewer new investments. And when workers use fewer new tools and technology, their productivity and wages rise more slowly.

Questions for Thought and Discussion:

1. How can average real wages fall and average real compensation rise at the same time?

2. Why can’t worker compensation be substantially increased by forcing corporations to spend a larger fraction of their current profits as compensation to workers?

3. Why could lower taxes on business profits increase workers’ real compensation over time?

4. Are workers and their business employers better viewed as competitors with one another or as complements to each other?

**18. Efficiency, Productivity and Wage Rates The Midnight Economist**

Asserted Karl, “I have discerned a massive, fundamental error in economic analysis.”

“I am not amused,” mused his mouse associate, Adam, “by massive, fundamental errors.”

Karl hastened to explain. “You and your economist friends often speak of *efficiency* in production. And efficiency, as I understand it, calls for each person to specialize in doing what he does best.”

“Well,””murmured Adam, "efficiency *does* have to do with exploiting differences in productivities."

“That's what I said,” said Karl. “But the theory cannot work in the real world. There are millions of mice, but there are not millions of different kinds of jobs. It cannot be the case that each job is done by the mouse who does it better than can any other mouse. To put it differently, you know that not every mouse is the very best mouse in the whole world in doing some job. So efficiency would mean that most workers could have no job, for most workers are not the world’s best in doing anything. And having most workers unused can’t be very efficient.”

“True,” agreed Adam, “most of us would find no place in production if the only ones to work are those who are absolutely the best in their respective occupations, if ‘absolutely the best’ means turning out the most widgets per hour. But there is work to be done--and done efficiently-- even by those who do not have a physical input-output advantage in producing anything, if they will work where their *disadvantage is least*. Most of us are not the best in anything, but we are *relatively less* bad in some jobs than others. Each of us should work where we are least bad. Compared to me, you are slow in making widgets, but you are still slower in making gadgets, so the community gives up very little when you make widgets instead of gadgets.”

“But,” carped Karl, “how could I compete with you in the market if I am slower than you in producing everything? Being simply less slow in one kind of job than in another is not good enough. The economy sacrifices relatively few gadgets when I make widgets, but no widget producer will hire me instead of you.”

“But he will,” assured Adam, “”rovided that your money wage compensates for your inferiority. Comparatively speaking, you do best in producing widgets. You turn out only half as many widgets per day as I do, but you do even worse compared to me in any other job. And you can undersell me in the widget labor market if you accept a wage rate less than half of mine. Your *low money wage* more than offsets your *physical disadvantage, and* the wage-expense per widget would be less when employing you instead of me.”

“So,” exclaimed a relieved Karl, “people of relatively low physical productivity can compete by receiving still lower money wages.”

“And,” added Adam, “high wages are high because they reflect high output.”

Questions for Thought and Discussion:

1. What is the logic of the difference between comparative advantage and absolute advantage, with respect to efficiency?

2. If efficiency required absolute advantage, how many houses, factories, cars, farms, etc., would be efficient? hy are people, capital, equipment, cars, etc., used even when they aren’t "the best"?

3. How do wages and prices, if they are allowed to vary in response to market forces, compensate for absolute disadvantages? What would wage and price floors do to the well-being of the lowest quality (absolutely most disadvantaged) resources available for sale?

4. If you could mow the lawn half as fast as your brother, when would it be efficient for you to mow the lawn? What if you were twice as fast? What is the opportunity cost principle involved?

**19. Employment and Wages, Competition and Fairness The Midnight Economist**

The editorial writer was speaking about employment and wages.

There is something wrong with “the system,” he said, for there are more workers than jobs: “there is never a surplus of jobs,” and the unemployment rate is invariably greater than zero. Even those who have jobs, he added, are not likely to be paid what they are worth, for the market is “always a buyer’s market,” tilted in favor of the employer. Daddy Warbucks can decide by whim how many and whom to hire and on what terms, while the poor but honest worker can only accept whatever is offered.

The unemployment rate *is* greater than zero. The way the measurement is made guarantees that. An officially unemployed person is one who declares himself to be part of the labor force--he wants a job and purports to be looking for one--but does not have a job. But both the notion of “the labor force” and the notion of “unemployed” are based heavily on estimates, preferences and tactics of people. A person may falsely declare himself to be a job candidate to qualify for welfare aid. He may be interested in a job but price himself out of the market with an unrealistic assessment of either his productivity or of demand for his sort of services. He may be sensible but feel inadequately informed about market options and is currently searching for information--and the more generous is unemployment compensation, the longer he is inclined to search.

So there is always some unemployment--thank goodness. If everyone is always to be employed, a worker could not quit a job for any reason, including investment of time and foregone current income to seek a better job.

The problem of unemployment is not jobs being fewer than workers. On *some* terms, a job is *always* available in an open market. But a wage and the hours of labor required to earn it can be so unrewarding that a person is rational to decline the job offer and remain unemployed.

The more valuable the worker, the higher the bid for his services. The high wage offer reflects rational concern of employers for their well-being, not a delicate sense of altruism or fairness. If you are technologically efficient in performing services which the community values highly, and if relatively few other workers are so productive, you will prosper. It is competition among the hateful employers that raises wages, for they must bid against each other for labor to supply demanded products and thereby earn rewards. And it is competition among the lovable fellow workers that holds wages down by providing alternatives to employers.

Questions for Thought and Discussion:

1. Why would we not want the unemployment rate to be zero?

2. Why is it not clear whether the official unemployment rate over- or understates the “true” degree of unemployment?

3. Would you want to live in a house where the bathrooms, kitchens and bedrooms were fully “employed” 24 hours a day?

4. Why does the *Midnight Economist* insist that workers don’t compete with employers, but that employers compete with other employers and workers compete with other workers?

5. Who do students in your class compete with?

**20. Sweatshops: Outrage and Analysis The Midnight Economist**

A major newspaper has run a series of stories and commentaries on southern California sweatshops. We are told much of morality and legality; but we are provided no analysis of economic efficiency or policy efficacy or appropriateness in personal adaptation to cruel circumstances.

In the garment industry, retailers--dress shops and department stores--buy merchandise from manufacturers; the manufacturers may contract with others to supply them; the contractors may sub-contract with sewing shops, which do the actual producing. The retailers, the manufacturers, and even the contractors may do well; the hard-pressed, viciously competitive sewing- or sweat-shops and their women workers do *not* flourish.

Journalists and political sorts deem sweatshops to be evil, and evil is to be directly eradicated. We are to pass strict laws, strictly enforced, to abolish low pay, long hours, unpleasant working conditions (including work at home) and use of children.

But is that really the end of the story, the end of analysis of the problem, the end of policy prescription? We simply outlaw the scourge of sweatshops and walk away in prim satisfaction?

What is to happen to the erstwhile workers--commonly uneducated, poorly trained, illegally in a land foreign to them, with little experience and marketplace sophistication--who have had their livelihoods abolished? They had been surviving--even if meanly by civilized standards-- in market competition by selling their limited services of low value at meager wages. Taking away those miserable jobs, pricing them out of what had been their best option, does not magically provide them with better alternative employment. Reducing their already poor power to compete, leaving them more handicapped than before, is a strange way to help them.

The sweatshop situation does have tragic elements. But to alleviate the tragedy, we must get straight the base of the tragedy. It does little good to damn greed, for all of us--not just garment producers and sellers--are afflicted by abundant greed. The real source of the terrible circumstances of sweatshop workers is their few and unappealing alternatives. With better options, they would leave the sweatshops.

They do not voluntarily leave, for they have no better options, either here or in their native lands. Why not? Because they have little of value to offer in the labor market. And they have little to sell because they have little education and training, little geographical mobility and knowledge of employment possibilities, and their condition is made still harder by having no resident husband and too many children.

A policy which helps to generate a solution will have to deal with enhancing the productivity and market effectiveness of these workers. Abolishing their jobs can hardly help. Moral outrage has its place. But it is not in adequate substitute for systematic thought.

Questions for Thought and Discussion:

1. Are “exploited” workers who choose to work long, hard hours for little pay benefited by laws that ban working for so little?

2. How long would you continue to work at your current job at your current pay if both you and your employer knew you had a better job offer pending?

3. Why would improved education and training help raise incomes of sweat-shop workers more successfully than mandating higher wages for such jobs?

4. Why do you think international migration, legal and illegal, is hugely affected by the state of the economies in different countries?

**21. Measuring Income Inequality The Midnight Economist**

In a system of capitalism, personal income is determined basically by productivity: those prosper most who produce much of what the community values most highly.

Since productivity varies much over the population, income shares vary much. Indeed, income varies widely in all societies.

Still, some of us are irked by and worry about the extreme ends of income distribution. If the rest of you shared my preferences, then gladiators and clowns--including baseball players, TV network anchor types and other comedians--would not command annual salaries in the millions. And none of God’s children would have to survive with only a few thousand dollars a year.

Whatever the “appropriate” or “legitimate” amount of income inequality, just how unequal is the distribution? To use one well studied example, the average income in the best paid one-fifth of working families was six times larger than the average in the lowest fifth. Whether or not a ratio of 6 to 1 be deemed scandalous, that measure greatly distorted reality as detailed by Robert Rector and Kate Walsh O’Beirne, of the Heritage Foundation.

First, there are *taxes.* Even a flat-rate income tax substantially reduces the dollar amount of after-tax differential: a 30 percent tax paid by everyone cuts the pretax income difference by 30 percent.

Second, gross data of family incomes ignore differences in *sizes* of families and in number of *workers* per family. Contrary to mythology, the average household in the top one-fifth of incomes is larger than that in the lowest bracket, so per capita incomes are closer than family incomes. Better-paid families also have more wage-earners than have poorer families--and the market *productivity* of those workers is greater.

Finally, the Census Bureau traditionally counts only *cash* income--before taxes, at that-- and it undercounts cash and especially noncash *government assistance.* Oddly, it manages also to count some government assistance to relatively well-to-do families more fully than the same kind of aid to poorer families. Altogether, government spending on low-income families is undercounted by 50 percent.

After appropriate adjustments in the data, income of the top one-fifth of households was not six times that of the poorest families; instead, the ratio was about 2.8 to 1. Indeed, comparing families with at least one full-time worker, we find the after-tax per capita ratio was less than 2 to 1.

Questions for Thought and Discussion:

1. Why would per capita consumption likely be far less unequal than per capita incomes in a given year?

2. Do you think people stay in the same part of the income distribution their entire lives? What difference would it make if they did not?

3. Why would an increase in the proportion of very young and very old household heads and an increase in divorce rates tend to increase measured income inequality?

4. How could increasing the amount of in-kind aid (not counted in the income distribution data) to poor people lower their market earnings and thus increase measured income inequality?

5. Why would attempts to redistribute income by taxing high income doctors very heavily result in even higher pre-tax earnings by doctors over time? (hint: would as many people become doctors in that circumstance?)

**22. Sneaky Taxes The Midnight Economist**

“A great idea,” bubbled mouse Karl. “Congress wants to give workers health insurance, unpaid leaves for new parents, day care for children, advance notice of plant closings, and more.”

“These goodies are not gifts,” said Adam. “Who will pay the immense cost?”

“The solution is obvious,” answered Karl. “Clever politicians just require businesses to provide them.”

“Sounds like a sneaky way to raise taxes,” Adam sensibly surmised.

“Nonsense!” snapped Karl. “Employers would be required simply to give workers the benefits they deserve.”

“But you ignore the productivity of labor,” admonished Adam. “Workers can be paid either in money wages or in benefits. If money wages are reduced to make room for increased benefits, total pay does not rise. But that is not what politicians propose. By mandating benefits, they will push workers’ pay above their productivity and thereby increase employers’ costs of production.”

“So what?” responded Karl. “Businesses have lots of profit; they ought to use some of it to provide more benefits for workers.”

