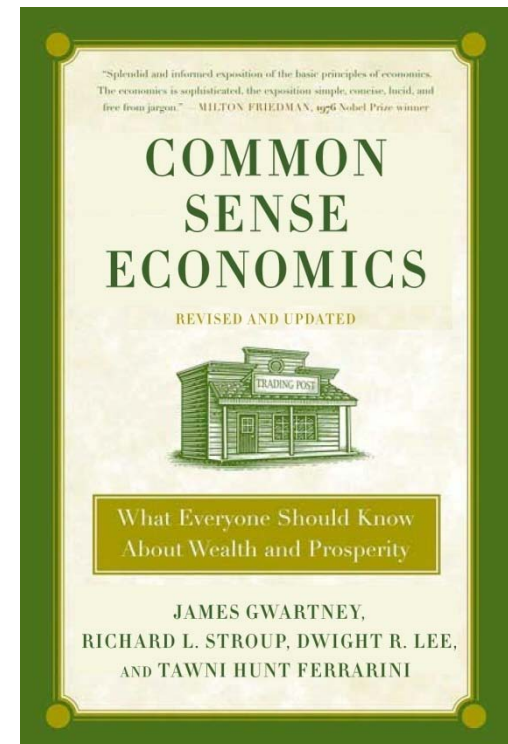


COMMON SENSE ECONOMICS ~ WHAT EVERYONE SHOULD KNOW ABOUT WEALTH AND PROSPERITY 2010

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<http://CommonSenseEconomics.com/>



QUESTIONS TO CONSIDER WHILE CONSIDERING THE TEN ELEMENTS OF CLEAR THINKING ABOUT ECONOMIC PROGRESS AND THE ROLE OF GOVERNMENT:

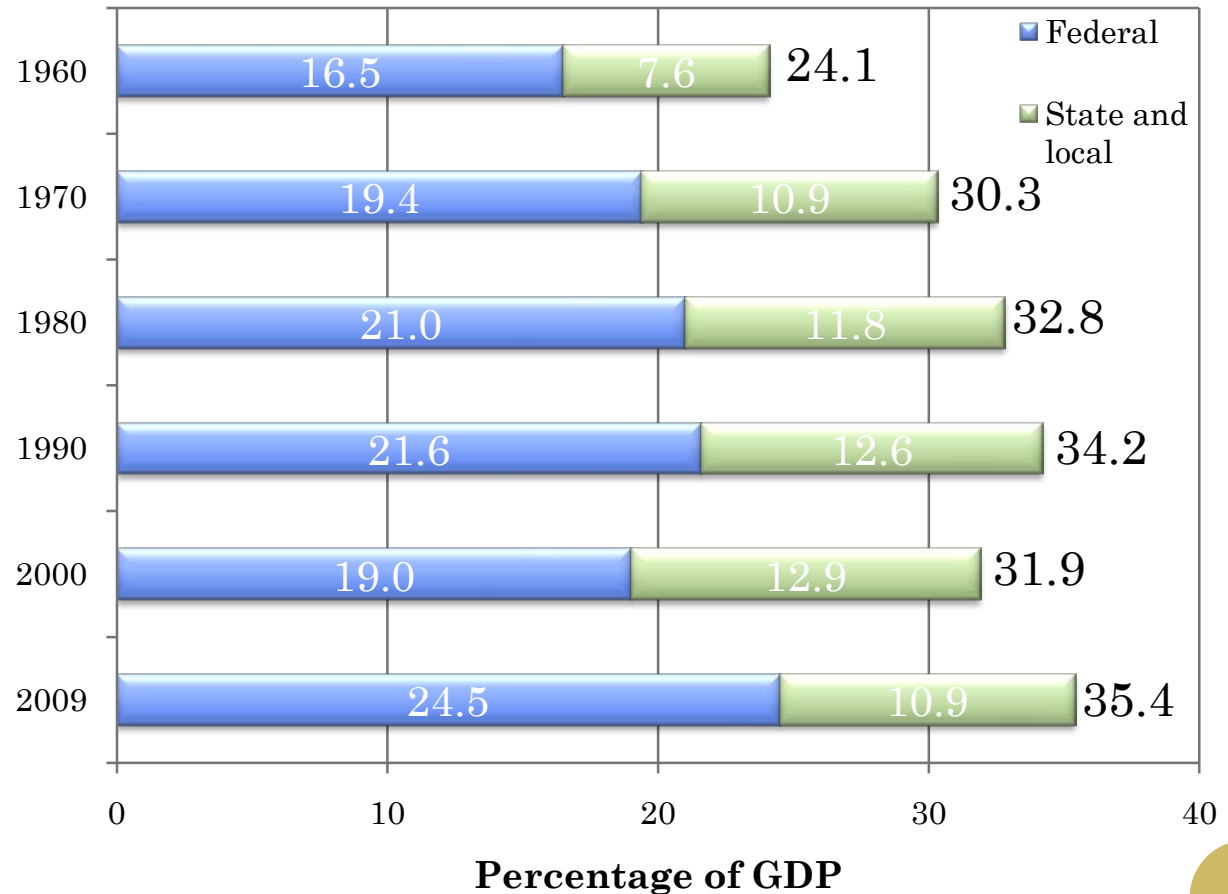
- What insights do economics provide about how the political process works?
- Why do the results of political actions often differ from the promises?
- Why will centralized government planning of and economy or sector often go awry?
- Does competition among governmental units help citizens get more value from government?
- Could constitutional rules help direct government action more consistently toward activities that enhance the quality of life of citizens?

