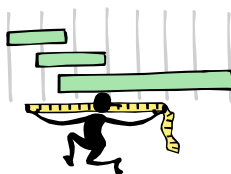


Common Sense Economics:
What Everyone Should Know About Wealth and Prosperity
 (Gwartney, Stroup, Lee, and Ferrarini - St. Martin's Press, © 2010)

Reading Guide

Part II. Seven Major Sources of Economic Progress



Legal System: The Foundation for Economic Progress Is a Legal System That Protects Privately Owned Property and Enforces Contracts in an Evenhanded Manner.

1. Explain the meaning behind the following quote from Tom Bethell: “Property sets up fences, but it also surrounds us with mirrors.”
2. Can the owners of private property do anything they want with the things they own? Why or why not? What does private ownership allow the owner to do?
3. What are the (four) reasons why the incentives provided by property rights promote economic progress? Explain why each provides the owners of assets with a strong incentive to use their resources wisely and engage in actions that benefit others as well as themselves.
4. Why is the evenhanded enforcement of contracts an important source of prosperity?
5. “Private ownership forces resource users to confront the cost of the resources they utilize. Without private ownership, it is difficult to see how the benefits of resource use could be balanced against the costs incurred.” Evaluate this statement.
6. If the ownership of a resource is insecure, how will this affect the value of the resource and the efficiency of its use? Why is legal entitlement of things like real estate, automobiles, scientific discoveries, and intellectual property important?
7. Do you think the world will soon run out of important natural resources such as oil or timber? Why or why not? If the resource is privately owned, what will happen to its price if supply should decline relative to the current use rate? How will this influence the likelihood that the supply of the resource will be exhausted?

Competitive Markets: Competition Promotes the Efficient Use of Resources and Provides a Continuous Stimulus for Innovative Improvements.

8. What makes a market competitive? Why is competition important?
9. What must a firm do in order to compete effectively? Do firms operating in a competitive market have an incentive to keep cost low and produce goods that consumers value highly relative to cost? Do they have an incentive to innovate and develop improved products?
10. In a competitive market, what happens to firms that fail to provide consumers with desired goods at prices equal to or less than those available from other firms? Is this good or bad? Is there a positive side to business failure?
11. When markets are competitive, what determines whether a new innovative product will be successful?
12. What determines whether corporations, individual proprietorships, employee-owned firms, consumer cooperatives or some other form of business structure will dominate in a market? In a market economy, are firms forced to use a specific type of business structure?
13. How is the size of a firm related to the concept of economies of scale? Why do the authors of CSE assert that there is no “right answer” as to the appropriate size of a firm, but rather that competition decides?
14. Is competition “pro-business?” Do business firms generally lobby legislators requesting that they make sure that their market is open to all potential producers, or do they often ask legislators to erect barriers limiting competition from various rivals?
15. What is “creative destruction”? Historically, how has creative destruction influenced the quality of our lives? Provide some examples that reinforce your answer to this question.

Limits on Government Regulation: Regulatory Policies That Reduce Trade Also Retard Economic Progress.

16. How will licensing and other government regulations that make it difficult to enter markets and operate legally influence competition? How will such regulations influence gains from trade, innovation, and income levels?
17. How will regulations that make it more costly for an employer to layoff or dismiss current employees affect the unemployment rate of youthful workers and other new labor force entrants? Explain.

18. “Price controls that set the price of a good or service above the equilibrium level will reduce the volume of trade, while controls that set prices below the equilibrium level will increase the volume of trade.” Is this statement true or false?
19. What is the “informal economy”? How does regulation influence the size of the informal economy? According to Hernando de Soto, what is the impact of regulation in developing countries?
20. Why do business and labor organizations often lobby for regulations that limit competition? When more and more resources are directed toward lobbying for political favoritism, how will total output and living standards be affected?
21. “Exchange based on mutual agreement is powerful evidence that the activity is both beneficial and productive.” Is this statement true? Why or why not?

An Efficient Capital Market: To Realize Its Potential, a Nation Must Have a Mechanism That Channels Capital into Wealth-Creating Projects.

22. What is capital investment? Why do business firms often use machinery and other capital assets to produce goods and services?
23. If an economy is going to grow, why is the allocation of investment capital into productive projects crucially important? What determines whether a project is productive?
24. When investment is allocated by government decision-makers, what determines which projects will be undertaken? How will the political allocation of investment funds influence the likelihood that investment funds will be persistently directed toward productive projects?
25. Even though the centrally planned countries of the former Soviet bloc had high investment rates, their growth rates were relatively low? Was this surprising? Why or why not?
26. Two large government-sponsored corporations, Fannie Mae and Freddie Mac, dominated the mortgage market during 1995-2008. Why did these two firms have a competitive advantage over other lenders in the mortgage market?
27. Responding to regulations and political pressure, Fannie Mae and Freddie Mac began approving mortgages with little or no down payment and extending more loans to sub-prime borrowers in the late 1990s. What impact did this policy initially have on the demand for and price of housing? How would you expect this policy to influence the mortgage default rate with the passage of time?

