1-Page Book Summary of Basic Economics

What is economics? Economics is the study of the use of scarce resources that have alternative uses, and how to allocate these resources to maximize output.
There has never been enough resources to satisfy everyone completely - tradeoffs must be made on an individual and societal level. The decisions around **how to allocate these scarce resources to produce the best output** is the central question of economics.

Economics is not about making moral judgments about what choices are morally better than others, just as mathematics doesn’t explain love.

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**Prices Allocate Resources**

How are scarce resources allocated across an economy?

The straightforward way is for a central authority to decide what to do. In a feudal economy, the lord tells people what to grow and how to sell it. The Soviet Union operated similarly, with the government determining how much steel to produce in Bulgaria and how much wheat to be grown in Ukraine.

The problem with this method is that economies are so complex, with many millions of products and services, that **allocating resources optimally across millions of items is incredibly difficult**. Counterproductive incentives also arise in these centralized systems, as we’ll discuss later.

Instead of a central authority, **market economies use prices to allocate scarce resources**. Prices allow individuals to bid higher for goods that have more value to them. Prices connect market participants in a complex network without a central coordinator.

Prices allow producers and consumers to ignore why things are getting cheaper or more expensive - they can simply make decisions based on prices alone.

Prices provide financial incentives - profits and losses - to affect behavior in the use of resources. **Losses force the producers to stop producing what consumers don’t want**, thus shifting resources from wasteful to more productive activities.

Profits are the cost to society for efficiency. If profits were counterproductive, you’d see nonprofits taking over for-profit industries, or socialism providing higher standards of living than capitalism - but in reality the reverse is more likely to happen.

When prices are artificially altered relative to their natural market price, inefficiencies result, causing **market distortions**.

- Rent control causes artificially low prices, causing undersupply and overconsumption of housing.
- Minimum wage laws cause artificially high prices, reducing employment and increasing discrimination (since they flatten a range of workers into a single price).

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**Businesses**

Much is said about “outsized profits” earned by businesses. They seem like unnecessary arbitrary charges added onto the cost purely to benefit the owners. But this ignores the risks inherent in creating businesses. Half of all new businesses fail in 4 years, and most former titans (like Kodak) eventually go bankrupt as they fail to adapt to changing circumstances.

**Profits provide incentives for businesses to produce goods that consumers most want at the lowest cost.** Without these incentives, businesses would be less efficient, producing lower quality goods with less concern for cost, as in the Soviet Union.

Furthermore, **there are natural limits to the profits that can be earned** - high profits in one sector encourage competition, which reduces profits and increases quality. Without this competition for profits, businesses would have less incentive to adapt to changing conditions to maximize consumer value. **Business profit is the price society pays for efficiency.**

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**Work and Pay**

Labor - people’s time, energy, knowledge, and skills - is a scarce resource. Paying for work provides incentives for people to work and provides a set of constraints on employers.

**Just like any other resource, pricing labor allocates scarce resources that have alternative uses.** Paying engineers higher salaries than artists shifts people’s time toward engineering, where their output to society may be larger.

**What determines a person’s pay?**

- On the demand side, the productivity that the person is able to produce to the employer is the upper limit. A worker who added $100,000 to a company but asked for $150,000 in salary would not be hired. This would be unprofitable for the
On the supply side, the pay other people with similar output are willing to accept is the lower limit. That same worker would not be able to get a salary of $80,000, if there are other comparable workers willing to work for $60,000.

**Artificial Prices in Labor Markets**

Human labor is a resource like any other, and that markets price resources efficiently without the need for central control.

However, there are artificial changes to labor prices in the form of artificial floors. Minimum wage laws, mandatory benefits, job security, working conditions, collective bargaining and occupational licensing all have the same effect - they artificially increase the price of labor above what they would be in free competition. This causes a surplus of supply and less demand for labor.

Because of the surplus in supply, buyers (employers) can be more selective about who they hire. This typically disadvantages younger, less skilled, and minority workers, who become delayed in acquiring job skills and experience and thus stifle their lifetime income.

If there were no minimum wage laws in the United States, more people would be employed, with the median person earning lower wages than with minimum wage laws. This "spreads employment more evenly." And the workers still retain free choice - if they were clearly better off not working for the employer at a lower wage, they would choose not to work. Instead, minimum wages tend to make low-wage workers worse off by closing off one of their already limited options.