GOVERNMENT AND THE ECONOMY

- Government expenditures are now more than a third of our economy. This highlights why it is important to understand how the political process affects resource allocation.

THE GROWTH OF GOVERNMENT SPENDING BETWEEN 1960 AND 2009

Measured as a share of GDP, government expenditures rose substantially during 1960-1980. Since 1980, total government expenditures have been approximately one-third the size of GDP. In 2009, federal expenditures were 24.5% of GDP and total government expenditures were 35.4% of GDP. What does economics indicate about how these funds will be allocated?



CLEAR THINKING PROPOSITION #1

- Government promotes economic progress by protecting the rights of individuals and supplying goods that are difficult to provide through markets.

WHAT ROLE FOR GOVERNMENT?

A wise and frugal government, which shall restrain men from injuring one another, which shall leave them otherwise free to regulate their own pursuits of industry and improvements, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government.

-Thomas Jefferson

PROTECTIVE VS. PRODUCTIVE FUNCTIONS OF GOVERNMENT

- Government serves a **protective function** when it
 - Creates, upholds and maintains a legal framework.
 - Protects and enforces the rights of individuals to their person and property.
- Government provides a **productive function** when it
 - Supplies public goods. These goods are not easily provided by markets because they are consumed jointly and it is difficult to exclude those who do not pay.
 - National defense and regional flood control projects provide examples.

CLEAR THINKING PROPOSITION #2

- Allocation through political voting is fundamentally different from market allocation, and economic analysis indicates that the latter is more consistent with economic progress.

THE POLITICAL PROCESS

- Is merely an alternative form of social organization
- Is not a corrective device that can consistently be counted on to provide a sound remedy when problems arise

THREE MAJOR DIFFERENCES BETWEEN DEMOCRATIC POLITICAL AND MARKET ALLOCATION:

- Majority rule provides the basis for government action, while market activity is based on mutual agreement and voluntary exchange.
- There is little incentive for voters to search for and acquire information about either issues or candidates because their choices will not be decisive. Thus, individuals will be better informed when making market choices than political choices.
- The political process imposes the same option on everyone, while markets allow for diverse representation.

CONSIDER A SIMPLE ECONOMY WITH FIVE VOTERS.