“Including money wages and benefits,” explained Adam, “labor compensation represents nearly three-fourths of national income. In contrast, after-tax corporate profits represent far less than a tenth as much. Compare that amount with the likely cost of the mandated benefits. A health insurance bill recently before Congress could itself have cost businesses close to one-third of all after-tax profits earned that year!”

“That *is* a big sum,” admitted a surprised Karl.

“Government could not take such a huge chunk of profit without devastating national production and employment,” continued Adam. “The mandated benefits would be a tax immediately on labor and consumers and indirectly on corporate profits.”

“Is that what you meant when you said the required benefits would push workers’ pay above their productivity?” asked Karl.

“Yes,” affirmed Adam. “The cost of labor would rise, so goods and services would cost more to produce. Because of the higher cost of production, each affected business would increase its price and reduce its output.”

“That would harm almost everybody,” Karl keenly conceived.

“Indeed, it would,” answered Adam. “Higher prices would hurt consumers, reduced production would weaken demand for labor and cause employment and pay to fall, and higher production costs would cut profits and hurt stockholders.”

“So, as consumers, workers, and stockholders, we all end up footing the enormous bill,” concluded a crestfallen Karl.

Questions for Thought and Discussion:

1. Why would mandating benefits tend to make most workers worse off, once money wages have adjusted to the changes? If it was “worth the cost” to workers, why wouldn’t employers have already offered those benefits?

2. If increased mandatory benefits were combined with a legal minimum wage or existing union contract wage, so that wages could not adjust to the change, what would the effects be?

3. What does this essay suggest about “soak the big corporations” solutions to social “problems,” especially those facing workers?

4. Why might mandating benefits be politically popular? What does this have in common with corporate profits taxes and the employer half of Social Security and Medicare taxes?

**23. Medical Folks and Artichokes The Midnight Economist**

What shall we do about the persistently rising cost of medical care? Artichokes may suggest the answer.

The price of artichokes depends on many things. One is the number available. As with virtually all goods and services in the marketplace, a greater supply makes the price of artichokes lower than it would otherwise be. And smaller supply makes it higher.

But doctors are not like artichokes, concludes a study about health-care costs. For medical folks, a larger supply is likely to raise, not lower, the price of medical services.

Why the difference? Because doctors are smarter than artichokes. Artichokes do not consult with consumers and advise them to buy more of their services to promote good health. Doctors do. As the number of doctors increases, the study suggests, on average they perform and bill for more services and thereby maintain their incomes.

Doctors, not consumers, control demand for medical services, so more doctors means more demand for those services. And increasing demand means higher prices and greater expenditures for medical care. As proof, the study shows that during the 1980s the number of physicians and their average income both increased.

The suggested prescription for rising medical costs is to limit the number of doctors. But before we begin closing down medical schools, we ought to ask if physicians *really are* all that different from artichokes.

True, doctors can influence spending for their services. But that influence results largely from the way we finance most medical care. Consumers of medical services pay out of their own pockets for only a small fraction of the services they buy. Since 1981, out-of-pocket expenses have been less than 25 cents out of each dollar patients spent for health care.

If shoppers knew that private and public food insurance would pay for most of their artichoke purchases, they would stuff their carts with them. And as demand increased, artichoke prices would rise, farmers’ incomes would go up and growers would be motivated to produce more of them. A larger supply of artichokes would then occur along with a bigger income for farmers. But we would not conclude that artichokes are somehow influencing buyers and bloating demand. Nor would we advocate limiting the number of artichokes on the market. Doing so would only make their price still higher.

Similarly, demand for medical care is bloated because consumers usually are spending someone else’s money when they buy doctor’s services. Limiting the number of physicians in the face of that subsidized demand would raise doctor’s fees and fatten their average income. Yet, such a recommendation of supply curtailment comes from the study, which was authored by (you guessed it) two doctors.

We can contain the cost of medical care. But we aren’t likely to do so by pretending that, in the marketplace, medical folks are not at all like artichokes.

Questions for thought and discussion:

1. Why does the Midnight Economist argue that doctor’s ability to influence the demand for medical services “results largely from the way we finance most medical care”?

2. What would the proposal to limit the number of doctors have on the market for medical care, for a given demand for medical care?

3. Why do you think there is no private “food insurance” offered for sale to people?

4. What would health insurance do to the privately borne cost of medical care, if the demand for medical care was relatively inelastic? What would it do to the total cost of medical care, including that borne by private and public insurers?

**24. Diseased Kidney, Pure Hearts, and Dialysis for the Brain The Midnight Economist**

I am quite attached to my kidneys. So far as I know, they feel the same toward me. But I have two of them, and the National Kidney Foundation assures us that one good kidney is enough. Some people do not have one good kidney. At some finite price, I would be willing to sell one of my kidneys; it is easy to imagine a person in grave kidney difficulty being willing to meet my supply price. I would sell my kidney for his money; he would sell his money for my kidney; in our respective assessments, each of us would be better off.

A person with bad kidneys has available only limited strategies of survival. Possibly he has access to expensive, cumbersome and confining dialysis treatment; possibly a kidney is available from a deceased donor; possibly someone will simply give a kidney. Obviously, the patient’s situation would be improved by adding to his possibilities the alternative of *buying* a kidney. But according to the National Kidney Foundation, such “cash payment” is “immoral and unethical.” And there is strong support for a Congressional bill which would prohibit the purchase and sale of human organs.

Surely, economics is not to be the ultimate arbiter of morality and ethics. Indeed, economics is amoral, being simply a technique of thought to help explain--dispassionately, even (if we may say) cold-bloodedly--certain cause-and-effect relationships. In uncoerced exchange, both parties gain, and, if no one else is hurt, it might seem pretty clear that the transaction should be permitted. But maybe the National Kidney Foundation and congressmen are attuned to a higher, more subtle Truth. Perhaps it is better for the kidney patient to die--morally and ethically, to be sure--than to participate in utterly contaminating market exchange. Some wiII suspect that a more likely explanation of the anti-market position is sophomoric sophistry.

The registering of demand preferences, the inducing of supply responses, the freedom to exchange privately owned assets--all this is not a trivial or doubtful luxury, tolerable only in halcyon and unstrained circumstances. The market produces sinews of adaptability to and survival in an unfriendly world.

The contribution to our well-being of market processes of trade are never more apparent than in rolling with the kidney punches of fate. A house burns down, a car is stolen, disease strikes. We are confronted by grave misfortune, and tears; wit and government cannot undo the initial injury. But there are ways and ways of dealing with the problem. We can *minimize* the costs. We achieve our *best* possible situation by pursuing the best of the available options. Those options commonly involve other people, and through market procedures--procedures of bidding, offering, and contracting--we improve our condition.

All this strikes reasonable people as reasonable. It is reasonable, not only with respect to houses and cars, but also kidneys. The unreasonableness of some is a pity--especially since there is no dialysis for the brain.

Questions for Thought and Discussion:

1. Why are markets for kidneys “immoral and unethical,” when voluntary exchange is ethical for police, firemen, soldiers, coal miners, and high-rise steel workers, each of whom accepts higher pay in exchange for more risk?

2. Market responses to natural disasters as well as personal disasters are often called “profiting from others’ misery.” How is one’s profit in such a case a benefit to the victim of the disaster? Who does ruling out the possibility of profit, say through banning certain market transactions or imposing price ceilings, help in such a situation? Whose options are expanded as a result?

3. It is often said that the reason markets in human organs would be wrong is that the value of human life is infinite. How is this argument unconvincing? What does our behavior, say, ingetting to school or choosing our breakfast, imply about the value of our own lives to us?

***The Midnight Economist***

**for**

**Robert L. Sexton**

**Exploring Economics, 7e**

**Macroeconomics**

(Chapters 18-27)

**1. The Causes of Unemployment The Midnight Economist**

In this country, the unemployment rate is rarely below 3 to 4 percent, and at the depth of the Great Depression, it rose as high as 25 percent. Why is there ever unemployment of workers?

Usually, the answer runs in terms of bad (or at least inadequate) psychology or economics. Some complain that the core of the unemployed are lazy, unambitious, irresponsible. Others contend that unemployment is a result of insufficient aggregate demand---and so the cure for unemployment is forced inflation. For some people and some circumstances, such answers have some validity--but much more is involved.

First, many officially counted as unemployed are heavily and rationally investing their resources in looking for work. They are sampling the market, seeking information on employment alternatives. That information is valuable, but it is not obtained either freely or instantaneously, and generally, the faster it is to be acquired, the more costly it will be.

We should hardly want to have the measured unemployment rate kept at zero, for preclusion of unemployment would mean virtual preclusion of quitting one job in order to get a better one and of searching for a best job by those entering or reentering the work force. Such precision would greatly restrict freedom as well as dilute efficiency.

A second cause of unemployment are laws and arrangements which inhibit adjustment of prices of labor services. Long-term labor contracts--with or without benefit of union pressure--can get in the way of market adjustments. If demand for labor falls but the price of labor is pegged, the quantity of labor workers want to sell at that price is more than employers will buy.

Other workers are unemployed, not because demand has fallen while the wage rate is maintained, but because wages are raised to artificial levels in the face of constant demand. One can price himself out of the labor market by stipulating a required wage of $1,000 per hour. Or one can be priced into unemployment by government making it illegal for his services to be bought or sold below a stipulated minimum wage.

Finally, one can rationally, and thus predictably, decline employment because of sufficiently attractive alternatives which have been provided--provided, in large part, by those too anxious to do good. A considerable amount of a variety of welfare is available for the unemployed. Few would want to sweep away all amounts of all types of welfare aid. But there is an inherent problem in welfare programs, a problem of work incentive.

Suppose a person receiving $12,000 a year in aid now has the option of taking a job at $14,000. Foregoing the $12,000 in order to obtain the $14,000 is, in effect, a staggering tax on his earned wages of over 85 percent! Actually, the tax is bigger than that, for he will have to pay income tax on his wages. It is an unreasonable test of the work ethic to ask a person to accept employment when the work-tax will approximate 100 percent.

So we will continue to have some unemployment--partly because market information is costly, prices are not fully adjustable and welfare imposes a tax on accepting a job.

Questions for Thought and Discussion:

1. Suppose everyone wishes to marry an appropriate partner. Would we then want the number of single people at any given time to equal zero? How is dating like job search?

2. What effect would there be on workers’ incentives under an unemployment insurance system that replaced 70% of after-tax wages for up to 26 weeks? What if it lasted for 99 weeks? What if those payments were loans, instead?

3. How might a higher minimum wage raise unemployment rates among some groups and in some locations and lower them in others?

4. How do discouraged workers and part-time workers who cannot find full-time jobs alter the “true” unemployment rate compared to that measured?

**2. On Measurement and Interpretation: Glasses and Doughnuts The Midnight Economist**

From what perspective and with what emphasis are we to view various variables of the marketplace? Is the glass half full or half empty?

In a recent ten-year period, our real output increased 35 percent--an annual rate of 3 per-cent, which approached twice the rate of increase of the working-age population and was three times the rate of increase of the total population. Further, employment rose by 21 percent, more than the proportionate increase in the working-age population. So it is apparent that the decade was one of appreciable expansion of employment, productivity and per capita real income.

For contrast, consider a ten-year period when the number of people unemployed rose 65 percent and the unemployment rate increased almost 30 percent. Obviously, this was a difficult, if not disastrous, time of collapsing economic activity.

Actually, both sets of data pertain to the *same* period, 1971-1981. How can the same decade be one of high and rising employment and also one of high and rising unemployment? Evidently, whether it was among the best of times or one of the worst is largely in the statistical eye of the beholder.

It is common to attach great weight to the rate of unemployment. That rate is a statistical construct comparing an estimated number of people without a job who profess to be seeking a job, with an estimated number of people in the so-called civilian labor force.

The official unemployment rate is a tricky tool of analysis. The reported rate can be deemed misleadingly small, for it does not reflect those who have become so discouraged in seeking employment that they have dropped out of the labor force and are no longer counted, and it does not indicate the part-time employees who want full-time jobs.