**Money and Banking**

Money facilitates the production and distribution of wealth. Barter of goods and services is awkward - if you make a chair, you may not want enough apples for the value of a chair, nor will the apples retain value for long. If you do accept apples, you may then need to spend time finding someone else who will trade for apples. You might also produce fewer chairs, knowing it's difficult to get paid for your chairs.

Money allows chairs and apples to be exchanged for an intermediary thing, which can be subdivided into very small units. When people agree on what will be used as the intermediary of exchange, that becomes money. To an individual, money is equivalent to wealth only because it can be exchanged for real goods and services.

**Banking**

What purpose do banks serve? First, they guard money, for which they have economies of scale compared to individual businesses.

More importantly, banks supply businesses with money and lines of credit to businesses to bridge them over unpredictable drops in income and allow them to undertake large investments. Here banks also have economies of scale and risk pooling, reducing lending costs below those of their customers. In turn, businesses that borrow can operate on a larger scale, reducing cost and improving societal standards of living.

**Government Functions**

Market transactions occur within a framework of rules, and those rules must be enforced for efficient economies to arise.

Governments serve the function of enforcing rules, like property rights, that allow market transactions to occur. They also guard against negative externalities of transactions (like a coal plant polluting air).

**Government Debt**

The national debt tends to grow with inflation, population growth, and national income growth.

The debt is better considered not as an absolute number but rather a percentage of GDP.

In some cases, a high national debt is secondary to other concerns, such as fighting World War II. However, a high peacetime national debt is troubling, since there is no reduction in spending in sight as there is in the end of war.

Generally, to pay for current benefits like the military and civilian personnel, governments use tax revenues, allowing those benefited to pay. For investment projects like highways and schools, governments sell bonds, go into debt, and essentially push the cost onto future generations who will benefit from the investment.
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Economics is the study of the use of scarce resources that have alternative uses. Examples of resources include land, labor, natural resources, and capital.

There has never been enough resources to satisfy everyone completely - tradeoffs must be made on an individual and societal level. The decisions around how to allocate these scarce resources to produce the best output is the central question of economics.

As an analogy, in a battlefield with wounded soldiers, there are never enough doctors and nurses to go around. Some wounded are past the point of being saved, others have a chance if they get urgent care and will die if they won't, and others will recover without any urgent treatment. Thus the limited medical resources must be allocated to maximize output - this is an economic problem.

The allocation of resources is...
These transaction prices have ripple effects throughout the economy, with one price in one sector being transmitted to related sectors automatically, without passing through any central authority. These prices determine how much of each resource gets used where.

If someone else produces a better product, or a lower price for the same product, that fact gets conveyed through prices, not a central authority, and is acted on by consumers. **Prices also mean that producers and consumers don’t have to know why things are getting cheaper or more expensive - they can simply...**

Basic Economics Summary Chapter 3: Price Controls

In a repeated theme in *Basic Economics*, a good way to see why the principles are important is to see what happens when they are not functioning.

Why is it a big problem for pricing to be disrupted? In short, because it causes misallocations of resources. But why is that a big problem? If these are just internal transfers within a closed system, misallocations of resources may seem zero sum - money goes to sugar producers when it would otherwise have gone to pig farmers.

The real losses come from misallocation of scarce resources and a reduction in the total wealth of society.

Here are three situations where artificial prices arise - centrally set prices, artificial price ceilings, and artificial price floors.

**Centrally Set Prices**

In the Soviet Union, prices were set not by supply and demand, but by central planners. However, as we discussed earlier, it has been historically impossible for a central authority to have detailed knowledge across millions of goods, then to set pricing optimally.

In a market economy, individuals with the most knowledge of their situation bid for resources. Prices automatically calibrate to cause resources to flow to their most valued uses. Producers would treat their resources as scarce and valuable, consuming them efficiently.

In the Soviet Union, mis-optimized pricing caused surpluses of some goods and shortages in others. For instance, the state would raise the price of moleskins above what would have arisen naturally in the market, which prompted hunters to get more of them than demanded by consumers, leading to unused pelts rotting in warehouses. Meanwhile, this labor and land use was not used efficiently for a more valuable use, like food, causing food shortages.

This situation also produced bad incentives. In a market economy, producers have natural incentives to use resources efficiently to increase profits and reduce losses. In contrast, in a centrally planned economy, when producers are instead judged based on their output and not efficiency/profitability, they ask for more than they need...