- Assume there are some voters who want to fund a government project with taxes.
- Consider the following scenarios.
- A simple majority vote would push the economically inefficient policy through.

Table 1. Costs and Benefits of a Hypothetical Government Project

Voter	Policy Benefits Received	TAX PAYMENT	
		Plan A	Plan B
Adams	\$15.00	\$12.00	\$18.00
Brown	\$15.00	\$12.00	\$18.00
Green	\$15.00	\$12.00	\$18.00
Jones	\$ 3.00	\$12.00	\$ 3.60
Smith	\$ 2.00	\$12.00	\$ 2.40
TOTAL	\$50.00	\$60.00	\$60.00

EVEN WHEN THE POLITICAL PROCESS IS CONTROLLED THROUGH VOTING,

- It does not have anything like profits and losses that can be counted on to direct resources toward productive and away from counterproductive activities.
- Instead, when unconstrained by constitutional limits, elected officials gain votes by taking resources from some and using them to “buy” the votes of a majority.
- If you take from Peter and give to Paul, you can usually count on the support of Paul.
- As the government becomes more heavily involved in favoring some at the expense of others, resources will be shifted from productive into favor-seeking activities like lobbying.

CLEAR THINKING PROPOSITION #3

- The costs of government are not only taxes.

POLITICIANS OFTEN SPEAK AS IF TAXES MEASURE THE COST OF GOVERNMENT.

- Taxes are a direct cost of government.
- However, there are three other costs to consider.

THREE TYPES OF ADDITIONAL COSTS ASSOCIATED WITH GOVERNMENT SPENDING

1. The **loss of private sector output** that could have been produced by the resources employed by the government.
2. The cost of **resources expended in tax collection and enforcement** of government mandates.
3. The cost of **price distortions** caused by taxes and borrowing.

LOSS OF PRIVATE SECTOR OUTPUT

- All funds, including taxes, have alternative uses.
- Funds spent on police protection, highways, missiles, education, health care, or any other “government project” have alternative uses that could have been spent in the private sector where the individuals spending the dollars were directly responsible for the associated rewards, failures and risks taken.

COSTS OF COLLECTION AND ENFORCEMENT

- Taxes must be collected, and tax laws and regulatory orders must be enforced.
- Salaries and commissions are paid to tax assessors, their assistants, inspectors, and their staff. Stationary, printing, marketing, fuel, rent for office space, computers, etc. are all expenses that add to the overall tax burden.

IN 2004, THE SMALL BUSINESS ADMINISTRATION FINDS THAT

- The annual cost of federal regulations in the United States increased to more than \$1.1 trillion in 2004.
- This sums to \$8500 per household, or 11 percent of national income.¹

PRICE DISTORTIONS

- Taxes distort incentives.
- Some exchanges will not occur because the tax makes them no longer advantageous.
- Deadweight loss of taxation adds 9-16% over and above the costs of enforcement and compliance.

POLITICIANS HAVE AN INCENTIVE TO CONCEAL THE COST OF GOVERNMENT

- *Taxing is much like plucking a goose. It is the art of getting the greatest number of feathers with the least amount of hissing.*
 - Former Senate Majority Leader Robert Dole
- Politicians often speak of imposing taxes on business. But the truth is that all taxes are paid by people.
- The political attractiveness of budget deficits, money creation, and various indirect taxes stems from the desire of politicians to conceal the costs of government programs.

CLEAR THINKING PROPOSITION #4

- Unless restrained by constitutional rules, special-interest groups will use the democratic process to fleece taxpayers and consumers.

THE POWER OF SPECIAL INTERESTS

- Special interests will help politicians get elected (money and workers).
- While others are harmed, there is little incentive to act in opposition.
- Thus, politicians cater to special interests.

