



Influential Issues

Thinking Economically

TEXAS PUBLIC POLICY FOUNDATION

By Arthur B. Laffer

Talking Points

Economics and Its Laws

- ★ People always act in their own self-interest, but self-interest does not necessarily mean selfishness. For example, someone may volunteer at a soup kitchen because it satisfies their conviction to help the poor.
- ★ Economics is the study of how humans adjust their behavior to seek happiness as they define it.
- ★ Economics is a science; its laws are like those of physics—immutable. Attempts by policymakers to circumvent these laws always result in unintended consequences.

The Value of Things

- ★ The value of a good is not determined by the labor it took to make it, or how much the materials cost, but rather how much the good is subjectively worth to an individual.
- ★ Transactions in a free marketplace are always mutually beneficial, otherwise the buyer or the seller would never have agreed to it.
- ★ When government set minimum prices above market prices, there will be a surplus of goods. On the other hand, if the government sets maximum prices below market prices, there will be a shortage of goods.

Government and Institutions

- ★ Respect for private property is at the heart of economic decision-making—the less secure one's property, the less incentive there is to work and be productive.
- ★ Market prices are signals that let producers know what they should produce more of, and what they should produce less of.
- ★ The rule of law, instead of the arbitrary rule of a king or sultan is necessary for economic prosperity, since otherwise there would be too much uncertainty to justify productive work.

State Competitiveness

- ★ Since individuals can travel and move their businesses freely between state borders, states have an incentive to compete for the best businesses to generate growth for the state.
- ★ According to the Laffer Associates' Economic Performance indicators, which are measured based only on variables influenced by state officials, Texas ranks first in terms of how desirable it is to live and conduct business here.
- ★ However, Texas ranks 10th in the Economic Outlook indicator, which unlike the Economic Performance indicator looks to the future, instead of the past.

Economics and Its Laws

The study of economics proceeds from two key assumptions—scarcity and self-interest—that are common to all people. The first asserts that there are a finite amount of resources in the world, and the second states people will always act in their own self-interest. When an economist says that people act in their self-interest, or to “maximize utility,” this is a purely formal statement that implies nothing about the value or propriety of the specific preferences of the individual. A heroin addict gets utility from his next fix, and Mother Theresa gets utility from helping poor children. Though both are acting in their own self-interest, one is being selfish, the other is being selfless. The economist can use his tools to explain both types of actions.

The Law of Diminishing Marginal Utility

A crucial economic insight is that people make decisions “on the margin.” This principle solves the classical “water-diamond paradox,” which poses the following riddle: If water is so important to human life, while diamonds are a mere frippery, then why are diamonds so much more expensive than water? The answer is that economic decisions are based on marginal utility. Nobody ever chooses between “water” and “diamonds” as abstract categories. Rather, the actual choice people face in everyday life is between a definite unit of water versus a certain unit of diamonds. And though water in general is essential, its relative supply is so great that (in normal circumstances) most people would much rather sacrifice one unit of water than one unit of diamonds.

The formal rule explaining all of the above is the law of diminishing marginal utility. Not only do people value goods according to their marginal (rather than total) utility, but this marginal utility declines as the supply of the good increases. Being rational, people assign the first unit of a good to its most important use—so the first gallon of water is reserved for drinking. But then

successive units are assigned to goals of successively lower importance—the 20th gallon of water might be used for bathing, while the 1000th might be devoted to washing the car.

The Law of Increasing Marginal Costs

Just like consumers, producers make decisions on the margin and don’t ask, “Do I like money more than milk?” Rather, the question for producers is, “How many cartons should I produce at a given price?”

It is a technological fact that for any production process, at some level of output the additional cost (i.e., marginal cost) of producing one more unit begins to rise. It might be because of the difficulty of finding the additional materials and labor needed to increase production, or it might be that the equipment only works optimally in a certain capacity of output, or that transportation costs begin to rise as both inputs and outputs have to be shipped longer distances. But regardless of the specifics, at some point marginal costs have to rise. If they didn’t, it would mean a single factory could efficiently produce all of the world’s cars, or that the entire crop yield of Earth



The law of increasing marginal costs explains why one factory cannot produce all of the world’s cars.

could be reaped from a single acre of farmland. No, at some finite level of output, at least one of the ingredients in the production process becomes overburdened, making additional units very costly to produce. Rising marginal costs explain why successful producers don't sell an infinite amount.