Basic Economics Summary Chapter 4: Myths about Prices

We'll cover a number of myths about prices and their role in the economy.

**Myth: High Prices are a Sign of Greed**
Many people see prices as obstacles to getting what they want. Beach-front homes in Malibu are priced at millions of dollars, out of reach of most of the country. This can be labeled in the popular press as “greed is driving up the price of housing,” as though people are charging more than the product is worth.

However, this ignores the fact that the price becomes a reality only if others are willing to pay them and if a transaction happens. One could price her phone at $5,000,000, but no one would be willing to buy at that price. Therefore, greed has little impact on what others are actually willing to pay.

Thus, high prices are not a sign of “greed” on the part of homeowners - prices merely reflect the scarcity of beach-front homes, that there are not enough beach-front homes to satisfy all of us. Different economies ration these houses differently - in a feudal economy, the lord would ration the houses by fiat, giving houses to certain people. They could also be rationed by lottery. No matter the method, the rationing would still have to happen.

Related: people tend to over-attribute economic situations to individual actors and intentions, like greed or politicians’ stupidity. In reality, most people do not have the force to shape markets, and are merely responding to their individual incentives like everyone else. In the Soviet Union, it made a lot of sense for each individual officer to make suboptimal planning decisions (the punishment for deviation was death), even if systemically it caused massive inefficiencies.

Inversely, some people tend to depersonalize the market too much, treating it as a mysterious entity. In reality, markets are simply made up of people, and understanding individual wants and drives can lead to better understanding of markets.

Here are other situations that are commonly seen as unsavory and greedy, but occur for good market reasons:

- In areas of famine or emergency, the prices...

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Basic Economics Summary Part II: Industry and Commerce | Chapter 6: Profits and Losses in Businesses

(Shortform note: we're presenting the chapters a little out of order, starting with business profits and losses, then combining the chapters on business operations in the next Shortform chapter.)

Much is said about “outsized profits” earned by businesses. They seem like unnecessary arbitrary charges added onto the cost purely to benefit the owners. But this ignores the risks inherent in creating businesses. Half of all new businesses fail in 4 years, and most former titans (like Kodak) eventually go bankrupt as they fail to adapt to changing circumstances.

Further, the average rate of return on corporate assets before taxes is between 4-12%, and after taxes between 2-8%. This is lower than what the average guess might be.

Profits provide incentives for businesses to produce goods that consumers most want at the lowest cost. Without these incentives, businesses would be less efficient, producing lower quality goods with less concern for cost, as in the Soviet Union.

Furthermore, there are natural limits to the profits that can be earned - high profits in one sector encourage competition, which reduces profits and increases quality. Without this competition for profits, businesses would have less incentive to adapt to changing conditions to maximize consumer value. Business profit is the price society pays for efficiency.

Losses encourage businesses to stop producing goods that consumers don’t want. Forcing a reduction in investment this way shifts scarce resources to where they can have more valuable uses - like Kodak losing money so that labor that would have gone into film photography can go into digital photography instead.

If a business fails to adapt to ever-changing market conditions, other companies that provide better products will take a greater share of the profits, and the incumbent will incur lower profits or losses. In extreme losses, the business will shut down and is prevented from needlessly consuming more resources. For example, when computers came along, typewriter companies consumed fewer scarce resources by...
Basic Economics Summary Chapters 5-7-9: Business Operations

The book explains the economics behind a number of business operations, including the role of middlemen, the cost of inventory, and executive compensation.

Changes in Markets

Businesses need to respond to a variety of changes:

- Social changes
  - In the 19th century, the majority of people lived in small rural communities, with high cost of goods to small scattered stores. Montgomery Ward operated a mail order service, delivering products at lower costs than those charged by rural stores. But as urbanization happened in the 1920s, urban department stores became more efficient, leading to the rise of JC Penney.
  - Grocery chain A&P was dominant for decades, from the 1930-50s. Located in central cities, A&P stores had operational efficiency that allowed charging lower prices. However, the automobile led to suburbanization, which led to supermarkets and their advantages of scale (including lower delivery costs per unit, and larger transaction sizes with lower overhead per $).