Conversely, the rate is bloated by those who find it rational, given the welfare rules, to claim to desire employment but who actually do not want a job or who decline jobs while waiting for better offers. And the rate can be increased through expansion of the labor force by those now seeking employment for the first time or by those rejoining the competition for jobs.

From 1971 to 1981, jobs increased robustly, employment expanding twenty-one million. But the measured labor force went up even more, by twenty-four million.So unemployment rose three million, and the unemployment rate went from a moderate 5.9 percent to a large 7.6 percent. The labor force rose proportionately faster than the work-age population. And the labor force became a bigger fraction of population because of more participation by women: the proportion of the male population in the labor force actually fell a bit, while the proportion of women increased a whopping 20 percent.

The real performance of the economy--job creation and production--was pretty good. The *statistical measurement* of unemployment camouflaged the positive aspects of that performance. But some find the hole more fascinating than the doughnut.

Questions for Thought and Discussion:

1. How could a rapid increase in available jobs lead to an increase in the unemployment rate? How could a rapid decrease in available jobs lead to a decrease in the unemployment rate?

2. If employment and unemployment rates both rose at the same time, what would you do to determine what was happening in the labor market?

3. If one person tried to paint an optimistic picture of current economic conditions and another tried to paint a pessimistic picture of the same conditions, could they often both succeed? Why does knowing something about the limitations of economic data help protect us from being misled by such people?

**3. Diddling With Data The Midnight Economist**

There is vastly more to economic analysis than counting things and comparing numbers. Measurement is at places vital in identifying the sizes and shapes of problems and in deducing what might best be done about them. But tools can be used badly and for inappropriate purposes. There are those anxious to diddle with data, not to comprehend the world, but to promote a political purpose.

The calculation of the unemployment rate provides illustration. The unemployment rate is simply the ratio of the number unemployed to the number in the work force. But the measurement of that ratio is inherently tricky and tenuous, involving not only estimates, but also preferences of the people involved.

Who is in the labor force? We include everyone within an age range who has a job or who supposedly wants a job and is seeking one. In measuring unemployment, we do not count those not looking for work. And some who are not working but would like a job have given up looking. But when they are so discouraged about finding employment that they give up, they are no longer participating in the labor force: The dropout reduces both the measured labor force and the number officially unemployed, making the calculated unemployment rate smaller than before.

There are journalists and politicians who make much of this reduction in the official unemployment rate by discouraged dropouts. A *New York Times* report acknowledges that the number of those who have given up seeking work is “unknown,” but somehow guesses that it is “perhaps more than a million.” If we correct our calculations by quite arbitrarily adding I million to both the labor force and to the number of unemployed, then the unemployment rate would be raised by about 0.7 percent.

So the true state of unemployment is somewhat camouflaged by our pretending that dropouts are not there. But the long newspaper account says nothing about another accounting quirk with opposite impact: the bloating, of both the labor force and the number unemployed by those who pretend to want a job but actually will not accept work. No one denies that there are people who officially but falsely state that they are looking for work in order to be eligible for unemployment and other welfare benefits. And through padding the reported size of the labor force and thus of the number considered unemployed, the determined unemployment rate is made too big.

But some find it politically convenient to make things look as bad as possible. While failing to note the welfare-seekers who deviously make the unemployment rate larger than it is, the story puts some emphasis on those who are employed but allegedly are “on the edge of unemployment, facing the hardships and insecurity of the jobless.” “Probably more than 3 million” temporary, part-time, freelance and underpaid workers, the paper suggests, really ought to be considered unemployed. hus goes the dubious diddling with data in an election year.

Questions for Thought and Discussion:

1. If I wanted to make the unemployment data appear worse, would I want to add discouraged workers to those officially unemployed? Why?

2. If I wanted to make the unemployment data appear better, would I want to adjust the data for those officially unemployed but not really looking for work? Why?

3. Should part-time workers be counted as “fully” employed? Does it matter whether they want a part-time job or a full-time job?

**4. Public Works: The Oversold Solution to Unemployment The Midnight Economist**

With a high unemployment rate, politicians scramble to create the image that they are taking corrective action. It has become good copy, in particular, to propose federal funding of public works jobs to rebuild roads, bridges, sewers and other infrastructure in order to reduce unemployment.

Public works programs, in themselves, create specific jobs, of course. But expansion of public jobs is likely to cause employment to contract elsewhere, leaving no net increase.

Other employment will contract because federal expenditures on public service jobs must somehow be financed--financing which will reduce spending elsewhere. If the federal government increases public works spending, then it must reduce other government expenditures, raise taxes, or run deficits.

Iffederal expenditures are reduced for other programs, such as national defense, then fewer people will be employed producing guns. Or if transfer payments to individuals are reduced, then fewer people will be employed producing the butter which would otherwise have been demanded. In either case, decreases in federal expenditures in one area in order to make room for increases in public works will not provide a net increase in national employment.

Similarly, if taxes are increasedin order to fund the expansion in public works, then taxpayers will have less income to spend. Demand for and employment in the production of consumer goods will contract. This contraction will occur whether the increased tax is directly on consumers’ incomes or is an increased excise tax on a particular good, such as gasoline.

If, instead, the expansion of public works is financed by enlarging the federal deficit, then the government will either have to borrow or create new money in order to pay its bills. If it borrowsfrom the community, the government must intensify its competition with businesses and households for scarce credit and crowd out borrowing for private investment. Spending of private funds for private purposes would be displaced by government spending of funds sequestered from the people.

If the increased deficit spending were financed by greater money creation*,* however, then spending would not be decreased in other areas, and there could be a temporary, modest rise in employment as public works jobs were increased. But soon the rate of inflation--which is a form of taxation--would increase and threaten future productivity and employment. A bit more employment today is obtained at the expense of less employment and more misery in the future.

For relatively high rates of unemployment, there is no panacea, no easy way out. But neither candor nor competence is what the public commonly gets from its elected officials. It is more popular to promise the quick fix--even when there is none.

Questions for Thought and Discussion:

1. Why are new jobs “created” by government projects and the related multiplier effects logically invalid as benefits of government spending projects?

2. How is the logic of this article an application of opportunity cost reasoning?

3. Why might it be politically attractive to avoid being specific about where the dollars for a government program will come from?

4. If there is a given natural level of real output (corresponding to the production possibilities frontier) at a point in time, what is given up for $1 more in government purchases? When would that $1 increase in government purchases make us better off, and how would it do so?

5. How do lags and forecasting problems make effective jobs programs hard to implement?

**5. GDP: The Baby and The Bath Water The Midnight Economist**

Gross Domestic Product--fondly known as GDP--is a money measure of aggregate output, the dollar value of all goods and services produced in the economy over some period. It is an imperfect measure, and a few have suggested throwing out the notion.

There *are* problems and limitations in using GDP figures. For one thing, the *dollar value* of a basket of goods is determined by both the *physical quantity* of goods and the *price tags* on those goods. From 1979 to 1980, GDP in this country went up almost 9 percent. That sounds great. But prices went up close to 10 percent, with real output actually falling over I percent. There is a big difference between 9 percent and -1 percent. In dealing with GDP, watch out for inflation.

Another problem pertains to *qualitative* changes. Automobiles and refrigerators today are hardly the same commodities as automobiles and refrigerators of thirty or fifty years ago. But these differences are not indicated by the number of units produced and their prices at different dates.

There is also the complication of *population* change. If real output goes up 15 percent over a period while the number of people increases by 20 percent, output per person falls. Some countries have such a large rate of population increase that most of their output is absorbed in simply maintaining per capita income: they run hard just to stay in the same place.

And what of income *distribution?* Several oil-producing countries experienced huge increases in GDP per person during the 1970s, but 95 percent of the residents did not gain.

So there are these and other technical issues in interpreting and using GDP data. There remains an even more basic matter of exactly *what* is being measured.

GDP is only a money measure of the economy's *output.* It is not a comprehensive measure of the community's *well-being.* Thehuman condition is a function of many variables-- psychological, sociological, philosophical, theological, as well as economic. How well established and how well respected are the standards of the community? How confident and committed are the people--and confident and committed with respect to what?

Now, GDP is pertinent to many of the more subtle aspects of life. People are more likely to be content and get along well when the economy is flourishing. But GDP figures themselves-- the money value of production--do not include measures of propriety, gentility, courage, discipline, love...which most fundamentally determine the quality of people and their lives.

But, then, GDP was not *intended* to try to measure such things. What GDP *does* measure is very important, however. Properly used, GDP data can tell us useful things about some vital aspects of the world.

Questions for Thought and Discussion:

1. If prices rise more rapidly than GDP over time, does real output rise or fall?

2. If loaves of bread went from 1 to 2 pounds in size and from $1 to $2 in price, did the cost of buying bread rise or did people pay more for more bread? Is the analysis of other quality improvements essentially the same or essentially different than this example?

3. If the population growth rate fell from 2% per year to 1% per year and the real output growth rate slowed from 4% per year to 3% per year, is there any change in the growth rate of per capita real output?

**6. Determinants of Economic Growth The Midnight Economist**

Most agree that producing more of what we want most is a good thing; but they can see that growth is complex in prerequisite and process and hard to sustain in a stingy world.

What *are* the immediate determinants of economic growth? Many things. Some analysts--including economist Arnold Harberger in a publication of the Institute for Contemporary Studies--have tried to classify them.

Economic growth entails production, and production entails combining productive inputs into commodity outputs. Given climate and endowments of nature, aggregate output depends on the *quantity,* the *quality* and the *efficiency of use* of scarce labor and capital. What, in turn, determines the quantity, quality and efficiency of labor and capital?

The quantity of labor is a function not only of the size of population but also of the proportion of the population in the labor force and of the proportion of the labor force which is employed. The amount of capital stems from net rates of saving and investing, not only domestically but also by world financial partners.

Questions of quality are more subtle. The quality of labor services is affected by health and age composition and occupational distribution, by education and technological knowledge and general cultural attributes, by on-the-job training and work experience and managerial direction. The quality of capital is intertwined with the quality of some kinds of labor. It reflects at any given time the state of the industrial arts--the level of production knowledge applied from the accumulation of knowledge available. And over time, in global competition, just to stay in the same place, a community must run fast through improvement in designs and technical innovation.

For growth, resources of substantial amount and of high quality still must be used efficiently. Somehow--through processes of acquiring information and of applying optimal decision rules--we are to shift workers and capital from Iower-productivity to higher-productivity activities, developing appropriate specialization and division of labor, exploiting economies of scale and innovating new products.

More than two centuries ago, Adam Smith concluded that the *quality* of resources and the *efficiency* of their use are more important than their *quantity.* The poorest nations, he noted, have the largest working proportions of population. What primarily determines how well we live is, as Smith put it, “the skill, dexterity and judgment with which [our] labor is generally applied.” That is still true.

Questions for Thought and Discussion:

1. Why isn’t there a single “correct” recipe for economic growth?

2. Does increasing investment necessarily increase economic growth?

3. How many of the determinants of economic growth are not a function of property rights? Of marginal tax rates?

**7. The Stock Market’s Anchor The Midnight Economist**

“Beware the stock market!” advises a chorus of critics. The market has lost its anchor, they say, because stock prices no longer reflect the real economy. Instead, those prices mirror mainly crowd hysteria and whims of large institutional investors interested only in short-term gain.

Why else, they continue, would the Dow Jones Industrial Average have plunged? And why else would variability of stock prices have increased in recent years? Surely, earnings prospects of corporations do not change so greatly and abruptly to explain these wide variations in prices.

Many factors determine a stock’s price. But that price is essentially the market’s *present*

valuation of a corporation’s *expected* earnings in the future. By buying a share of common stock, one becomes part owner of the company, and so receives a share of its earnings as dividends. If earnings grow, dividends, too, are likely to grow. So investors bid up the price of the stock today.