A “SWEET” EXAMPLE

- To protect the incomes of sugar growers, the government passed the Sugar Act of 1934 to stabilize sugar prices and protect U.S. sugar producers from foreign competition. This Act and amendments to it are still in place.
- Today, the federal government disperses about \$1.9 billion in sugar subsidies annually.
- The average consumer pays \$20 per year in higher sugar prices and sugar using industries like soft drink companies substitute high fructose corn syrup for sugar because of the relatively high cost of sugar in the U.S.
- \$16 million contributed to politics by the sugar lobby during the two most recent political cycles.

WHO WINS AND WHO LOSES UNDER THE SUGAR SUPPORTS AND QUOTAS

- A small hand full of U.S. sugar producers wins.
- The following lose when the price of sugar is artificially high?
 - U.S. consumers
 - U.S. sugar users - such as the U.S. candy manufacturing industries

LOGROLLING AND PORK-BARREL PROJECTS REINFORCE THE SPECIAL INTEREST EFFECT.

- As Exhibit 7 illustrates, projects can be bundled together and obtain majority approval even when each of the projects is counterproductive.

Exhibit 7: Trading Votes and Passing Counterproductive Legislation

Net Benefits (+) or Costs (-) to Voters in Equal Size Districts

Voters of District	Bridge to Nowhere	Indoor Rainforest Project	Ethanol Subsidy	Total
A	\$100	-\$30	-\$30	\$40
B	-\$30	\$100	-\$30	\$40
C	-\$30	-\$30	\$100	\$40
D	-\$30	-\$30	-\$30	-\$90
E	-\$30	-\$30	-\$30	-\$90
Total	-\$20	-\$20	-\$20	-\$60

CLEAR THINKING PROPOSITION #5

- Unless restrained by constitutional rules, legislators will run budget deficits and spend excessively.

The attractiveness of financing spending by debt issue to the elected politicians should be obvious. Borrowing allows spending to be made that will yield immediate political payoffs without the incurring of any immediate political cost.

—JAMES BUCHANAN

BUDGET DEFICITS AND THE NATIONAL DEBT

- When government spending exceeds revenues, a deficit will occur.
- When the government runs a deficit, it is financed by borrowing, the issuing of Treasury bonds.
- The borrowing increases the national debt, the total outstanding bonds on which the government must pay interest.
- In contrast, a budget surplus (excess of revenue relative to spending) would reduce the government's outstanding debt.

KEYNESIAN REVOLUTION AND BUDGET DEFICITS

- Prior to 1960, it was widely believed that the federal government should balance its budget. Except during war, this was pretty much the case.
- Keynesians argued that budget deficits should be run when the economy was weak.
- Keynesian view released politicians from a balanced budget constraint.
- Ever since, the federal government has run deficits year after year except for 1998-2000.

WHY DEFICITS OCCUR

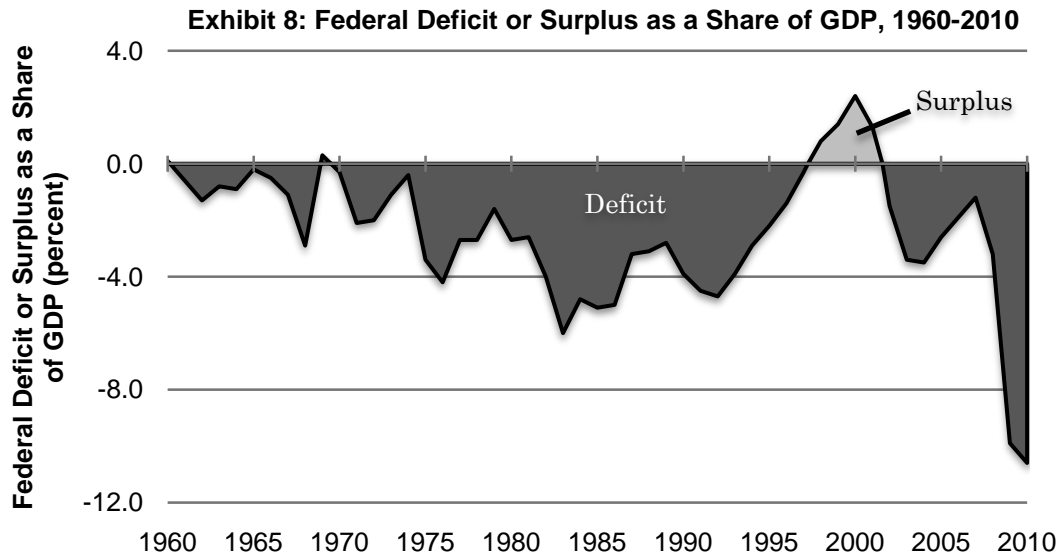
- Spending makes it possible for politicians to provide voters with immediate, highly visible benefits.
- Deficits and borrowing push the visible cost of government into the future.
- Spending is much more politically attractive than taxing.