- Economic changes
- Technological changes
  - Rockefeller produced new products from petroleum, extracting more value and reducing the price of its main product kerosene, instead of letting it go to waste.
  - Newspapers were the primary means of disseminating news, until the Internet made them largely obsolete.
  - Digital cameras made film photography like with Kodak obsolete. (Ironically, Kodak invented the digital camera.)

- Business model changes
  - With the rise of credit cards, retailers often made more profits from managing their own credit card programs than from actually selling goods.

- Changes in business leadership

Often companies fail to adapt because their calcified ways of doing things are not efficient at producing the new type of product people want. Howard Johnson's fast food chains failed to compete with McDonald's because its restaurant practices were less efficient at creating fast food than McDonald's practices, which were optimized from the start.

Specialization and Middlemen

**A company is limited in the...
leading to high profits for businesses - if this were really the case, competitors will soon arrive who will compete the profits down to a rate of return similar elsewhere in the economy. Water finds its level.

However, monopolies, oligopolies, and cartels reduce competition, control prices, and thus distort markets. The monopolist would earn a rate of return necessary to attract the capital required, but no competition arises to drive down prices.

The real harm of monopolies is not consumers paying more for goods - within an economy, this is simple redistribution of wealth. Rather, at the higher artificial price, fewer goods are demanded and produced than at a lower market price. Thus, a monopolist produces less output with the same available resources.

For instance, in many cities the government supports a monopoly on taxicabs by limiting licenses and setting prices. This artificially limits the number of drivers; people who would be willing to drive at market rates are prevented from doing so, finding other work of lesser value. Furthermore, the higher price of cab rides reduces the number of rides and overall consumer standard of living.

What is Actually a Monopoly?

A monopoly exists when a specific person or organization is the only supplier of a particular good or service. This causes a market distortion and reduces consumer welfare.

In common parlance, large companies and market leaders are often misconstrued as monopolies. But if a company...
In fact, income distributions tend to reflect people in different stages of life - namely, older people earn more. Older people...

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Basic Economics Summary Chapter 11: Distortions in Labor Markets

We've learned that human labor is a resource like any other, and that markets price resources efficiently without the need for central control.

However, there are artificial changes to labor prices in the form of artificial floors. Minimum wage laws, mandatory benefits, job security, working conditions, collective bargaining and occupational licensing all have the same effect - they artificially increase the price of labor above what they would be in free competition. This causes a surplus of supply and less demand for labor.

Minimum Wage Laws
Even though minimum wage laws are meant to benefit workers, they can lead to increased unemployment. The real minimum wage is always zero. With artificially higher wages, employers tend to use more capital as a resource. Rather than hiring extra people, employers get more mileage through existing workers through overtime or by investing in technology to make workers more efficient.

Countries with no minimum wage laws like Switzerland and Singapore tend to have lower unemployment rates of 2-3%. Furthermore, countries with no minimum wage laws and fewer mandatory benefits tend to have shorter periods of unemployment and faster turnover.

Because of the surplus in supply, buyers (employers) can be more selective about who they hire. This typically disadvantages younger, less skilled, and minority workers, who become delayed in acquiring job skills and experience and thus stifle their lifetime income. Indeed, minimum wage laws were once explicitly advocated to reduce competition with minorities, who were willing to work for less (such as African-Americans in the United States in the 1930s).
Labor unions benefit from minimum wage laws, since experienced unionized workers tend to displace younger, less skilled workers as the minimum wage goes up. (Shortform note: imagine that a young worker would cost $8/hr in a market, but a skilled worker would cost $15/hr. An employer could make the decision accordingly. But if the minimum wage became $14/hr, the cost difference between the two workers shrinks to...

Basic Economics Summary Chapter 12: Other Problems in Labor Markets

Unemployment Statistics

Unemployment rate is usually defined as the percentage of people who are looking for jobs who are unemployed.

If the base - the number of people who are looking for jobs - decreases due to giving up or going back to school or retiring, then the unemployment rate can decrease even if the number of people without jobs increases.

Furthermore, comparisons across countries and cultures can be problematic. Countries with more generous welfare and unemployment policies, like France, can remove people from the labor force, thus decreasing unemployment rate. For instance, over 70% of people aged 55-64 work in Switzerland, compared to 37% in France, whereas the unemployment rates do not look as stark.

An alternative metric is to measure what percentage of the adult population outside of institutions (colleges, the military) is working.