28. Government allocation of mortgage credit through Fannie Mae and Freddie Mac played a central role in the erosion of mortgage credit standards, the run up in housing prices, and the eventual collapse that led to the severe recession of 2008-2009. Did the political leaders that supported Fannie Mae and Freddie Mac accept responsibility for their role in creating the perverse incentives that generated the recession? Did they blame others for the crisis? Is this surprising?

Monetary Stability: A Stable Monetary Policy Is Essential for the Control of Inflation, Efficient Allocation of Investment, and Achievement of Economic Stability.

29. What are the functions of money? Is money productive – does it help people get more out of their resources?
30. What is inflation? What is the primary cause of inflation?
31. How does money of stable value influence the volume of trade? When the inflation rate is volatile, how is the volume of trade affected? How will this influence the income levels of people?
32. When policymakers shift to a more expansionary monetary policy, what will be the initial impact of this policy on interest rates, investment, and the level of economic activity? If the expansionary monetary policy is continued over a lengthy time frame, what will be its major impact?
33. Monetary policy exerts an impact on the level of economic activity with time lags that are variable and often lengthy. How will these time lags influence the ability of monetary policy-makers to stabilize the economy? If monetary policy-makers are constantly shifting back and forth between expansionary and restrictive monetary policy, what is the likely impact on economic stability?
34. During 2002-2004, the expansionary monetary policy of the Fed pushed interest rates to historic low levels. What impact did these low interest rates have on the demand for and price of housing? As the inflation rate rose beginning in 2005, the Fed shifted to a more restrictive monetary policy that pushed interest rates upward. What impact did this policy have on the demand for and price of housing? What impact did the more restrictive policy have on the mortgage default and housing foreclosure rates during 2007?

Low Tax Rates: People Will Produce More When They Are Permitted to Keep More of What They Earn.

35. What is meant by a marginal tax rate? Why is it so important to always consider the marginal tax rate in policy discussions?

36. How do high marginal tax rates affect the incentive of individuals to earn and invest? How will high marginal tax rates influence the personal income levels people are able to achieve?
37. “When marginal tax rates are high, tax-deductible expenditures become relatively cheap.” Explain the meaning of this statement.
38. Will higher marginal tax rates always generate more revenue for the government? Why or why not?
39. In 1932 the Republican President Hoover and the Democratic controlled Congress adopted a huge tax increase. Tax rates more than doubled and the top marginal rate was increased from 25 percent to 63 percent in one year. What impact did this tax increase have on economic activity? Is it a good idea to increase tax rates during a recession? Why or why not?

Free Trade: A Nation Progresses by Selling Goods and Services That It Can Produce at a Relatively Low Cost and Buying Those That Would Be Costly to Produce Domestically.

40. Are the principles underlying the gains from international trade different than those underlying domestic trade? Why or why not?
41. Paraphrase the three reasons given by the authors explaining why free trade allows nations to produce and consume more than would otherwise be possible.
42. How does competition from foreign producers affect American consumers? How do trade barriers affect the realization of gains from specialization and economies of scale?
43. “Trade restrictions neither create nor destroy jobs; they reshuffle them.” What is meant by this statement?
44. Why will the dollar value of the items Americans buy from foreigners tend to equal the dollar value of the items Americans sell to foreigners? (Hint: what does the foreign exchange market do?)
45. Would Americans be better off if importers had to obtain permission from government officials before they could buy things from foreigners? Would politicians be better off—would they have more campaign contributions?
46. Would Americans be better off if the states imposed trade restrictions limiting the purchase or sale of goods and services to the residents of another state? Would total U.S. employment be larger? Explain.
47. In 1932, the Smoot-Hawley trade bill increased tariffs by approximately 50 percent. President Herbert Hoover, Senator Reed Smoot, Congressmen Willis Hawley, and other

proponents of the bill thought the higher tariffs would “save jobs” and stimulate the economy. Were they right? What impact did the legislation have on the Great Depression?

48. What is the primary source of the political popularity of tariffs and other trade restrictions? Will politicians often be able to derive political gain from trade restrictions even if they exert an adverse impact on the economy? Why or why not?
49. “Good intentions provide little protection from the consequences of bad policy.” Do you agree or disagree with this statement? Cite examples supportive of your view.

Concluding Thoughts

50. How do institutions and policies influence income differences across countries?
51. What are the five freest economies in the world? Are countries with more economic freedom more prosperous than those that are less free?
52. When less developed countries adopt institutions more consistent with economic freedom, have they been able to grow rapidly and achieve higher income levels? Cite evidence in support of your response.