But even the most knowledgeable investor cannot know the future. The best one can do is *anticipate* it, and anticipations change like the weather--warming up stock prices one day and cooling them down the next.

Even if anticipated earnings remain constant, investors can change what they are willing to *pay* now for those future earnings. Having a right to a dollar next year is worth less than having that dollar now. So the future dividends expected from a stock are *discounted* to determine what one will pay for them today. And the *rate* of that discount is affected by the perceived risk of the investment. Greater risk means a heftier discount, and a heftier discount means a lower price for a stock--even if its stream of expected dividends remains unchanged.

Monetary policy, tax rates, trade policy, elections, rumors of war--such economic and political events alter the risk of stock investment. And earnings prospects themselves can quickly change. So stock prices can soar or plunge even though they follow expectations of the future economy.

That connection is illustrated by recent history. Consider the relationship between stock prices and corporate earnings. A substantial positive correlation exists between change in one year’s stock prices and changes in *next* year’s corporate earnings.

So today’s stock prices embody risk-adjusted anticipations of tomorrow’s earnings. As anticipations change, they can produce wide variations in stock prices. Those variations occur even though stock prices remain anchored to the expected economy of tomorrow.

Questions for Thought and Discussion:

1. Does this analysis support or reject the idea that large institutional investors are “interested only in short term gain”? How can stock prices change substantially due to unexpected changes in current results, without indicating only an interest in short term gain?

2. Why does the substantial correlation between one year’s stock price change and the change in next year’s corporate earnings support the idea that stock prices change to reflect expectations about the future?

3. How would greater risk of future government intervention that would reduce the profits from an investment change the discount rate people would use in evaluating a company’s prospects, and therefore the company’s stock price?

4. How is the argument made here a reflection of the random walk hypothesis? What would you have to forecast correctly to consistently earn high profits from investing in stock?

**8. Supply-Side Silliness and Sense The Midnight Economist**

These are not days of high sophistication in economic policy discussion. Much too much has been claimed by some, much too little has been conceded by others, and a confused community may acquiesce in dilution of good policy and adoption of lousy policy, perpetrated through the hysteria of ignorance, the bias of ideology and the shenanigans of partisanship.

The confusion of the community has been generated in part by overexuberance with respect to substantive content of taxation and government spending programs and by stylistic excess in promoting those budgetary proposals. As interpreted by the community, these cheer-leaders--journalists, academics, government officials--promised price level, employment and output results which would be both instantaneous and painless.

The advocates had to realize that that really is not the way the world works. And yet, their basic product is excellent. Indeed, reputable economists over a long time have explained the sound sense of what is now called “supply-side” economics.

The essential basis of this long-established sound sense can be easily indicated.

First, policies--changes in incentives and procedures--can have effects on what people do and how they do it.

Second, these repercussions of policies are not confined to single, first-order reactions. As in throwing a rock into a pool, the initial splash makes waves and ripples which spread far.

Third, such policy impacts involve individual people. Everyone finds his personal well-being of interest to himself and nearly everyone exhibits considerable shrewdness in using his own resources effectively within the constraints imposed on him and the options availabIe to him.

Fourth, this shrewdness in individual adaptation to circumstances and response to incentives is largely predictable. If tax rates, monetary policies and regulation of financial and industrial institutions encourage consumption and discourage long-term production planning, we can fully expect saving to be curtailed, investment to be inhibited and misdirected, productivity to decline and the growth of personal real income to stagnate.

Supply-side incentives to produce certainly are not the whole realm of appropriate economic policy. And reducing consumer and producer tax burdens in the aggregate and reducing tax rates at the margin will not work miracles even over time, much less immediately. It will remain hard--as it has been since Adam and Eve blew it--to live well. To live well, we must--by the sweat of the brow--produce much. But wewill produce much, relative to our productive potential, only when we find it individually rational to do so.

The essence of supply-side economics is to provide us the circumstances and the ground rules which will induce and guide us to produce much.

Questions for Thought and Discussion:

1. One of the effects of reducing tax rates would be an increase in the after-tax incomes of those with relatively high earnings. What sort of “ripple effects” would this have? Could it even change some people’s majors in school? Why?

2. Would it be more accurate to describe supply-siders as supply-and-demanders, who object to an overemphasis on aggregate demand to the neglect of effects on incentives to produce?

3. Why would a reduction in tax rates not be painless? Who might suffer? (hint: what happens to the value of itemized tax deductions?)

4. Why would a reduction in tax rates that was anticipated to be only temporary not cause nearly as large a supply-side response as one that was expected to be permanent? Does the same logic hold for how long other parts of the existing ground rules (e.g., regulations) will remain as they are now?

**9. Prices and Taxes The Midnight Economist**

“Taxes are what we pay for civilized society,” observed Oliver Wendell Holmes in an era of very low taxation. But more taxes do not necessarily produce more civility. Nor do higher tax *rates* necessarily provide more government *revenue.*

For higher taxes are like higher prices: they affect the way people behave. Take the rental car industry. Hertz and other companies had announced the biggest rate increases in years. But consumers rented too few cars at the higher prices. When companies realized they were making less money at the new rates, prices tumbled back toward their original levels.

Similarly, government can receive fewer tax revenues by charging higher income tax rates for its services. Economist David R. Henderson reviews the growing body of evidence that higher tax rates can reduce total tax collections by affecting incentives to work and to avoid taxes. He reports that tax changes have the most impact on individuals paying the top rate.

That impact is not surprising, for a proportionate change in all tax rates *disproportionately* affects incentives of higher-income taxpayers. A 10 percent rate increase allows someone initially in a 50 percent bracket to keep 45, instead of 50 cents, of an additional dollar earned. The loss of 5 cents--which is 10 percent of the original 50 cents kept by the taxpayer--appreciably increases incentives for tax avoidance and leisure. For someone in the 20 percent bracket, however, the same 10 percent rate hike reduces the after-tax earnings of a dollar from 80 to 78 cents, a reduction of only 2.5 percent. In this later case, the incentive to avoid taxes or earn fewer dollars rises much less than for the taxpayer in the higher tax bracket.

If the top rate rises sufficiently, it can so magnify incentives for tax avoidance and leisure that tax revenues actually fall. Various studies confirm this result. In the United States, a top rate of about 35 percent appears to come close to maximizing government revenues.

Other countries might have different rates which maximize their tax collections. Still, many government leaders seem to be learning that the road to greater revenues can be paved with lower, not higher, tax rates. *The Wall Street Journal* reports that 55 of 86 nations with income taxes cut their top tax rates from an average of nearly 56 percent in 1985 to 47 percent in 1989. And here at home, government officials sooner or later will have to admit that higher income tax rates for *wealthy* individuals are unable to provide the additional funds they seek for more government spending or for a balanced federal budget.

So beware, middle-income taxpayers! If the expansion of government spending is not constrained, and if there is great pressure to balance the budget, then taxes on your *moderate* incomes are likely to rise.

Questions for Thought and Discussion:

1. Which government functions are necessary for a “civilized society”?

2. Why would you expect that the higher one’s tax rate the larger the behavioral response to a tax rate reduction? Why might across-the-board tax rate reductions increase tax revenues from high tax bracket earners, but reduce tax revenues from low tax bracket earners?

3. How much would taxable income have to grow for a 10% tax rate reduction to raise total tax revenues?

4. Why is one’s marginal tax rate, compared to the marginal cost of “tax shelters” a key determinant of the extent of tax avoidance for a taxpayer?

5. Are tax rate reductions for higher tax bracket earners better described as benefits to the rich, some of which eventually “trickle down” to others when they spend the tax cuts, or as “supply side” incentives to increase production by those with the worst current incentives to produce?

**10. Budgets, Deficits, and Economic Performance The Midnight Economist**

There is this Sunday television discussion program. As such things go, it is quite a good show. But the regular participants and most of the guests are specialists in *politics.* This is a problem, for national politics and policies are heavily connected with *economics.* And political sorts commonly are not very good economists.

A recent session on the federal budget and its deficit was sanctimoniously summed up with the crack, “We must start to pay for what we get.” That sounds puritanically proper. But what does it mean?

Who are we, and have we been getting things without *paying? Government* pays for what it gets. And the funds with which payment is made come from nominal taxation of and borrowing from the *community*.

With a given pie, when government buys more resources or products, less is left for the rest of the community. This sequestration of private wealth--whether or not government does good things well with what it takes--is taxation, regardless of the financial procedures by which it obtains the dollars it spends. The government does pay for what it gets and the community gives up what government gets. Government borrowing (instead of explicitly taxing) does not mean that we have managed to delay payment. When government spends now, it is, in reality, taxing now.

For Senator Snort and television philosophers, the sum of good public finance is: balance the budget--with the proviso that the balancing be by raising tax collections still more, not by curtailing the increase in spending.

This is sophomoric economics. First, the *size* of the budget is vastly more important than the *imbalance* of the budget--and the size is measured by *spending.* Second, the simple prescription of balancing the budget tells us nothing of the *nature* of taxes or the *direction of* spending--or government-imposed *mandates* which do not show up in the budget. Third, the budget-balancing prescription ignores how well the economy has *performed* with budgets and deficits of different sizes.

In the decades of the 1950s, the budget was close to balanced, and the deficit was not large in the ‘60s. The deficit became conspicuous in the 1970s, and then, relative to GDP, it doubled in the 1980s. The deficit did not rise because of tax starvation. As a proportion of GDP, government revenue in the 1980s was 10 percent larger than in the 1950s; but spending was over 30 percent greater.

Our problem has been the growing *size* of the budget. And as government spending rose each decade, the rate of national output growth fell significantly, and the rate of inflation and interest rates in the 1970s and 1980s were much greater than in the 1950s and 1960s.

Big government budgets--that is, much spending--have hurt our economy. Spending relative to GDP hit a peak in 1985. Further containment of spending not only will help the economy, it will, as a bonus, correct the deficit.

Questions for Thought and Discussion:

1. Why does the *Midnight Economist* insist that when the government spends now, it is, in reality, taxing now? Why does this make the size of the budget more important than its balance?

2. Is the choice between financing government spending by taxes or deficits better understood as a choice between taxing today and taxing tomorrow?

3. If the government wanted to increase the amount of a good produced, without the cost showing up in the budget, why would mandates that firms provide that good be politically attractive?

**11. Inflation and the Cost-Push Mirage The Midnight Economist**

Inflation is a chronically increasing price level. It is caused by additions to the nation’s stock of money--additions which persistently exceed the growth of the supply of goods and services. Excessive growth of money causes excessive growth of spending; and it is over-exuberant spending which pushes up the price level.

Still, many believe the mythology that inflation is caused by rising costs. Business managers often justify their own rising prices on the ground that costs are increasing. Indeed, some innocents mock the idea that money growth, rather than costs, causes inflation. “That’s okay in theory,” they delicately sneer, “but real world experience shows that it is rising costs that push up prices.”

The contest is not between theory and practice, but between good theory and bad theory. Perceptions of inflation may have been gained from experience, not a textbook, but they are theory, nevertheless: they still represent general explanatory propositions.

This cost-push theory of inflation, however, is *bad* theory precisely because it is not supported by real-world evidence. It does appear that rising costs are pushing up prices, but that impression is an illusion. It is an illusion caused by the way *inventories* of goods delay the effect of money supply increases.

When increased money growth causes total spending to rise more quickly, sales of particular businesses, such as fast food restaurants, will increase. But sales fluctuate from day to day and week to week, so managers of these businesses cannot immediately know that this sales increase will last.

As sales continue to rise, restaurants will use up their inventories of meat. Larger orders will then be placed with suppliers, and inventories of meat packers, too, will begin to shrink.