The unemployment rate can never reach zero because of "frictional..."
In loans, interest rates compensate lenders for risk and for the delay in receiving money back. Money is more valuable today than it is in the future - at the very least, you could earn interest on money in a bank, or invest it in the stock market. You may also die and lose on the opportunity to spend that money; or the bond issuer may go bankrupt.

Therefore, people are willing to buy bonds (lending their money to the bond issuer) at a certain interest rate considering the above factors. If you are willing to part with $100 to earn $104 a year from now, this sets your interest rate at 4%. Naturally, in the bond...

Basic Economics Summary Chapters 14-15: Insurance, Human Capital, Natural Resources

This chapter considers other vehicles dealing with risk and time, such as insurance and human capital.

Insurance

Like speculators, insurers take on risk from individuals because they can weather individual risks by pooling large numbers.

Insurers also seek to reduce risk, charging lower prices to safe drivers and reducing premiums for losing weight. Higher prices for more risk conveys to people the costs created by their chosen activity or behavior and incentivizes them to reduce risk.

From the individual's perspective, insurance also reduces risk - the cost of insurance has to be less than the cost of uninsured risk, otherwise the transaction wouldn't happen. Without insurance, the higher cost must be priced into the product - thus, the cost of an insured product is lower than the cost of an uninsured product.

Insurers take money from premiums and invest - approximately 66% of life insurance companies' income comes from premiums, and 25% from earnings on investments. Insurers aren't just making outsized profits - competition reduces the cost of premiums to a market equilibrium.

When an entity becomes large enough, they can self-insure at cheaper rates. Car rental agency Hertz may own enough cars that it can assess risk across its fleet and price risk into the rental cost, perhaps better than an insurer can. It may not make sense to transfer risk at a cost without reducing actual risk, since the outside insurer has its own management costs and needs room for profit.

Insurance Problems

While insurance generally reduces risks, insurers also have to deal with a few problems:

- **Moral hazards**, where the knowledge of being protected actually increases risky behavior. Thus calculations of current risk may not reflect real risk after insurance.
- **Adverse selection**, where riskier people tend to buy insurance while non-risky people don't, in ways that are currently opaque to the insurer. If the insurance company assumes the risk level over the entire population, but only riskier people buy insurance, the insurer may...

Basic Economics Summary Part V: The National Economy | Chapter 16: National Output

The basic economic principles that apply to specific markets for goods also apply to national economies as a whole. The supply and demand for a nation's output can fluctuate, just like supply and demand for a single good fluctuate.
National Output

The national output is what is produced during the current year. It is distinct from a country's total wealth, which is accumulated across time and can be used to allow a country to live beyond its current production.

The most common measure of national output is Gross Domestic Product (GDP), the sum of everything produced within a nation's borders.

Much is made of comparisons of GDP - how it's changing over time, how one nation compares to another. But comparing GDP across any dimension has complications:

GDP comparisons across time have issues of changing composition of the output.

- Cars in 1950 are far less advanced than cars in the 2000, so merely comparing number of cars is misleading.
- Work compensation increasingly comes in benefits, rather than direct wages, so just comparing wages is misleading.
- Work that had previously gone unpaid (like farming, making homemade clothes, cooking food, raising children) may now be outsourced to the marketplace, and is now counted in national output, even though the volume of activity has not actually changed.
- Developing countries that improve healthcare allow the poor and elderly to better survive, but their survival now lowers the average income.
- Trying to adjust by cost of living is difficult, since rare luxuries like flat-screen TVs can reduce in price dramatically and become commonplace, while common goods may increase in price due to quality.
- Economists estimate consumer price indices have an inflationary bias of 1%, so real inflation is 1% less than the CPI.

GDP comparisons between nations can be inaccurate.

- The quality of output may differ, even if the quantity is identical.
- Different age distributions will show younger nations to have less output, because younger people do not require healthcare costs that are...

Basic Economics Summary Chapter 17: Money, Banking, and Inflation

Money facilitates the production and distribution of wealth.

Barter of goods and services is awkward - if you make a chair, you may not want enough apples for the value of a chair, nor will the apples retain value for long. If you do accept apples, you may then need to spend time finding someone else who will trade for apples. You might also produce fewer chairs, knowing it's difficult to get paid for your chairs.

Money allows chairs and apples to be exchanged for an intermediary thing, which can be subdivided into very small units. When people agree on what will be used as the intermediary of exchange, that becomes money. To an individual, money is equivalent to wealth only because it can be exchanged for real goods and services.