SPENDING WATCHDOGS

- There is little or no incentive for a legislator to be a spending “watchdog”.
- Consider the incentives to overspend if every member of Congress decides to go to dinner one night and split the bill by $1/535^{\text{th}}$. What are the incentives to spend “efficiently” if each member has to pay for each item ordered? How is this altered when each pays $1/535^{\text{th}}$ of the bill?

FEDERAL DEFICITS AS A SHARE OF GDP

- The federal government has run a budget deficit most every year since 1960. Given the political incentive structure, is this surprising?



Source: Office of Management and Budget, *President's Budget, FY 2011 Budget, Table 1.3*
<<http://www.whitehouse.gov/omb/budget/historicals/>>

SPENDING, DEFICITS, AND THE FEDERAL DEBT: THE CURRENT SITUATION 1/2

- The federal government financed approximately 40 percent of its expenditures by borrowing during both 2009 and 2010.
 - This increased the federal debt by nearly \$3 trillion in just two years.
 - These huge deficits have pushed the federal debt to dangerously high levels.

SPENDING, DEFICITS, AND THE FEDERAL DEBT: THE CURRENT SITUATION 2/2

- Moreover, the federal government has promised senior citizens future payments under the Social Security and Medicare programs that are far greater than the payroll tax revenues that provide their financing.
 - The debt implied by the unfunded Social Security and Medicare liabilities is almost four times the size of the official national debt.

WHAT WILL HAPPEN IF THE FEDERAL GOVERNMENT DOES NOT BRING ITS FINANCES UNDER CONTROL?

- There will be repercussions in credit markets (higher interest rates, others will be less willing to lend to the U.S. federal government, etc)
- The excessive debt could fuel another financial crisis in the future (consider what has recently happened in Greece)
- There will be higher personal and business taxes in the future
- The debt could lead to additional money creation and inflation in the future

HOW CAN THE U.S. FEDERAL GOVERNMENT BE CURED OF ITS ADDICTION AND RECKLESS SPENDING? POSSIBILITIES INCLUDE:

- Amend the Constitution to require the federal government to balance its budget annually
- Require a two-thirds or three-fourths approval by both Houses of Congress for spending proposals and increases in the federal government's borrowing power
- Limit this year's spending to last year's level of revenues
- **Bottom Line:** Create incentives for legislators to take on new spending only if they are willing to tax, charge users for the government services or spend less in other programs.

CLEAR THINKING PROPOSITION #6

- Government slows economic progress when it becomes heavily involved in trying to help some people at the expense of others.

The tool of politics (which frequently becomes its objective) is to extract resources from the general taxpayer with minimum offense and to distribute the proceeds among innumerable claimants in such a way to maximize the support at the polls. Politics, so far as mobilizing support is concerned, represents the art of calculated cheating or, more precisely, how to cheat without being really caught.

- James R. Schlesinger
Former Secretary of Defense

THERE ARE TWO WAYS INDIVIDUALS CAN ACQUIRE WEALTH:

○ Production:

- People can get ahead by producing goods or services of value and exchanging them for income. This method of acquiring income helps the exchanging partners and enhances the wealth of society.