The price of meat has not yet changed because inventories have absorbed the initial impact of the increased spending. ut as more orders to replace depleted inventories work their way down the chain of distribution, orders for cattle also will rise faster. The available amounts of meat are inadequate to meet the rising amounts demanded at existing prices. As a result, prices of cattle will rise as packers bid more intensely for scarce supplies. Higher prices for cattle then cause meat packers to raise their prices; and higher meat prices cause fast food restaurants, in turn, to charge more for their hamburgers.

As higher prices work their way up the distribution chain to the consumer, they create an illusion that higher costs are pushing up prices. But both costs and prices are being pulled up by the increased spending caused by a more rapidly growing money stock. Because the effects of more money and more spending are delayed by inventories, hasty conclusions about the cause of inflation can be deceptive. It may seem that costs are pushing up prices, as it may seem that there is water on desert land. But both are mirages.

Questions for Thought and Discussion:

1. In a period of inflation, why is the resulting increase in demand (in nominal, current-dollar terms) the cause of rising costs?

2. Why can a longer, more complicated distribution chain lead to greater lags between demand changes and price (cost) changes?

3. Why do sellers feel the need to justify price increases as caused by increased costs, but not the need to similarly justify price reductions?

4. Can cost-push inflation arise from other causes than inflationary monetary policy?

**12. Oil Shocks and Long-Term Monetary Policy The Midnight Economist**

Much of the world experienced a succession of “oil shocks” since the early 1970s. How shocking is an oil shock likely to be? What is the nature of the shock? And how are we best to respond?

An oil shock itself is a reduction in input supply. With curtailment of a key input, national *output* falls. With rising costs of production and transportation and resulting diminished output, *prices* tend to rise. *Interest rates,* too, can rise with anticipated inflation and with the public borrowing more to maintain its spending in the face of income loss.

This was the pattern in the earlier oil crises--falling output, rising prices, some increase in interest rates. The late 1970s episode seems to fit into the same sort of picture as that of the early 1970s. True, the American economy is much more energy efficient now than in 1973, as reflected in greater real output per unit of oil used, and this reduces the production and price impacts of sudden changes in the availability andcost of oil. Even so, the economy is hardly immune to shocks of oil supply and oil prices.

So the Fed faces a policy dilemma. Should the Federal Reserve *increase* money growth to maintain *output or curtail* moneygrowth to repress *inflation?*

A rise in oil prices by itself does not go far in generating inflation: with a constant money supply, increases in prices in some goods arc likely to be accompanied by decreasesin other prices. Still, even if the amount of money is just maintained, there will be inflation if output falls. The decline in production increases the *ratio* of money to output, and the *relative* increase inmoney leads to higher prices.

Must output fall? No monetary policy can make more oil available. Reduced input means reduced output. And as output falls, there will be some rise in unemployment, for the economy’s adjustment to the new circumstances of supply and prices will not be made instantaneously, without frictions and lags.

So what should monetary policy be? We cannot *both* expand and contract money growth at the same time. And in trying to fine-tune the economy, we are likely to hurt ourselves in the long run while failing to help ourselves in the short run.

Many economists urge a *steady long-term* policy. We cannot escape temporary wiggles in the price level and the rate of output. Indeed, in working on either of those problems, we probably will worsen the other--and even worsen *both* of them in the long pull. Don’t try to fine-tune what is untunable.

But there is a third choice: Suffer with patience what is unavoidable in a period of transition, try not to make bad situations worse, and, instead, “maintain money growth at a rate consistent with *long-term* growth of output and declining inflation.”

Questions for Thought and Discussion:

1. Why, given a fixed stock of domestic resources to work with, would an adverse supply shock to the price of imported oil lowerthe natural level of real output? (hint: how much of our other goods would we have to trade away to maintain the same level of oil imports?) Can creating more money change this result?

2. In terms of aggregate supply and demand, what choices face monetary and fiscal policy makers in response to an adverse supply shock? What tradeoffs are involved? ow do forecasting and lag problems fit in?

3. Does the *Midnight Economist* have much faith in minimizing the adverse consequences of supply shocks via “fine tuning?” Why? Assuming fine tuning could help social coordination sometimes, but could hurt us at other times, how would you decide whether you favored policy activism or stable policy rules?

**13. Money, Non-Money, and Reputation The Midnight Economist**

“Poor Professor Allen,” murmured a commiserating Mouse Adam. “The dear man is disappointed, and irritated in his dismay.”

“So what's new,” cried Mouse Karl with cruel candor. “All economists are always unhappy.”

“He has special reason to be annoyed,” replied Adam. “On a trip some time ago, he leased a car from a leading rental firm. On returning the automobile the next day, the two clerks of the firm obviously were confused, and consulted with each other, but explained nothing to Professor Allen. He later discovered that they had charged his credit card an amount larger than the one initially quoted. A request was then made to correct the over-charge. Three months later, the firm acknowledged its error, apologized, and sent him a certificate of about the amount of the discrepancy which can be applied to a future rental.”

“So, after a bit of a delay, the problem is perfectly resolved,” trumpeted Karl. “Allen was initially charged too much, but now the money has been repaid.”

“No,” corrected Adam, “he was charged too much *money,* but *h*e has *not* been reimbursed in *money.”*

“Don’t be cute,” criticized Karl. “I have heard you say that money is what money does, and that what money does is to pay for things. The certificate can pay for a car rental, so the certificate is money.”

Adam tried to be patient. “*Anything* with market value,” he said, “can be used in a swap for something else. But not everything is *money.* Money is so-called generalized purchasing power: it is a general claim which can be exercised by *any* holder to buy *any* good at *any* time from *any* seller. But the certificate is not transferable and can be used only by Professor Allen; it cannot be converted into cash and must be used only in renting a car from this company; and it must be used, if at all, within one year. The certificate is a claim, to be sure, but it is a very specific, not general, claim, and thus falls far short of being money. So the company still gains, and Professor Allen still loses, from the initial ineptitude of the company.”

“I concede,” conceded Karl, “that Allen has some reason for frustration. If money exists, it is because those things which make up money are different in some respects and in some degrees from non-money assets. The certificate is not money--and, for a given face value, obviously the certificate is not as valuable as the same amount of money.”

“Money certainly facilitates trade,” observed Adam. “By reducing the costs and inconveniences of transactions, it makes us more productive in our use of scarce resources. From the view of the community, it is thus a pity when a firm substitutes non-money for money in settling monetary obligations. The efficiency of the economy is thereby diluted--as is the reputation of the firm which tries too hard, but unwisely, for short-term gain and temporary advantage.”

Questions for Thought and Discussion:

1. If Russian citizens were paid in rubles but there was nothing in Russian stores to buy with the rubles, would rubles really be money?

2. Is getting a certificate to buy something you would have bought anyway equivalent to getting money?

3. If the value of a domestic currency is falling rapidly, why might many people in a country use dollars to conduct their exchanges?

**14. Banks, Money and Policy The Midnight Economist**

In recent months, many financial writers and officials have spoken with seeming earnestness about a horrendous “credit crunch.” Since the reference pertains to borrowing from banks, the so-called credit crunch is a “*money* crunch,” for banks create money when they make loans. And, supposedly, there is a crunch because banks have quite abruptly--and mysteriously--begun to lend much less than they could lend. And this has caused a recession. Is all this consistent with analytic fundamentals?

Except in the most bizarre of circumstances, banks love to lend. The interest they get on loans they make is a major portion of their income. Banks are curtailed in the amount of lending they can do by reserve requirements. While banks must hold *minimum* reserves, they can hold *more* reserves than the minimum.

During the Great Depression of the 1930s, banks did hold vastly more reserves than were required: They found it more prudent to sit on “excess” reserves than to make loans which likely would not be repaid. But the depression was bizarre in the extreme, and for half a century, excess reserves have been kept very small.

We are, indeed, in a period of reduced rate of economic activity. But the slowdown is not recent and sudden. Both employment and national production rose rapidly during 1983 and early '84; they rose moderately form mid-1984 through 1988; and they have risen very slowly since 1988.

It is not coincidence that growth of the money stock has followed a similar pattern. But the slow growth of money since mid-1988 has not stemmed from some perversity of the banks, which would be reflected in ballooning excess reserves. Virtually through 1990, there was no change in the long-established pattern of very small--indeed, minimal--excess reserves. Even with very recent modest increases in excess reserves, banks have continued to be essentially fully loaned up.

Banks cannot lend on the basis of excess reserves they do not have. Nor have they kept excess reserves low by greatly increasing conservative purchases of government and other securities rather than by riskier lending. In fact, the ratio of loans made to securities bought has barely fluctuated over these past three years. In short, when additional reserves have been made available, banks have correspondingly loaned.

But if banks are to have more reserves, the Fed will have to take the initiative to make them directly available, for the banks will not borrow reserves. For two generations, banks have borrowed hardly at all from the Fed, and that pattern, too, has continued. So lowering the discount rate--the interest rate charged by the Fed on loans to banks--cannot be expected to increase appreciably bank borrowing of reserves and subsequent lending.

Why, then, the great enthusiasm over recent cuts in the discount rate? Is it possible that--perhaps for sensible reasons--the Fed wishes to be *perceived* as following an expansionary policy while *actually* remaining neutral?

Questions for Thought and Discussion:

1. Can banks be blamed for a sizable reduction in their willingness to lend if excess reserves in the banking system are not rising?

2. Why is holding excess reserves less costly in a period of deflation than in a period of inflation?

3. Why is a changing target for the Fed Funds interest rate a more accurate indicator of the direction of monetary policy than a change in the discount rate?

**15. Money and Open Market Operations The Midnight Economist**

Many have some notion that national money income is determined by the amount of money spending on output, that the amount of spending is determined largely by the amount of money, and even that the amount of money is subject to close control by the Federal Reserve.

But just *how* the Fed increases or decreases the amount of money is a widespread mystery. Journalists commonly wander astray and occasionally they are joined in confusion by purported business economists. The Fed does not appear to try very hard to instruct the amateur economists in journalism and commerce.

Most money is created by bank lending--commercial banks create the deposits they lend. Banks are required to hold reserves equal to a minimum fraction of their deposit liabilities. They can hold *more* than the minimum, but banks earn income by making loans, so they do not sit long on “excess” reserves. If reserves increase, an increase in lending and money is not likely to be far behind. So the proportion of total reserves in the excess category has been perennially very small and very steady.

An increase in reserves can come from bank borrowing from the Fed. And there has been much amateurish attention paid to the interest rate charged by the Fed on its loans to banks. The impression has been created that changes in this so-called discount rate are the main means by which the Fed manages the money supply. That impression is incorrect.

Banks rarely borrow *much* of their reserves from the Fed regardless of the discount rate. And they rarely borrow much *more* when the Fed lowers the rate or much *less* when the Fed raises the rate. Since 1973, the discount rate has been jerked up and down again and again over an enormous range, but the ratio of borrowed reserves to total reserves--like the ratio of excess reserves to total reserves--has almost always been very small. Indeed, over the past three years, borrowed reserves have been virtually zero.

If banks have not *borrowed* much of their reserves, where did the reserves come from?

A number of things--including various actions by the public and by banks--can affect the amount of reserves in the banking system. But the dominating thing is “open market operations.” The Fed often enters the government securities market. If the Fed buys securities from bond dealers, it thereby directly creates money dollar-for-dollar equal to the value of the purchase. More important, there will be additional reserves, on the basis of which banks can create a multiple of new checking deposits. There has long been an extremely large correlation between Fed purchases and sales of government securities, on the one hand, and the money supply, on the other.

If the real policy game is open market operations, why all the interest rate hocus pocus? It has been suggested that the interest rate diddling has been mainly a diversion, to distract Congress and the administration from silly, activist fiscal policy. But political tactics are in the realm of abnormal psychology, where civilized people dread to tread.

Questions for Thought and Discussion:

1. Can a substantial increase in the money supply occur without Federal Reserve action?

2. Why does the fact that banks desire to increase their profits imply that they will seldom keep substantial excess reserves?