Banking

What purpose do banks serve? First, they guard money, for which they have economies of scale compared to individual businesses.

More importantly, banks supply businesses with money and lines of credit to businesses to bridge them over unpredictable drops in income and allow them to undertake large investments. Here banks also have economies of scale and risk pooling, reducing lending costs below those of their customers. In turn, businesses that borrow can operate on a larger scale, reducing cost and improving societal standards of living.

These loans arise from money deposits, which enable distribution of resources through the economy with banks as an intermediary.
A bank makes efficient use of its deposits for 2 reasons. First, not all depositors are going to want all their money at the same time, so they need only hold a fraction of the reserves. Secondly, banks settle transactions between each other not by transferring the literal amounts, but rather settling the difference in total balance.

Because of this efficiency, banks practice fractional reserve banking, wherein they hold only a fraction of the reserves needed to cover deposits (in the US, the reserve requirement is about 10%). They then issue loans and earn interest. These credits are re-deposited in other banks, allowing...

Basic Economics Summary Chapter 18: Government Functions

The government provides a number of functions that are highly relevant to the economy's function.

Law and Order

Market transactions occur within a framework of rules, and those rules must be enforced for efficient economies to arise.

Economies with an unreliable legal framework, where application of the law is mercurial, increases investment risk and thus decreases the amount of investing relative to a reliable market economy. The laws don't necessarily have to be fair - they just need to be reliable to reduce risk.

Economies with an unreliable legal framework are more likely to be corrupt, causing drag on the economy by increasing the cost of doing business and allowing bureaucrats to delay businesses. For instance, it takes fewer than ten days to start a business in Singapore, compared to 155 days in the Congo. Companies and talented people leave the country for a more hospitable place, and foreign companies are loath to hire local workers who may be dishonest.

Social Order

Business transactions among strangers are required for successful mass economies. If people don't trust each other, transactions don't happen, and the cost of business increases.

The "radius of trust" is different among different groups and nations. If the radius is limited to the nuclear family, then the size of the company is limited only to the size of the family, since owners don't hire more workers for fear of theft. This drastically reduces the potential for economies of scale.

In small radius-of-trust societies, insulated groups whose members trust each other have a large competitive advantage, such as Hasidic Jews. The costs of doing business are lower. The social isolation makes it very costly for anyone in that community to lose her standing by cheating on agreements.

Government can promote honesty through laws, education, and examples set by public officials.

If laws are poorly enforced or bad laws are created, it can be far more profitable to violate laws than to abide by them. Inevitably resources will flow to those who can profit...

Basic Economics Summary Chapter 19: Government Finance

Governments must collect resources to pay for their expenditures - the US government spent $3.5 trillion in 2013. If revenues exceed spending, then there is a budget surplus; otherwise, there is a deficit, which can add up over time to the national debt.

Government Bonds and National Debt

The national debt tends to grow with inflation, population growth, and national income growth.
The debt is better considered not as an absolute number but rather a percentage of GDP.

In some cases, a high national debt is secondary to other concerns, such as fighting World War II. However, a high peacetime national debt is troubling, since there is no reduction in spending in sight as there is in the end of war.

Generally, to pay for current benefits like the military and civilian personnel, governments use tax revenues, allowing those benefited to pay. For investment projects like highways and schools, governments sell bonds, go into debt, and essentially push the cost onto future generations who will benefit from the investment.

When these purposes are confused - when the government goes into debt to fund current expenditures - this is as sensible as an individual borrowing more than current income to pay for dining this year. Even though this is politically favorable since it avoids raising taxes, future generations will pay the price.

Much of the US government's debt is held by its citizens, resulting in internal transfers. In effect, the sequence runs like this: citizens buy bonds, the government gets money to spend, the bond comes due, and the government collects taxes from its citizens to pay bonds. When instead the bonds are held internationally, then future generations of Chinese will collect wealth from future generations of Americans.

The national debt can increase in size to a tipping point that discourages further investment. When the debt is large enough, investors will worry about the creditworthiness of the nation, as well as its ability to turn over these bonds without raising interest rates, which would in turn raise...

Basic Economics Summary Chapter 20: The Incentives of Government

Why do politicians seem to adopt policies that seem so bad for citizens? This seems to occur regardless of the politician's party or positions.

Here are a bevy of reasons.