○ Plunder:

- Sometimes people get ahead by “plundering” what others have produced. That is, the plunderers’ gain is at the loss to another. This method not only fails to generate additional income but it also consumes resources and thereby reduces the wealth of the society.

PRODUCTION OR PLUNDER?

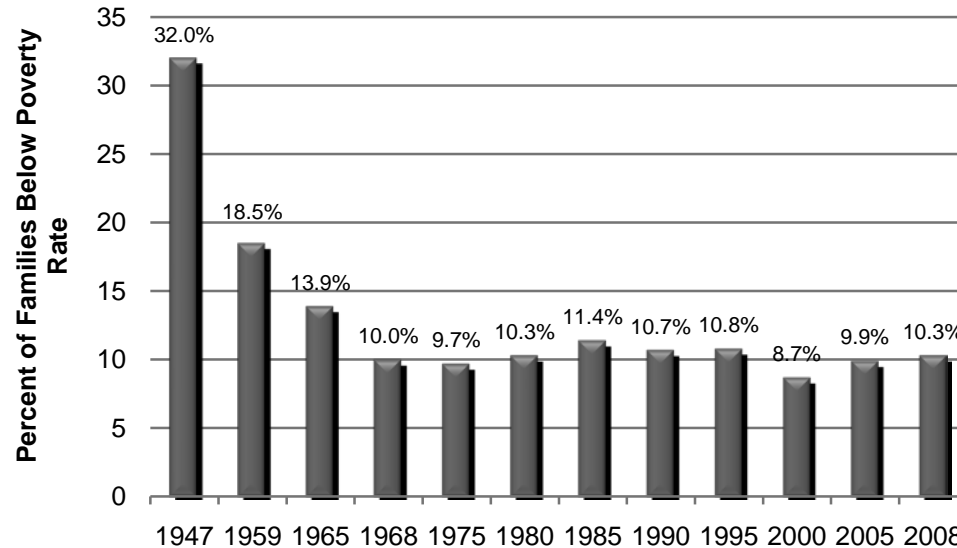
- Governments promote economic prosperity when they encourage productive activity and discourage plunder. Only a neutral government can protect its citizenry from plunder. Discuss how it does so. Draw special attention to property rights.
- Governments can be, and often are, used as an agent for plunder causing resources to be “lost” when directed at favor-seeking activities or toward well organized special-interests. Discuss how this “rent-seeking” reduces overall wealth.

CLEAR THINKING PROPOSITION #7

- The net gain to those receiving government transfers is less, and often substantially less, than the amount they receive.

WAR ON POVERTY, 1/2

Exhibit 9: Poverty Rate, 1947-2008



Source: U.S. Dept. of Commerce, *Characteristics of the Population Below the Poverty Level: 1982, Table 5*; and U.S. Census Bureau, *Historical Poverty Tables - Families* (Available at: <http://www.census.gov/hhes/www/poverty/histpov/hstpov4.xls>)

- Even though per capita income has more than doubled since the late 1960s, the poverty rate is virtually the same today as when the War on Poverty began.

WAR ON POVERTY 2/2

- As Exhibit 9 shows, the results of the substantial increase in anti-poverty spending during the late 1960s were disappointing.
- This is not surprising because:
 - It is difficult to improve people's well-being through income transfers.
 - The *unintended consequences of secondary effects* get in the way.

WHY TRANSFERS AND SUBSIDIES ARE LARGELY INEFFECTIVE

- They reduce the incentive of both taxpayer-donor and transfer recipient to earn income
 - Increased tax burdens repress incentives to increase production and earnings.
- Competition for transfers erodes most of the long-term gain of the intended beneficiaries.
 - When qualification requirements are present, resources and potential production are wasted as individuals seek to meet them.

TO DECREASE THE LIKELIHOOD OF POVERTY

- Three things young people can do that will reduce the likelihood of their future poverty
 1. Complete high school (at a minimum)
 2. On entering the work force, continue working and seek a full-time job
 3. Get married before having a child
- The people who choose these three options are unlikely to spend much time in poverty.