3. If bands do not increase borrowed reserves when the Fed reduces the discount rate, will a decrease in the discount rate increase the money supply?

**16. Monetary Policy: Price Objective and Money Control The Midnight Economist**

Maintaining perennial--and thus easily predictable--stability of the price level would not, directly and by itself, solve our most basic economic problems. We could live poorly even with little price-level fluctuation. But while a flourishing economy requires much more than absence of inflation, we can do best in a hard world if not plagued by large and erratic swings in prices.

We have policy *tools,* and we can stipulate policy *goals.* Zero inflation is an attractive goal of monetary policy. But specifying a goal does *not* tell us how to use the tools, for there can be much slippage in the linkage between manipulation of the tools today and the uncertain repercussions a year or two down the road. We can state a long-term destination and still not know just what to do, step-by-step and day-to-day, in order to get there.

What we *can* do is use the tools and take the steps in ways consistent with analytic principle and coherent interpretation of history and of present circumstance. The very consistency of our tactics in trying to implement our strategy will help us along the path: Production and consumption decision-makers would be comforted if persuaded that the goal of the Federal Reserve is zero inflation and that there will be ongoing policies of steady, non-erratic, empirically justified administration of those policy variables--mainly, the money supply--which are under our control.

Sensible, consistent, predictable monetary policy and its application will not generate unwavering zero inflation. There are too many variables in addition to money which affect inflation, and there are lags which are too long and too uncertain in the connections of cause-and-effect, to guarantee that steady money growth will mean a steady inflation rate. But those same complexities of the world--complexities of both social psychology and institutional mechanisms make impossible the achieving of specified inflation by discretionary diddling with the policy tools.

Attaining with appreciable precision a stipulated inflation objective requires us to do things we cannot do well enough. Holding the rate of money growth *constant* (we can come close to doing that) will not yield a constant rate of inflation (zero or otherwise) in a changing world. But we do not know enough to *manage* the rate of money growth to offset those changes so as to generate a constant inflation rate.

Either we grandly decree the price level and then try somehow to manipulate money increase to meet and keep the price objective or we more modestly *stabilize* money growth and then let the price level settle down with minimal fluctuation. In trying for too much, we end with less than we could have had. It is shrewd to acknowledge our policymaking inadequacies and acquiesce in the feasible, to settle for the best we can do in a hard, imperfect, frustrating world.

Questions for Thought and Discussion:

1. Why would a more credible commitment by the Fed to a stable price level tend to reduce long term interest rates?

2. Why won’t a steady growth of the money supply generate a constant inflation rate over time?

3. Why do problems of lags and uncertainty make it impossible for the Fed to precisely target the price level?

**17. Monetary Policy: Living and Learning The Midnight Economist**

Live and learn. But living is only a necessary, not a sufficient, condition for learning. For all of us, learning is hard, and some seem actually to resist the losing of their virginity of ignorance. Rarely has the learning been harder and the resistance more stubborn than in the area of monetary analysis and its application to policy.

Still, most feel in their bones that the amount of monetary spending ongoods is relevant to the money prices of those goods. And they are receptive to the idea that monetary spending is dominated by the amount of money. Putting it together, they can almost grasp the conclusion that increasing money fast enough--so that spending expands faster than the amount of goods being bought--will raise prices; and the way--the only way--to subdue inflation is to curtail the increase in money.

That is what we have seen over the past quarter of a century. In the late 1950s and early 1960s, money expansion was very modest, and the price level barely rose; from the mid-sixties through the seventies, money expanded much faster than output could be increased and inflation was horrendous by civilized standards; during the last few years, the trend of money growth has greatly fallen, and inflation has fallen from some 1.1 percent in 1980 to about 4 percent now.

As the price levelfollows the rate of money creation, interest rates follow the price level. When past and current inflation leads to general anticipation of further inflation, market rates of interest are bloated. Lenders will not lend unless the loan contract includes a premium which compensates, at least in large part, for expected fall in the purchasing power of the dollars to be later repaid.

Inflation has fallen greatly. Interest rates, too, have fallen--but not as greatly. Expectations of inflation have been reduced--but interest rates have not come down correspondingly. Why not?

Professor Allan Meltzer, of Carnegie-Mellon University, holds that market rates of interest can embody a second kind of premium. Along with a premium of *anticipated inflation,* there is now a premium of *risk.*

The average rate of money expansion has, indeed, fallen over the last several years. But it has been an extraordinarily bumpy ride, with large, erratic short-term bounces above and below the declining trend. In light of the history of our monetary management, the trend itself is uncertain; with huge gyrations around the trend, lenders and borrowers are twice cursed.

To compensate for this additional uncertainty, lenders add a risk premium to the long-term loans they make. These higher rates spread to short-term loans as borrowers offer to pay more in an attempt to escape the increased rates on longer loans. Higher interest rates--higher than those which would stem from anticipated inflation alone--spread throughout financial markets.

Some of us have learned as we have lived that low inflation-adjusted interest rates require money creation at a rate which not only is *small* but also *steady*.

Questions for Thought and Discussion:

1. Why has long-term inflation been called “always and everywhere a monetary phenomenon”?

2. Why would an increase in the money supply, if it would not ever lead to an increase in inflation, tend to decrease interest rates? Why do continued increases in the money supply tend to increase interest rates?

3. Why does the variability of money growth, as well as its average growth rate, tend to increase interest rates and retard investment?

4. Why, after a sustained period of low inflation, would the risk premium on long-term bonds be lower?

**18. Monetary Instability, Uncertainty, and Productivity The Midnight Economist**

For well over two hundred years, economists have realized that the *amount* of money in the economy is not nearly as important as *changes* in the amount. The economy can readily adapt to a constant money stock, and the size of that money stock makes little difference. But when the amount of money changes, there are repercussions; the repercussions varied, with some prices, interest rates, outputs and employments changing faster and changing more than do others; these lagged and dispersed changes can hurt many people even as they may benefit a few.

We are learning more of an additional complication. Not only are changes in the amount of money significant, but *variability* ofthe money change also can affect our real economic activity. Over a period of years, the money stock may rise by x percent; but it makes a difference whether that increase comes about steadily and quite predictably or erratically and surprisingly.

Much of the linkage between *changes in money* and *performance of the economy* involves *uncertainty. If* changes in money are highly erratic, people respond in ways of self-defense that tend to increase costs and reduce effectiveness, thereby lowering national income. And if changes in money are large enough to generate increasing *inflation,* then greater inflation itself will create additional uncertainties which discourage production, for higher inflation means more variable inflation. Over much of the recent past, we have made for ourselves the worst of both worlds: money has commonly been increased too fast and always increased too unevenly.

There are many changes. A world of innovation and mobility and effectively registered community preferences is obviously a changing world. But adaptation to advances in knowledge and to shifting desires is very different from adaptation to unpredictable changes in the amount of money and to fluctuating degrees of inflation. Deliberately changing one’s tactics during the game is one thing; being confronted with arbitrary changes in the rules and their interpretation or in the dimensions of the playing field is something entirely different.

When we manage the money supply badly--aberrantly increasing it too rapidly and then much too slowly, usually with inflation of a widely fluctuating rate--we unnecessarilyadd to our burdens of uncertainty in an already hard world. Much of what we do today is based on anticipations of tomorrow, and greater uncertainty makes the game more difficult. Unavoidable risk is not to be avoided, but we are not obliged to magnify our distractions and misdirections by lousy policy. With a highly variable amount of money, and perhaps highly variable inflation as well, we try to find refuge from the greater risk and muddled market signals by adopting shorter planning periods and reducing venturesome investment.

In our attention to coping with aggravated uncertainty, efficiency is diminished and we produce less well. It is not shrewd to produce less than we can in a world where, at best, we can never produce all we want.

Questions for Thought and Discussion:

I. If money exists to lower transactions costs in a society, thereby allowing exploitation of differing comparative advantages to raise our standards of living, how does greater volatility of money growth affect money’s ability to facilitate mutually beneficial exchange?

2. Why might the real interest rate rise in response to greater volatility of money growth? What would this do to investment and the growth of real output over time?

3. Can monetary volatility generate net gains (gains that exceed losses to others) to society?

4. How would volatile money growth affect the stability of velocity? How would a rule specifying a fixed money growth rate affect velocity?

**19. A Target of Permanent Zero Inflation The Midnight Economist**

Inflation is not required for prosperity; indeed, inflation can accompany slow growth of the economy. Over the past century, we have flourished most with either very moderate inflation or slight disinflation. This was the case from the 1890s to the first World War and in the 1920s, when the price level was approximately steady or even fell a bit; it was the case also from the late 1950s to the late '60s and during the mid- and late 1980s, when inflation was low. By contrast, from the early 1970s to the early '80s, inflation was large but the growth of output was small.

There could be some short-term costs for some in reducing the rate of inflation. Any change in major economic variables--such as inflation and interest rates--is likely to benefit some members of the community and make others worse off. Reducing the inflation rate would tend to favor creditors over debtors. Interest rates would tend to fall a bit as inflation anticipations are diminished, which would give current holders of securities a small, one-period gain. And there is the common concern--not entirely ridiculous even if often exaggerated--that even a short and gentle period of disinflation would generate a recession.

Such unevenly spread, but limited, transitional gains and costs would seem of small consequence compared to the major advantages of permanent establishment of virtually zero change in the price level. Keeping the inflation rate around zero would minimize various social and economic costs and increase productivity.

While some--through either deliberate shrewdness or unconscious good Iuck--can benefit economically and politically from inflation, the community generally can hardly gain. Rapidly and erratically rising prices do not increase the amount of our resources or improve the technology with which our resources are used. Rather, say the economists of the Cleveland Fed, the confusion and concern generated by inflation “...redistributes income arbitrarily...reduces national income by fostering inefficient decisions about production and consumption...induces people to use scarce resources both to forecast inflation and to protect themselves...and...hampers growth of productive capacity by discouraging saving and investment...”

The Fed has just one fundamental policy purpose: stabilize the price level. It cannot much affect employment and output in the long run, and it ought not to diddle and tinker with interest rates and exchange rates and short-term hyping and suppressing of economic activity. Well establishing an effective commitment to zero inflation would dilute the ability of the Fed to do things it should *not* do, while enhancing prospects of continuing success in doing what it should do.

Questions for Thought and Discussion:

1. Why can’t an increase in the rate of inflation generate net gains for a society as a whole?

2. Why would an unexpected decrease in inflation benefit creditors at the expense of debtors? Would an expected decrease in inflation have the same effect?

3. Why could too much emphasis on the short term effects of monetary policy make it very hard to achieve a zero inflation rate target?

**20. Money and Mouse Work The Midnight Economist**

“The makers of monetary policy are dumb for keeping such a tight lid on the money supply,” complained Mouse Karl.

“It’s true,” acknowledged Adam, “the money supply is smaller now than it was at the end of last year. The Federal Reserve has long alternated between too little and too much money growth. We would all benefit from a policy of *stable* growth of money at a prudent rate.”

“Not now!” exclaimed Karl. “The Fed ought to pour money into the economy. With a greater supply of money and credit, interest rates will fall. Lower interest rates will then encourage businesses to invest more in new tools and technology. And with more and better equipment, the productivity of mouse work will rise.”

“I agree,” agreed Adam, “that more investment can increase mouse productivity. But I disagree that greater money growth will produce the increased investment.”

“Nonsense,” snapped Karl. “If you were a good economist, you would know that more money always lowers interest rates, and lower interest rates always raise investment.”

“Good economists,” gently suggested Adam, “do not just wiggle their whiskers and ignore critical evidence. And evidence does reveal that greatly increased money growth causes *higher* (not lower) interest rates and *less* (not more) investment.”

“I don’t believe it,” said Karl disbelievingly.

“Don’t forget the relationship between money and inflation,” cautioned Adam. “*Past* money growth--say from two years ago--combines with *today’s* real output growth to determine the rate of inflation. So when earlier money growth exceeds current output growth by a wider margin, monetary policy is more inflationary.”

