

Common Sense Economics:
What Everyone Should Know About Wealth and Prosperity
(Gwartney, Stroup, Lee, and Ferrarini - St. Martin's Press, © 2010)

Reading Guide

Part I. Twelve Key Elements of Economics



Element 1: Incentives Matter.

1. The authors state that “All of economics rests on one simple principle.” What is this principle?
2. Describe the following statement in your own words: “There is little reason to believe that a person making choices in the voting booth will behave much differently than when making choices in the shopping mall.”
3. Do incentives influence the choices of students? Do incentives influence the decisions of elected political officials? Did incentives influence choices under the socialist central planning system of the former Soviet Union? Provide examples.
4. If you respond to changes in incentives, does this indicate that you are selfish and greedy? Did Mother Teresa respond to incentives? Was she selfish and greedy?
5. If the price of a good increases because consumers want to purchase more than sellers are currently supplying, how will the higher price affect the incentive of consumers to purchase the good? How will the higher price affect the incentive of sellers to supply the good?

Element 2: There Is No Such Thing As a Free Lunch.

6. Why can't we consume as much of each good or service as we would like? If we become richer in the future, do you think we will eventually be able to consume as much of everything as we would like? Why or why not?

7. What does the cost of a good or service reflect? Does it ever make sense to make a choice without considering the cost? If you choose an option without considering the cost, what does this mean?
8. Why is it costly for you to purchase and item or make choices involving the use of your time? What is the meaning of “opportunity cost”? What is the opportunity cost of purchasing a book? What is the opportunity cost of reading the book?
9. If a good is provided free of charge to individuals, how will this affect their incentive to conserve on its use?

Element 3: Decisions Are Made at the Margin.

10. What does it mean to make a decision “at the margin”? Consider your purchases of food in the next month. As you choose how much you will spend on food and the amount of each food item you will purchase, will these be “marginal” decisions? Why or why not?
11. A restaurant offers an “all you can eat” lunch buffet for \$10. Jim has already eaten three servings, and is trying to decide whether to go back for a fourth. Describe how Jim can use marginal analysis to make his decision.
12. “Pollution is causing \$100 million worth of damage to the environment and we are only spending \$1 million to reduce pollution. We are clearly not spending enough on fighting pollution.” Is this statement true? Is marginal analysis needed to answer this question? Explain.

Element 4: Trade Promotes Economic Progress.

13. Why do people engage in trade? If one of the trading partners gains, must the others involved in the transaction lose an equal amount? Why or why not?
14. Is trade productive? Could trade be productive even if nothing new was produced? Explain.
15. What are the three major sources of gains from trade? Explain the source of the gains derived by the trading partners in each of the three cases.
16. What is the law of comparative advantage? Why does it lead to specialization, and explain how this influences the total output the trading partners are able to produce?
17. Why do you trade for things rather than produce them yourself? Would you be better off if you did not buy so many things from others? Would Americans in general be better off if they did not buy so many things from others?
18. What are economies of scale, and how are they achieved? What role can economies of scale play in increasing the gains from trade?

Element 5: Transaction Costs Are an Obstacle to Trade.

19. What are transaction costs? Why are they an impediment to trade?
20. “Countries that impose obstacles to exchange – either domestic or international – reduce the ability of their citizens to achieve more prosperous lives.” Indicate why you either agree or disagree with this statement.
21. What is a “middleman?” Give a couple of examples of middlemen. Do middlemen perform valuable services? Why or why not?
22. How have the following influenced the volume of trade:
 - a. the internet?
 - b. the interstate highway system?
 - c. tariffs on goods purchased from sellers in another country?

Element 6: Prices Bring the Choices of Buyers and Sellers into Balance.

23. Why does the demand curve for a good slope downward to the right? What does the downward slope reflect?
24. What is the law of supply? What does it imply about the supply curve for a good or service?
25. If the quantity of a good consumers are purchasing exceeds the quantity producers are willing to supply at the current price, what will happen to the market price in the future? Why?
26. What does the height of the demand curve for a good indicate? What does the height of the supply curve for the good indicate? What condition must be present if an exchange is going to occur?
27. In a market economy, will units of a good be produced and purchased if consumers value them more than their cost of production? Explain. If the production cost per unit of a good exceeds the value derived by consumers, will the good continue to be produced and consumed? Why or why not?

Element 7: Profits Direct Businesses Toward Activities That Increase Wealth.