Immutability:

The Law of Unintended Consequences

Economists have a duty to remind everyone as often as possible of the immutable nature of economic laws. Just like with the laws of physics, economic laws are simply descriptions of reality. Scarcity can no more be ignored than gravity. Policymakers who think they can determine the proper price of a good better than the market will create no less a disaster than the captain of an ocean liner who believes his engines will allow him to pay no heed to momentum.

Economic laws cannot be broken—only ignored. Attempts to do so leave a convoluted trail of unintended consequences harming people who don't understand what went wrong or who caused the problem.

Mandates and subsidies of corn-based ethanol are a perfect example of this. Congress has ignored what market prices have been telling them about ethanol—it is too costly to be a substitute or additive for gasoline. Only now are the results of this becoming readily apparent. Corn prices have skyrocketed as the demand for corn increased. At first this was felt mostly by those who depend on corn tortillas as a food staple—large protest marches were set off in Mexico City when the price of tortillas doubled. But now the higher prices are being noticed here at home. The increased price of animal feed is leading to higher prices for poultry, pork and eggs. Even soft drinks, which rely on corn syrup, have been affected. Another result of the ethanol policies is that the increased production of corn is putting heavy pressure on water supplies throughout the Midwest and West.

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The Value of Things

Government is notorious for placing values on goods and services that prove to be vastly inaccurate. Two short anecdotes help explain why government has such a hard time with this. In the late 1950s, the Ford Motor Company rolled out the Edsel automobile. However, the car was discontinued after its third model year in what TIME.com later described as “one of the autodom’s most hilarious pratfalls.” At the opposite extreme were the Cabbage Patch Dolls of the early 1980s. Children coveted these to the point that their parents would line up outside stores for hours and pay many times the suggested retail prices just to get their hands on them. Who could have predicted these outcomes? Certainly not Ford, despite the company’s \$400 million investment in the Edsel. And it is doubtful that the maker of the Cabbage Patch doll knew what it had on its hands until after the craze had begun. So why is it so hard to predict the price, or value, of something?

Determining Value

It is hard to predict the price of a good or service because value is determined by human choice. Each individual determines how much another good is worth to him or her, and is willing to pay accordingly. In other words, value is subjective, varying from person to person. Thus the value of something, and the market price that



Voluntary trade benefits everyone by allowing all parties to a transaction to be better off.

serves as a proxy for that value, can only be predicted by guessing at the individual determinations of the hundreds, thousands, or millions of consumers who may purchase the product.

Now consider that in a market economy, every activity is a voluntary exchange between two or more consenting parties. Both parties to an exchange benefit, otherwise they wouldn't have agreed to it! But an observer, investor, or regulator can only know the price at which this exchange was made after the fact.

From this, we can see why in many cases the value of the output goods determines the value of the inputs—rather than the other way around. For example, why would a person be willing to trade away an orange for a handful of apple seeds? After all, you can't eat apple seeds (or at least, it's no fun to do so), and they're not particularly pleasing to the eye. So why give up a perfectly good orange for them? The answer of course is that with enough time, soil, rainfall, etc., the directly useless seeds can produce the tasty apples. In a sense, the value of the apple is mentally transferred to the items that produce it. Of course, this only applies to the person with the time, energy, and ability to grow the apples. A person living in

an apartment complex without a garden might very well give no value to those same apple seeds.

Given this, it is easy to see why the cost theory of value is wrong. For example, a meal from McDonald's in Boston is more expensive than a meal from McDonald's in Austin, despite the food being exactly the same. There are many cost-based explanations for this—wages in Boston are higher, rent for the building in Boston is more expensive, etc., but ultimately, this begs the question of "Why is the rent in Boston more expensive?," continuing the cycle again. Instead, people first value those goods (and services) that directly cater to their desires, and then use these evaluations to determine the relative importance of those goods (and services) that in turn can produce the first batch of items. In this example, more people want to live in Boston than in Austin, so they are willing to pay not only higher rent, but also higher McDonald's prices in order to live there.