“And with more inflation,” continued Adam, “interest rates rise as lenders add inflationary premiums to compensate for the cheaper dollars repaid to them in the future. More important, the uncertainties and distortions of greater inflation undermine incentives to make new investments. Overexuberant money growth generates inflation, and inflation is the enemy of investment.”

“Consider the period since 1970. During these years, the growth of real net fixed investment generally moved opposite to the direction of monetary policy. When earlier money growth exceeded current output growth by a wider margin, investment grew more slowly.”

“Or declined more rapidly?” asked Karl.

“Yes,” answered Adam. “So if the Fed poured lots of new money into the economy now, the likely outcome would be more future inflation. And more future inflation would mean *less* real investment.”

“I suppose,” supposed Karl, “that in the long pull we could have more investment if monetary policy did not lurch from one side to the other.”

“The Fed would encourage investment if it *consistently* aimed at producing a stable price level. And more investment would increase the productivity of mouse work,” added Adam.

“And since earnings depend on the productivity of our work,” concluded Karl confidently, “our standard of living would rise.”

Questions for Thought and Discussion:

1. If an increase in the money supply would have no effect on inflation, would it decrease interest rates and increase investment?

2. If lenders and borrowers quickly anticipated that a current increase in money growth will lead to inflation in the near future, how long will it take for long term interest rates to increase?

3. Why would a consistent focus on a stable price level tend to increase investment?

4. If one of the traditional “cures” for a recession is an increase in the money supply, why is it so difficult to deal with an inflationary recession?

**21. “Highs” and “Lows” with Sugar and Money The Midnight Economist**

Use of much sugar temporarily suppresses hunger, but it does so by creating a “sugar high.” Hunger disappears and energy surges. But this euphoria is deceptive, for energy quickly diminishes, fatigue follows and hunger for sugar returns. To relieve the renewed hunger, still more sugar may be eaten, only to be followed by more highs and still further lows. Sugar addiction may occur and bodily harm can ensue.

There is an analogy in economic activity and policy. or years, our economy has been operating on “sugar highs” of massive doses of new money. Many have hungered for the expenditure of Treasury funds. Much of this expenditure is financed, not by tax revenues, but by creating new dollars. Thus, the new government spending is not a deliberate *shift* from previous spending, substituting new projects for old, but, instead, is simply *added* to the old, ongoing expenditures.

Might this creating of more money increase production? The mere creation of money does not mysteriously broaden our technological knowledge or discover more raw materials. The real, physical aspects of life go on as before--and the only impact of the additional money is on the level of prices. So it is--*if* the community *understands w*hatis happening.

But if people are happily *fooled* by having more money, their “dollar high” leads them to feel optimistic and expansive. Believing that demand for *their* kind of services and products has unexpectedly and uniquely increased, they can be inspired to spend and lend faster, to work harder and to invest more.

But people are not stupid; they learn. They discover that an increase in the aggregate money stock is all that has basically happened. There has been no peculiar increase for *their* assets and rising prices are off-setting their larger money incomes. So expansion plans are scrapped and activity falls back to normal and even beyond: the artificial “high” has generated a responsive “low.”

If people have been similarly fooled in the past, it is harder to fool them again. The “highs” do not come as easily. If government *wants* to stimulate the economy, hyping it to an abnormally frenetic pace, the money dose must be *larger* than before. The injection necessary to fool people will have to be bigger and bigger in order to make the money increases greater than anticipated.

Unless we *persistently* increase the amount of money at an *increasing rate,* each “high” will give way to a “low.” But there are severe physical limits to how much we can increase the rate of output. We soon reach--and, indeed, long ago did reach--a point when money is increasing more rapidly than real output. From that point, further injection of money--like further consumption of sugar--does nothing but harm. We then live no better in terms of real goods; all we accomplish by trying to fool ourselves is the self-inflicted injury of inflation.

Questions for Thought and Discussion:

1. How do the short-run and delayed long run-effects of monetary expansion compare with the short- and long-term effects of sugar consumption?

2. Why is an increase in the money stock, like an increase in sugar consumption, unable to increase real output in the long run?

3. If we are fooled into temporarily producing more than we otherwise would have by expanding the money stock, are we better or worse off? What if we are fooled by the money stock growing more slowly than we expected? What about over theentire “binge-diet” cycle?

4. How fast would money have to grow each year for the “sugar high” of output beyond the natural level of real output to be maintained? What would happen as people learn to expect this rapid money growth?

**22. Misleading Indicators The Midnight Economist**

We have great difficulty figuring out where we have been and understanding where we are. Still, many are not deterred in trying to find ways of foreseeing where we are going.

Interest in the future is not confined to idle curiosity. If we were to know pretty well what prices and interest rates and national income will be a year or two from now, we could partially protect ourselves against bad developments and cash in on some of the good; and through public policy, we might mitigate prospective catastrophe and conduce prosperity.

To be able to predict is to enhance our power to control. But how to predict future activity of the economy? Well, there are purported “leading indicators,” an index of twelve economic variables, reported monthly. The index is supposed to change direction before turning points in economic activity, giving us warning of forthcoming booms and busts.

Some take such devices seriously. Maybe the devices do help more than they mislead. But they are to be handled very gingerly.

Predictably, the dozen variables represented by the index do not always point in the *same direction* or change direction at the *same time.* If they did, just one variable would be enough. But, with a divided jury of variables, we have the problem at any time of deciding which components of the index are to be taken most seriously.

The aggregate index can give *false* signals of imminent turning points in the economy. It can give *ambiguous* signals. And it can give signals subject to *misinterpretation:* an increase in prices of materials may reflect a discouraging supply shock rather than expanding demand. Some of the difficulty in using the index stems from *incorrect data*--it has proved prudent to revise the calculation in each of the first two months after its initial pronouncement, and the revisions can be so great as to reverse the direction of change of the index.

Finally, even when the figures prove to be accurate and give a clear and correct signal, the *lead time* of the warning can vary enormously. If the lag between the turning point of the indicator and the turning point of the economy is just a month or two, there is no warning at all: the turning of the index is not taken seriously unless the new direction is followed for at least three months. And if the lag approaches two years, then the warning is simply a uselessly vague indication that “eventually” economic activity will change.

It is hardly surprising that the index of leading indicators commonly indicates poorly. Many things can affect the future. What will the Federal Reserve, Congress, foreign fiscal and monetary authorities and suppliers, unique combinations of circumstances, and new business practices do to us next? But if fine-tuning control of the economy depends on prediction and if prediction relies on measuring and interpreting leading indicators, we should put little reliance on fine-tuning.

Questions for Thought and Discussion:

I. Why is knowing “where we are going” important if active macroeconomic policies are to help stabilize the economy? Why is knowing how far in advance and how accurately the index of leading indicators predicts important for such stabilization policies?

2. How do the lag problems associated with implementing monetary and fiscal policy changes interact with the variable prediction lag in the index of leading indicators, with regard to the success of attempts at fine tuning?

3. Why might the index of leading indicators send false signals about the future when price changes reflect supply shocks?

**23. A New Friend and Familiar Foolishness The Midnight Economist**

Recently, mouse Karl had returned from shopping and was furious about the high price he had to pay for a whisker brush. After Karl had fulminated about high prices and extolled the alleged virtues of price and wage controls, Adam was about to respond when a large spider appeared from behind a dusty volume.

“My dear fellows,” began the spider, “history is a prolific teacher of the destructiveness of price and wage controls. I know from personal experience, for I have lived many lives. Before beginning the numerous transmigrations which have brought me to my present spidery state, I was a scribe during the reign of the Roman Emperor Diocletian. The Edict of Diocletian in 301 A.D. was a chilling example of the pervasive problems which controls create.”

“What do you call yourself now?” asked Adam.

“My name is Waldo,” replied the spider. “But let me tell you of the havoc wreaked by Diocletian’s Edict when he foolishly tried to control prices and wages by government command.”

“Please continue,” encouraged Karl, who was eager to defend price controls.

“Not long after Diocletian assumed the throne,” Waldo said, “prices and wages increased to unprecedented heights. Much like modern day politicians, the Emperor blamed inflation on the greed of merchants and speculators.”

“Right on!” exclaimed Karl. “Greed, avarice--that's what makes prices high.”

“No” responded Waldo. “The inflation which Emperor Diocletian condemned was caused by excessive minting of new coins. For many years, to finance massive and growing government expenditures, emperors had issued more and more coins, causing the money supply to grow faster than the goods on which those coins were spent. Like a fly in a spider web,” said Waldo, “the more coins minted by emperors to cope with rising prices, the more entangled they became in inflation.”

“But what about the Edict?” asked Karl. “Surely price and wage controls cured inflation.”

“I remember well the disaster of the Edict,” answered Waldo. “Diocletian fixed the prices and wages that could be charged. Death was prescribed for those caught selling or buying at prices above the maximum official levels.”

“So," smirked Karl, “the Edict did work.”

“"No, it did not,” answered Waldo. “There were informers, supervisors and controllers everywhere. But even this iron corset of control could not alter the fact that the money supply was too fat. Given the amount of coins available to spend, people wanted to buy more goods than were available at those controlled prices. Goods were hoarded rather than sold, production fell, shortages abounded.”

“People simply had too much money to spend at the low, decreed prices. The lesson,” continued Waldo, “is that price and wage controls cannot cure inflation: they bring only regimentation, shortages, less wealth, and loss of much personal liberty. I know; I was there.”

Questions for Thought and Discussion:

1. Can trying to bring inflation under control by imposing wage and price controls be considered a case of one government policy error compounding another?

2. Why is it so hard to effectively enforce wage and price controls that are far from their equilibrium levels?

3. Without wage and price controls, what would happen to all the resources that must be devoted to their enforcement (and evasion)?

4. If a country’s official measure of inflation used controlled prices in its calculations, would the official inflation measure correctly measure inflation in a period of wage and price controls?

***The Midnight Economist***

**for**

**Robert L. Sexton**

**Exploring Economics, 7e**

**International Trade and Finance**

(Chapters 28-29)

**1. Trade and Mutual Gain The Midnight Economist**

Everyone in every society does it. They always have. But until less than 200 years ago, no one could explain why it is done--and Senator Snort and most editorial writers still do not understand.

The activity in question is trade, of course. Why do people do so much buying and selling? Presumably, they do not exchange just for the giddy fun of the activity. Instead, they swap in order to gain. Gain what? Well, after the trade, the trader considers himself to be better off, on balance, because he values more what he gets than what he gives up.

But if one participant is willing to trade away something he deems of lesser worth in order to obtain something of greater worth, surely that is the case for the other participant, as well. Each trader considers himself to have gained from the exchange. Otherwise, there would be no trade: If either person thought that he would lose from the transaction, he would not play.

So there are mutual gains from trade. Mr. A feels that Mr. A is made better off by the trade; Mr. B feels that Mr. B is made better off. Mr. A may believe that B is a fool to make the swap; Mr. B may be confident that A had been suckered; and Mr. C--an interested observer--may consider both of them to be strange, for no civilized person would want either of the goods being exchanged.

No matter. Each person is the appropriate, relevant judge of his own condition. If it is the personal, subjective estimation Of Mr. A that he has gained by the trade, then he has gained--no matter what the preferences and assessments of others may be. And Mr. B is the pertinent judge of Mr. B’s market options and actions.

Is all this obvious? It is pretty apparent once we see it. But Aristotle did not see it. Nor did Saint Thomas Aquinas. Nor even Adam Smith. For centuries, public policy was directed on the supposition that what one party to a trade gains must have been lost by the other. The concert of *mutual* gains, with all immediate participants being made better off, is one of some subtlety.

Comprehension of the notion of mutual gains is significant as well as subtle. Such comprehension provides orientation in confronting the world.