In a popularly elected government, the incentive is to do what is popular and garners votes, even if the consequences are worse than those of doing nothing.

Even worse, politicians are spending taxpayer money, not their own, so frivolous spending hurts them little.

Contrast political elections with the marketplace. In the marketplace, decisions can be made 1) instantaneously 2) for individual goods and services 3) that are wholly finished. In contrast, in politics, candidates 1) are chosen only once every several years, 2) come as a "package deal" - all their stances must be accepted or rejected in whole, 3) can only convey promises, not finished accomplishments, and thus constitute speculation.

No politician wants to be smeared as being against something that people generally value, like being accused of being "soft on crime" or against child safety. However, this can lead to categorical thinking, where certain things are considered absolutely bad and must be stamped out, regardless of the cost-benefit tradeoff. Constituents may contribute to this by having little grasp of the complexities of policy, instead falling prey to emotionally-charge rhetoric that is easier to understand. This can cause policies to be set that are net negative. Because policies typically have some conceivable benefit, the trend is toward more regulation, with few constraints on their growth.

Nor do politicians want to disrupt large voting blocs, like the elderly, government employees, farmers, or factory workers. This naturally leads to large noticeable changes for specific groups that are spread subtly across the larger population, such as tariffs to protect manufacturing jobs or protection of pensions, while the nation's taxpayers pay the price.

Even worse, political timelines are often much shorter than economic timelines, preventing the full consequences of policies from being connected...
International trade is not a zero-sum game, where one country is a winner and another is a loser. Both sides must gain, or it makes no sense to trade.

The same concepts that apply to transactions within a single nation also apply between nations. Freer trade allows scarce global resources to go towards their most valuable uses.

This may mean a loss of jobs in one sector with creation of jobs in another, but the economy is overall more efficient and the population at large benefits. Just as relaxing of interstate trucking restrictions in the US decreased jobs in railroads but created jobs in trucking in the same country, trade with manufacturers in Asia may lead to loss of manufacturing jobs but an increase in engineering or marketing jobs in the US.

There is no fixed number of jobs for countries to fight over - when countries become more prosperous, they all tend to create more jobs.

There are three primary reasons countries gain from international trade: absolute advantage, comparative advantage, and economies of scale.

### Absolute Advantage

Some countries are simply more efficient at creating a good or service - due to climate, geography, or skills. Prices are lower and consumers can enjoy more of it than without trade.

Bananas are grown more cheaply in the tropics because the sun provides cheap energy. In efficient trade, buyers in Iceland can buy cheap bananas from the Caribbean so that Iceland doesn't have to invest scarce resources in producing bananas at a higher price.

Indian tech support has a valuable advantage in being 12 hours ahead of the US, thus allowing US companies to provide round-the-clock support for cheaper than hiring graveyard shifts domestically.

A prosperous country tends to have more and cheaper capital, which gives it an absolute advantage in highly-capital intensive projects with high fixed costs.

### Comparative Advantage

A country might be so efficient that it produces anything more cheaply than another country. In this case, it still benefits the more efficient country to focus on what it is...

Transfers of wealth between countries take several forms:

- Direct investment through stock and bond investment
- Putting money in a country's banks, which will then issue loans domestically
- Remittances from outside workers back in to family
- Imperialists transferring wealth from nations they conquered (now more obsolete)
- Foreign aid

From a social equity point of view, ideally wealthy nations would invest much in poorer nations. However, rich countries tend to...
**Invest in Other Rich Countries** - out of $21 trillion in international bank loans, only $2.5 trillion went to poor countries. (This contradicts the claim that multinationals are exploiting Third World workers - if it were such a great deal, then American investments wouldn’t be primarily investing in other rich countries.)

In practice, poorer countries discourage investments due to high risk from unstable governments and risk of confiscation, corruption, and inadequate financial infrastructure.

**Trade Deficits and Surpluses**
There are many problems with typical considerations of national trade deficits and surpluses.

Much is said about how excessive importing (or trade deficits) impoverish a nation because money is being transferred out of the country. This is true if a nation's wealth is seen as its gold supply, but Adam Smith argued that the real wealth consists of its goods and services.

**Trade balance is not necessarily predictive of economic health.** In the Great Depression, the US had an export surplus, but both imports and exports were sharply reduced as a result of higher tariffs around the world. Nigeria has had trade surpluses in the recent past but is a very poor country.