This analysis can also be applied to the labor theory of value, which asserts that the only "real" sacrifice involved in production is human toil, because Mother Nature doesn't charge humans to use her resources. The truth is, how much effort someone puts into a project does not automatically translate into the quality of the finished product. For example, a person could spend several days preparing a literal mud pie that no one will pay a cent for. This reemphasizes the previous point that human choice determines value. Market price is simply the monetary expression of value.

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Market Prices

At any price producers are willing to sell a certain number of units, and consumers are willing to purchase a certain number of units. The market price is reached when producers are willing to sell the same quantity of units that consumers are willing to purchase. For example, if there is a surplus of goods, producers would simply lower their prices until they are able to sell their stock. However, if there is a shortage of goods, producers will raise prices until consumers want to purchase the exact number of units producers want to sell. This adjustment happens very fast in the marketplace, so that the market price always prevails.

At the market price, supply and demand balance perfectly. So when the government pushes the price lower through its threats of fines, consumers want to buy more units of the product than producers want to sell. A shortage results. When prices are allowed to freely fluctuate, shortages are quickly eliminated. But when the government is responsible, shortages can persist indefinitely. Things are just as bad when the government imposes a price floor. By forcing the price above the market-clearing level, the government creates a surplus. Producers keep churning out more units of the good than the consumers want to buy.

Market prices are an expression of the voluntary choices of individuals. When policymakers complain about certain prices being too high or too low, they are really criticizing the decisions of men and women to dispose of their own property as they see fit.

Government and Institutions

Although factors such as natural resources, climate, and education are certainly important, many economists have come to believe that institutions are far more significant in explaining economic development. After all, the U.S.S.R. had far more generous endowments of natural resources than Hong Kong, and yet the former had bread

lines while the latter was an economic powerhouse. Or consider the differences between East and West Germany, or North and South Korea—just about the closest thing to controlled experiments we have in macroeconomics. It is clear that institutions matter.

Private Property

The concept of private property seems obvious, but in fact it is a fairly recent historical development largely confined to the Western European countries. Besides the possible moral appeal of such an institution, a system of private property is the one most conducive to economic growth. By placing each piece of property under the sole control of particular individuals, the system (perhaps ironically) ensures greater attention to these resources than if “the community” owned everything collectively—as has been seen in the “tragedy of the commons.”

Recently, the assignment of private property rights as a solution to the tragedy of the commons has been ignored. Instead, such problems have been classified as externalities and seen as examples of market failure whereby the government must step in to remedy the problem. Pollution and fisheries are two of the most common externalities cited today.



Private property is the foundation upon which all of our other rights are based.

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Price Signals

When private individuals have the right to transfer ownership of their property, the free exchange of property generates prices that are simply a reflection of the ratios at which the underlying goods and services trade against each other. These market prices for final goods and resources allow firms to calculate the expected profit and loss from various ventures based on their evaluation of consumer preferences. They then shift their efforts out of losing areas and into what they hope will be profitable ones.

Market prices provide important signals to everyone in the economy, allowing for quick adjustments to new circumstances, such as a rapid increase in the demand for apples or a sudden decline in the supply of apples due to a hard freeze. However, market prices can only translate consumer preferences efficiently in the absence of price regulations. Interference with the pricing mechanism throws the entire system off kilter.

Free Enterprise

Private property and free markets have a moral component—people ought to generally be able to do what they desire with their own property. The interesting fact is that this freedom is not only “the right thing to do,” it’s also the efficient thing to do! In a free market, anyone is free to start a business and risk his own (or borrowed) capital, and let the consumers be the ultimate arbiters. This provides the best mechanism to harness the bits of

knowledge and expertise that are dispersed throughout the economy. In contrast, under full-blown socialism an innovator would have to send his idea up the chain of command, and wait for approval before carrying it out. Beyond the bureaucracy, this system suffers from the fact that no group of planners—no matter how smart—can possibly amass all the information possessed by the whole of society.

The Rule of Law

One of the cornerstones of Western society is the idea that the same set of laws should apply to everyone. Citizens must know what the rules are beforehand, and not live in constant fear of the arbitrary caprice of the king or sultan. This strikes most Americans as a simple matter of justice.