28. What must a firm do in order to make a profit?
29. What is the function of profits in a market economy? What is the function of losses?
30. If we want to get the most out of our resources, is the role of losses just as important as that of profits? Why or why not?

31. In a market economy, how do suppliers decide what to produce? Do they have an incentive to produce those goods and services that consumers value highly relative to their cost? Do the producers have an incentive to produce efficiently and keep costs low? Why or why not?
32. If a business is consistently making losses, should the government provide it with subsidies so it will be able to continue operating? Why or why not?

Element 8: People Earn Income by Helping Others.

33. In a market economy, what is the primary source of high earnings?
34. “High-income individuals must be exploiting others.” Is this statement true? What must one do in order to earn a high income in a market economy?
35. If one is motivated primarily by the desire to make a lot of money, will he or she still have a strong incentive to provide others with goods and services that they value? Why or why not?
36. How have the actions of Oprah Winfrey, Tom Hanks, Steve Jobs, LeBron James, and Bill Gates impacted the well-being of others? Have you been helped by any of them? Were you harmed by any of them?

Element 9: Production of Goods and Services People Value, Not Just Jobs, Provides the Source of High Living Standards.

37. What is the source of higher income levels and living standards? If there is an increase in employment, does this necessarily mean that income levels have increased? Why or why not?
38. Under the “Cash for Clunkers” program of July-November 2009, the government paid car dealers between \$3500 and \$4500 per vehicle to destroy approximately 700,000 used cars traded in when purchasing a new automobile. Did this program increase new car sales, output, and employment in the auto industry in 2009? What impact did it have on new car sales in 2010 and subsequent years? Did it improve the living standards of Americans? Would Americans be better off if an outbreak of crime destroyed 700,000 automobiles during the next few months? Why or why not?
39. Does government spending create jobs and expand employment? Why or why not?
40. Is there good reason to expect that projects financed or subsidized by the government will generate goods and services that are more highly valued than their cost? Why or why not? When goods and services are produced through market allocation, is there good reason to expect that they will be more highly valued than their cost? Why or why not?

41. When governments become heavily involved in subsidizing and granting favors to some businesses at the expense of others, how will this incentive structure influence the efficiency of resource use?

Element 10: Economic Progress Comes Primarily Through Trade, Investment, Better Ways of Doing Things, and Sound Economic Institutions.

42. Explain how each of the following promote economic progress:
- a. Investments in productive assets
 - b. Improvements in technology
 - c. Improvements in economic organization
43. “Our modern living standards are primarily a reflection of brain power, capital formation, and the quality of institutions.” What is the meaning of this statement? Is it true?
44. Entrepreneurs are people who undertake the risk of business activity with the expectation of earning profit. Why is the role of the entrepreneur vitally important as a source of economic progress? How do entrepreneurs influence the discovery and development of new products and better ways of doing things?

Element 11: The “Invisible Hand” of Market Prices Directs Buyers and Sellers Toward Activities That Promote the General Welfare.

45. Describe Adam Smith’s “invisible hand” principle. According to this principle, how does self-interest actually work to help others (even when unintended)?
46. How do consumers decide whether or not to purchase a product? How do producers decide whether or not to produce it? What coordinates their actions and brings them into harmony?
47. Suppose you have a pizza and a Coke at a local restaurant, and then go to a movie. How many people do you think contributed to your enjoyment of these activities? What motivated them to do so?
48. Why did Friedrich Hayek believe that the information conveyed by markets was so important? What is the “summary statistic” that communicates information to buyers and sellers and helps to coordinate their actions? Would it be possible for any central planning agency to acquire the necessary information to motivate and direct resource suppliers, investors, producers, and consumers in a sensible manner? Why or why not?
49. Suppose you decide that it is in your self-interest to establish a computer repair business. Will others be better off or worse off if your business earns a profit? How will the well-being of your customers be affected?

Element 12: Too Often the Long-Term Consequences, or the Secondary Effects, of an Action are Ignored.

50. What are secondary effects? Give several examples of secondary effects.
51. Why does failure to consider the secondary effects often result in fallacious economic reasoning?
52. In 2002, the Bush administration imposed steel import quotas that limited the entry of foreign-produced steel into the U.S. market. What were some of the secondary effects of this policy? Did the policy expand employment as the administration argued that it would?
53. Several cities have adopted rent controls that force the price of rental housing below the market level. What are some of the secondary effects generated by these controls?