THE DILEMMA OF ANTIPOVERTY SPENDING

- Income transfers to the poor (e. g. food stamps, health care, housing, and cash payments) provide protection against the adverse consequences of poverty.
- But, the transfers also encourage high--risk lifestyles (for example, dropping out of school or the workforce, childbearing by teenagers and unmarried women, divorce, abandonment of children by fathers, and drug use).

QUESTION FOR THOUGHT

- How will government subsidies for insurance premiums in hurricane prone areas influence the damage that will result from hurricanes? Explain your response.

CLEAR THINKING PROPOSITION #8

- Central planning replaces markets with politics, which wastes resources and retards economic progress.

THE “MAN OF SYSTEM”

The man of system is apt to be very wise to his own conceit. He seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board.”

-Adam Smith

THE “FATAL CONCEIT” OF CENTRAL PLANNING 1/5

- Central planning merely substitutes politics for market verdicts.
 - Subsidies and investment funds disbursed by governmental planners are influenced by political rather than economic considerations.
 - “Old” firms tend to be favored over “new”, growth-oriented firms.
 - “Pork-barrel” projects will be pursued.

THE “FATAL CONCEIT” OF CENTRAL PLANNING 2/5

- The incentive of government-operated firms to keep costs low, be innovative, and efficiently supply goods is weak.
 - Little is to be gained from efficiency gains and/or lower costs.
 - Higher per-unit costs are the norm as budgets expand and efficiency gains are minimal.

THE “FATAL CONCEIT” OF CENTRAL PLANNING 3/5

- Central planners spending the money of taxpayers will invest less wisely than investors risking their own money.
 - Private investors bear the consequences of poor investments directly.
 - Since little personal wealth is realized by planners, there exists little incentive to increase productivity and/or conserve resources.

THE “FATAL CONCEIT” OF CENTRAL PLANNING 4/5

- The efficiency of government spending will also be undermined because the budget of an unconstrained government is something like a common pool resource. The ownership of common resources:
 - Discourages people from using their property productively.
 - Thwarts wise stewardship.
 - Discourages people from developing their property in ways beneficial to others for possible exchange, transfer or sale.
 - Thwarts the wise development and conservation of resources for the future.

THE “FATAL CONCEIT” OF CENTRAL PLANNING 5/5

- There is no way that central planners can acquire enough information to create, maintain, and constantly update a plan that makes sense.
 - Markets channel information to both producers and consumers via the price system.
 - Market profit and losses discipline individuals and hold them accountable for constantly retrieving, maintaining and updating present and future plans based on efficiency, not political considerations.
 - The political process does not have anything like profit and loss that will persistently channel resources into productive projects.

CLEAR THINKING PROPOSITION #9

- **Competition is just as important in government as in markets.**

GOVERNMENT AND COMPETITION

- Leaders of public sector firms have little incentive to cut costs and/or increase productivity.
- Poor performance is often an argument for increased state funding or federal support instead of the stricture of bankruptcy.
- Citizens hold differing views on appropriate public expenditures; a centralized system cannot accommodate multiple viewpoints.

COMPETITION IS A DISCIPLINARY FORCE. THIS HOLDS TRUE IN GOVERNMENT, TOO.

- Let private firms compete on a level playing field with government agencies and enterprises in such areas as vehicle maintenance, postal services, food services, garbage collection, street maintenance, schools, and similar operations.
- Permit competition among decentralized government units—state and local governments. Let citizens vote with their feet with regard to which governmental units they believe are providing them the most value for their tax dollar.
- Do not allow federal subsidies, regulations, and bailouts to distort these choices.

CLEAR THINKING PROPOSITION #10

- Constitutional rules that bring the political process and sound economics into harmony will promote economic progress.