Yet as with the institution of private property, the rule of law performs a definitely utilitarian function too: it reduces uncertainty and allows businesses and consumers to invest in the future. There isn’t much real estate development or major factories near active volcanoes, and the reason is obvious: people won’t build if there’s a good chance the fruits of their efforts will be destroyed at any moment. By the very same token, the Industrial Revolution only occurred in Europe after the Magna Carta and other political events carved out a niche of autonomy for the private sector. Today this is borne out by the fact that the wealthiest countries in the world are the freest with stable institutions.

State Competitiveness

Variations in business climate—coupled with the free mobility of capital and labor within the U.S.—yield striking differences in economic performance among the states. It is important for policymakers at the state level to understand just how potent their decisions can be, not just for their citizens but also for the state’s revenues.

With people, products, and capital free to move from state to state, state governments are ultimately competitors. Pro-growth and anti-growth state economic policies

influence decisions on whether, where and how much to work, save and invest. These policies influence the ability of a state to retain and attract residents and businesses. The evidence suggests that pro-growth policies result in higher after-tax returns, increased economic activity and an eventual improvement in overall state fiscal health; anti-growth policies result in the opposite effects.

Rankings

For more than two decades, Laffer Associates has specialized in the analysis of state and local economic policies. In fact, over the years Laffer Associates' State Competitive Environment model has repeatedly demonstrated its ability to forecast changes in state competitiveness and thereby economic health and asset values. The result is a supply-side ranking of the states' economic outlooks from best to worst.

Any ranking of the states can take on a multitude of forms and compare a wide spectrum of variables: measures of economic health such as production, employment and income; housing prices; education; even the quality of the weather. Of course, all of these variables influence the desirability of living and doing business in a particular city and state. The Laffer Associates' model only includes variables that state officials can directly influence, with a particular focus on taxation (in its many forms) and changes in taxation.

Our Economic Performance measure is backward-looking, and ranks the states based on their performance in three (self-explanatory) categories. Texas ranks first overall on this measure, because it did well according to all three criteria. In particular, the large influx of domestic (i.e., non-immigrant) migration into Texas during 2006 was both a sign of, and a contributor to, the state's economic strength.

As with stocks, when it comes to states, past performance is no guarantee of future success. To better predict future performance, our Economic Outlook rank is forward-looking, and relies on our 16 factors to predict the relative economic performance of the states. Texas ranked 10th overall in this measure.



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Importance of Fiscal Policies

Just as the U.S. competes with other countries for the location of economic activity, states compete with each other for the location of factories, offices and jobs within the U.S. Competition of this type can be seen through tax-cutting battles between neighboring states and targeted tax incentives to encourage corporate relocation. As states seek to hold companies and workers within their borders and attract new ones, the winners and the losers will be separated by their ability to understand the competitive environment in which they exist and take steps to enhance their own state's appeal. State and local fiscal policies are far and away the most important factors determining changes in the competitiveness and, hence, relative economic growth rates among the states.

The average performance of the nine states without a personal income tax bested the average performance of the nine states with the highest top marginal personal income tax rates in each broad category examined. Relative to the high-tax states, the no-income-tax states experienced: higher levels of gross state product growth; greater personal income growth; higher personal income per capita growth; higher population growth; greater domestic in-migration as a share of population; greater job creation; and, despite the massive population inflows to the no-tax states, lower average unemployment rates. ★

About the Author

Arthur B. Laffer is a Senior Fellow at the Texas Public Policy Foundation and the founder and chairman of Laffer Associates, an economic research and consulting firm that provides global investment-research services to institutional asset managers, pension funds, financial institutions, and corporations. Since its inception in 1979, the firm's research has focused on the interconnecting macroeconomic, political, and demographic changes affecting global financial markets.

Dr. Laffer has been widely acknowledged for his economic achievements. His economic acumen and influence in triggering a world-wide tax-cutting movement in the 1980s have earned him the distinction as the "Father of Supply-Side Economics." He was also noted in *TIME's* 1999 cover story on the "Century's Greatest Minds" for inventing the Laffer Curve, which it deemed one of "a few of the advances that powered this extraordinary century." His creation of the Laffer Curve was deemed a "memorable event" in financial history by the *Institutional Investor* in its July 1992 Silver Anniversary issue, "The Heroes, Villains, Triumphs, Failures and Other Memorable Events."

Dr. Laffer was a member of President Reagan's Economic Policy Advisory Board for both of his two terms (1981-1989).

About *Influential Issues*

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