If one believes--as have a great many over the ages--that all the gain from an exchange goes to one trader, with that gain matched by loss suffered by the other trader, then the world is one of bitter conflict, a war of each against all others. But if it is understood that both parties gain from appropriate trade, then the world is seen as one of possible coordination to the benefit of all.

At best, we still will inhabit a world of scarcity--and thus a world of strain, frustration, and conflict. But we can best adapt to scarcity, making the world less hard and hateful than it otherwise would be, by trading to mutual benefit.

Questions for Thought and Discussion:

1. In physics, you learned about conservation of mass and energy. Why is voluntary exchange different--wealth creating rather than wealth conserving?

2. If you are mugged, is giving up your wallet a voluntary exchange? Is paying your taxes voluntary? Is there any guarantee either of these “exchanges” will leave you better off?

3. If I sell you an item I would be willing to part with for $50 and you would be willing to pay as much as $100 for, why do economists say both parties to the exchange gain, whether the price paid is $51 or $99?

4. If you hate the process of haggling over prices, do posted prices not subject to negotiation make you wealthier?

5. Do you think that people who shop at yard or garage sales enjoy the process of exchange more or less than most people?

**2. The Trade Deficit and Cheap Foreign Labor The Midnight Economist**

Cheap foreign labor is responsible for our enormous trade deficit. That is what many Americans believe. This myth persists with the tenacity of a hungry dog gripping a bone. It would help to bury it--the myth, not the bone.

First, the simple contention ignores differences in labor productivity. If, on average, foreign workers produced half as much per hour as do Americans, then foreigners could earn a wage no more than half as much if their unit costs are not to be higher. If you are paid $10 for making 10 pins in an hour, then each pin has a labor cost of $1. The unit labor cost is the same if I receive just $5 for making only 5 pins per hour. Foreign hourly wage rates below ours do not mean that foreign production *costs and prices* also will be lower.

Second, foreign workers are paid in their own currencies, not dollars. If a South Korean worker receives 2,000 won per hour, is that wage more or less than the $10 earned by an American? It depends on the rate of exchange between the won and the dollar. If the dollar could buy 2,000 won, then the Korean wage would be equal to $1. In that case, the Korean worker would earn less than the American. But if the dollar buys only 100 won, then the hourly wage of 2,000 won would equal $20, greater than the American wage. Whether the Korean earns more or less than the American thus depends on the rate at which dollars and won can be traded.

What do exchange rate gymnastics have to do with the argument about cheap labor and our trade deficit? If the gap between foreign and American *wage rates* rises above the gap between *worker productivities--*i.e., the American money wage more than offsets the American edge in physical productivity--then foreign labor would be relatively cheap. With American wages high relative to Korean, our imports would rise, our exports would fall, and the trade deficit would grow.

But here is a further point often ignored. As foreigners buy fewer American goods, they demand fewer dollars. And as we import more, we supply more dollars. The result is a surplus of dollars in international markets. This dollar surplus would cause the prices of the dollar to fall in terms of foreign money. And if it takes more dollars to equal a given foreign wage, then the dollar measure of that wage will rise. Foreign wages--measured in dollars--would rise until they reflected the difference between foreign and American productivities.

Given international productivity differences and the money payments to workers here and abroad, freely adjusting exchange rates will keep the general level of American wages competitive with foreign wages, even though foreign incomes generally are smaller in purchasing power.

Our trade deficit has ballooned in recent years, and some worry about that. But cheap labor abroad--reflecting lower productivity abroad--is not the cause of the deficit.

Questions for Thought and Discussion:

1. Why do Americans complain about being unable to compete with cheap foreign labor, while other countries complain they can’t compete with America because of our plentiful and cheap capital stock?

2. If foreign production was generally cheaper at current exchange rates, why would the exchange value of a dollar tend to fall as a result?

3. Why would a country with extensive new attractive investment opportunities tend to run a trade deficit?

**3. Foreign Lessons The Midnight Economist**

Foreign trade is not a simple subject. So it's not surprising that many find it foreign. And they are inclined to agree with proposals that superficially seem sensible yet actually produce misery.

Take the popular belief about imports and jobs. Layoffs in the auto industry and elsewhere seem to confirm that imports are destroying jobs of our workers. So why not put Americans first and protect their employment by restricting imports?

One problem is, such a policy is more likely to hurt than help American workers. No wonder a group of over 1,000 economists petitioned President Hoover in 1930 to veto the Smoot-Hawley bill, which proposed huge hikes in tariffs. At the time, its co-sponsor, Rep. Hawley, argued that, “The Tariff..is for the purpose of maintaining our industries, protecting our labor, sustaining our agriculture and promoting the general prosperity of this country.”

Economists knew that Hawley’s argument was wrong. But the bill sailed through Congress and President Hoover, with an eye on the upcoming election, signed it. The massive tariffs then helped to constrict world trade, reduce production and employment and promote the horror of the Great Depression, with the related fallout of World War II.

This was not the outcome intended. But Americans and others poorly understood (and politicians never admitted) that greater foreign trade usually means more, not less, production and employment in our country.

Recent experience confirms such a relationship between imports and employment. To measure employment, consider the number of employees in manufacturing, construction and mining, the so-called goods-producing industries. And to measure imports, take the value of imported merchandise as a percentage of national output.

Over the past decade and a half and longer, these two measures closely moved together. When imports increased as a fraction of national output, employment in American industries producing goods went up, not down.

Put simply, trade helps make the economic pie bigger. When we buy imports, we pay dollars to foreigners. Some of those dollars come back to us when foreigners use them to buy U.S. stocks, bonds and other assets. More funds then become available for our businesses to invest in new tools and technology and the greater investment boosts production and employment here.

Most of the dollars spent abroad return when foreigners spend them on our output. True, our imports can cause production and employment to shrink in some areas. But foreigners’ purchases from us expand production and employment in others. American workers then move to more efficient industries and businesses, where they are more productive and can earn higher wages.

Foreign trade promotes our nation’s wealth. That was an important lesson that President Hoover and Congress found so alien in 1930. But is the lesson any less foreign today?

Questions for Thought and Discussion:

1. Is the basic logic of international trade any different than that of domestic trade?

2. Do you worry about a balance of trade deficit with your grocer? If you refused to “import” products from a local grocer who offered a better deal than other grocers, would you be better or worse off?

3. Will restricting imports affect exports and export-related jobs? How?

4. Is the primary gain from international trade more jobs or jobs that are more valuable, exploiting each country’s comparative advantages?

**4. Import Restrictions and Specialization The Midnight Economist**

“Cheese imports from other mouse villages should be restricted,” exclaimed Karl. “More and more of our mice are buying imported cheese rather than cheese made here in our village.”

“I can understand that,” replied Adam enthusiastically as he licked his fingers. “I just ate several slices of imported cheddar and its quality was superior. Would you like a slice?”

“No!” sniffed Karl. “I prefer to buy cheese made by our own village workers.”

“That's your choice,” sighed Adam, “but why do you propose to restrict cheese imported from nearby villages?”

“Because mice in other villages are getting all the jobs producing cheese, while some of our own mice workers are unemployed,” said Karl. “Quotas on imported cheese would increase the demand for our own cheese and that would increase employment of our village workers.”

“You mean our village would be more productive because more mice would be busy producing cheese?” asked Adam.

“Exactly,” replied Karl, who was beginning to eye Adam’s imported cheese.

“If you are correct, then why not limit cheese imports into every household,” suggested Adam. “Every time a mouse family buys cheese--even our own village’s cheese--it is importing rather than producing the cheese at home. Wouldn’t that family be more productive if it were kept busy making its own cheese?”

“That would be silly,” responded Karl. “Some mice, like me, don’t even know how to make cheese. I would rather buy the cheese and spend my time working at the bread factory.”

“Of course it would be silly to produce everything here,” Adam agreed. “Compared to other villages, we are better in some lines of production than in others. Imports allow our workers to use their time more efficiently producing the goods and services at which they are most skilled rather than poorly producing everything we consume. We sensibly specialize, concentrating on what we produce relatively best.”

“I still think import restrictions on cheese would create more jobs,” retorted Karl.

“It is true that more of us would be employed making cheese,” explained Adam, “but the cheese would cost more, and it wouldn't taste as good.”

“Well, it’s not fair that mice in other villages should take jobs away from our own workers,” complained Karl. “What will they do? Remain unemployed?”

“They will be employed in the more productive industries of our village, such as baking bread,” said Adam. “If we limited the quantity of cheese we buy from other villages, the mice living there would have less money to spend on the bread we export to them. More of our villagers would be making cheese, but fewer would be baking bread. Since we are more productive at baking bread, our village would be worse off, not better off, because of the import restrictions.”

Questions for Thought and Discussion:

1. Do *countries* trade? Is there any analytical reason to distinguish the benefits of trade between individuals from that between countries? Why are such restrictions so much more common in international trade than the trade within a country?

2. Why would focusing only on the jobs currently held by people in an area tend to overstate the benefits to protectionism? Why do the numbers of those who lose jobs from eliminating trade restrictions overstate the negative effects of more open trade on unemployment?

3. Why might you expect that the cost per job “saved” by import restrictions would often greatly exceed the income from the job?

4. How would import restrictions affect exporters in a country? (e.g., how would Boeing be affected by import restrictions on computer chips?)

**5. Price Control in the Foreign Exchange Market The Midnight Economist**

A market is a procedure through which something is bought and sold at a price.

A market is a very useful institution: it brings demanders and suppliers together for exchanges which benefit both parties of the trade. And, if people in the market are free to bid and offer as they please, the exchanges are not only mutually beneficial, but also equilibrating: prices are agreed to at which buyers can buy and sellers can sell all they want at those prices--the market is cleared.

The foreign exchange market really *is* a market. The commodities traded are currencies of the world; and theprices are exchange rates--the dollar price of the yen, the peso price of the euro.

The foreign exchange market is a smooth-operating mechanism, for the commodities are standardized (a dollar is a dollar, but wheat comes in different grades) and communication is virtually instantaneous. So if the foreign exchange market is not hamstrung by government, it is readily cleared and market participants are not frustrated by shortages and surpluses.

Although equilibrium prices are generated by the intermingled activities of the people in the market, no person--private trader or government manipulator--can know at the beginning of the day what those equilibrium prices will turn out to be. So only by accident could a price-pegging operation establish a market-clearing price. There is no formula or procedure which will reveal before the fact what exchange rates an unencumbered market would provide today, tomorrow and all the following tomorrows.

And since an open market will efficiently equilibrate, with changing prices quickly reflecting changing supplies and demands, why are there always interventionists eager to decree prices? There is no reason to suppose that monetary authorities can do the market’s job better than can the market.

We do not require discretionary intervention by bureaucrats to clear the market; indeed, such intervention precludes equilibrium forlong, if it permits equilibrium at all. Even if the interventionists happened to specify an equilibrium price--which the market would have yielded, anyway--that price will not remain the equilibrium price. As incomes and preferences and prices and interest rates and technologies and input supplies and business practices and government policies change, the equilibrium exchange rate value will change; and if we are stuck with the old pegged price, then the foreign exchange market will no longer be cleared.

If the busybodies eventually wish to pull the peg and impose a different price--for it is costly to buck the market, defending and living with artificial prices--then they are back in the fog of uncertainty about where to replace the peg. And they do not know how long to wait before changing the peg, whether the change in the price should be done gradually or precipitously or how best to make do in the intervening imbalance.

Price-control of currencies--like price-control of wheat and apartments--does not give us equilibrium prices, and it does not help to correct disequilibrium prices. Markets are made less useful by the tinkering of price controllers.

Questions for Thought and Discussion:

1. Why are the chances that a government-set exchange rate will be at its equilibrium level so low?

2. Why are countries limited in how long they can maintain disequilibrium exchange rates?

3. Do pegged exchange rates, when governments can choose to change the pegs, reduce or increase the uncertainties in the foreign exchange market?