AS ECONOMIC ANALYSIS OF THE DEMOCRATIC POLITICAL PROCESS INDICATES

- Elected legislators have strong incentive to take resources from taxpayers and use them to provide favors to various voting blocks in exchange for political contributions, votes, and other forms of political support.
- When government moves beyond the protection of individual rights and becomes heavily involved in the allocation of scarce resources, favoritism of selected groups, at the expense of others, replaces equal treatment under the law.

WHEN GOVERNMENT IS UNCONSTRAINED,

- Political democracy will lead to excessive debt and excessive spending driven by exploitation of the taxpayer by favor-seeking interest groups.

GOVERNMENT CAN BE A POSITIVE FORCE FOR ECONOMIC PROSPERITY WHEN:

- The rules of the political game bring the self-interest of voters, politicians, and bureaucrats into harmony with economic progress.
- Limited government, equal treatment under the law, protection of property rights, and federalism are cornerstones of a structure of government that will achieve this objective.

RETURN TO OUR CONSTITUTIONAL BEGINNINGS

- If government is going to be a positive force for economic prosperity, the rules of the political game must bring the self-interest of voters, politicians, and bureaucrats into harmony with economic progress. It can do so by returning to our constitutional beginnings.

ARTICLE I, SECTION 8

- Limit the powers of the central government and let it provide for free trade among the states.

TENTH AMENDMENT (BILL OF RIGHTS)

The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.

ARTICLE I, SECTION 10

- Prohibit states from adopting legislation
“*impairing the obligation of contracts*”

FIFTH AMENDMENT (BILL OF RIGHTS)

No person shall be ... deprived of life, liberty, or property, without due process of law

- The government shall not take private property for public use, without just compensation.

A POSITIVE PROGRAM FOR PROSPERITY

- Create an Economic Bill of Rights with 8 Provisions Based on Our Constitutional Beginnings and Common Sense Economics

PROVISION 1

- Neither the federal government nor state and local governments shall use their regulatory powers to take private property, either partially or in its entirety, for public use without paying the owner the full market value of the claimed property.

PROVISION 2

- The right of individuals to compete in a business or profession and/or buy and sell legally tradable goods and services at mutually acceptable terms shall not be infringed by Congress or any of the States.

PROVISION 3

- Congress shall not levy taxes or impose quotas on either imports or exports.

PROVISION 4

- A constraint on the total level of federal spending must be imposed and the budget process should begin with the establishment of this constraint.

PROVISION 5

- A three-fourths approval of both Houses of Congress shall be required for all expenditure programs of the federal government. At least two-thirds approval of the legislative branches of state government shall be required for the approval of expenditures by state governments.

PROVISION 6

- A three-fourths approval of both Houses of Congress shall be required for the federal government to run an annual budget deficit or raise the overall limit on the national debt.

PROVISION 7

- A three-fourths approval of both Houses of Congress shall be required for the federal government to mandate any expenditures by either state governments or private business firms.

PROVISION 8

- The function of the Federal Reserve System is to maintain the value of the currency and establish a stable price level. If the price level either increases or decreases by more than 4 percent annually during two consecutive years, all Governors of the Federal Reserve System shall be required to submit their resignations.

TYING EVERYTHING TOGETHER

- When a government supports private ownership, freedom of exchange, competitive markets, the rule of law, and monetary stability, the stage is set for economic prosperity.
- As explained in Parts I, II and III, when the proper incentives exist with minimal government intervention, wealth accumulates among the masses in households and businesses across all sectors of an economy.

QUESTIONS FOR THOUGHT

- Did the framers of the U.S. Constitution get the general structure of government correct? Did the structure limit and enumerate the powers of the federal government? Did it provide for a competitive process among state and local governments? Did it protect individuals and their property from aggression by others and from the government itself? Cite sections of the Constitution in your response.
- Evaluate the proposed Economic Bill of Rights presented in Part III of *Common Sense Economics*. Indicate why you would favor or oppose each of the proposals, and explain why.