There are also misleading accounting practices. When countries have a trade surplus, they have more of a foreign currency, which they often use to invest in the local economy of that currency. If Americans...

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**Basic Economics Summary Chapter 23: International Disparities in Wealth**

The vast differences in wealth between people living in different countries can be emotionally troubling. However, Thomas Sowell argues that given the vast differences in factors underlying economies (geography, natural resources, culture), as well as the complex interaction of such factors, it is impossible to expect economic equality across the world.

Places with inherent advantages had more opportunities to develop urban industrial, commercial, and financial skills than disadvantaged areas. These advantages can kick off virtuous cycles that widen the gap.

Quick note: one study claimed that inequality is rising, because the ratio of the incomes of the top 20 vs lowest 20 nations increased from 23:1 in 1960 to 36:1 in 2000. However, this is misleading because the identity of the nations had changed - when comparing the same 20 countries in 2000, the ratio had declined to 10:1.

Relevant factors that differ between nations include:

**Geography**

**Agriculture**

- Land differs in fertility.
  - Fertile mollisols are found in the American midwest and Eurasia. They are seldom found in the tropics or sub-Saharan Africa.

- Rainfall, and even different absorption of rainfall
  - Loess soil in northern China holds more rain than limestone soils in the Balkans.

- Sunlight

- Lack of agriculture inhibits development of cities, which spur economic growth.

  (Shortform note: the book *Guns, Germs, and Steel* argues that the vast tracts of land in the same latitude in Western Europe - and thus a consistent climate - facilitated spreading of agricultural practices, compared to the longitudinal orientation of Africa with varying climates)

**Natural Resources**

**Water Access**
Water transport is far cheaper than land transport. Thus access to waterways increases imports and exports.

Calmer, flatter, contiguous, more consistent waters like European or Chinese rivers were far more helpful than sub-Saharan rivers that suffer huge plunges in elevation, vary dramatically in depth and width by season, and don't connect...

Basic Economics Summary Chapters 24-25: Myths about Markets

Many misconceptions have been addressed above. Well summarize important ones here for good measure.

Myth: The Market as a Thing, Not as Humans

A market is just humans engaging in transactions among themselves. When it's treated instead as a depersonified, third-party entity, rhetoric is allowed that takes away freedom from humans to transact on mutually agreeable terms.

Instead, restricting markets should be treated as subjecting humans to the will of third parties. (Shortform example: for instance, wage control laws may be seen as “preventing landlords and tenants from exchanging on the natural market price, thus leading to undersupply and increasing homelessness.”)

Myth: Profits as Gratuitious

Profits have been seen, at different times throughout history, as gratuitous overpayment beyond costs that restrict standard of living of people at large. Implicit in this is the assumption that whatever profits entrepreneurs and investors earn exceed the value they contributed.

However, it's clear that without private property rights and financial incentives, as in the Soviet Union, living standards simply worsen. People simply do better jobs when they have a personal incentive to do a better job than when they don't. (Shortform note: deeper reasons for this are not explored in the book, but are likely contributed to through innate biology and general inability of humans to act like self-sacrificing drones in a hive.)

No one would say that wages were just arbitrary charges added to the price of goods for the benefit of workers, when the product would not exist without the workers, and they wouldn't work without being compensated. Yet the same should be considered true of entrepreneurs and investors - the profits are incentive for the company creators to start the company and produce the service. This is just not often considered because the risks of failure and difficulty of work on that level are more opaque than the profits gathered.

An economist would argue - **the profits an owner earns are exactly the measure of the owner's contribution...

Basic Economics Summary Chapter 26: A Brief History of Economics

The book ends with a brief history of how economic thinking developed over the centuries.

- 1600s-1700s: mercantilists argued that a nation should export more than it imports, causing a net inflow of gold. They equated gold with wealth. They were preoccupied with transfers of wealth and increasing increase the power of their own nations relative to that of other nations, not creating wealth for people at large. This supported policies like repressing wages to lower export costs.

- 1776: Adam Smith published *The Wealth of Nations*, conceiving of economic activity as creating wealth and non-zero-sum. He saw wealth as the goods and services that determine the standard of living, not as the amount of gold. He rejected government intervention to help merchants, believing individuals could sort out interactions with each other just fine. This built the foundation of classical economics.

- 1817: David Ricardo published *Principles of Political Economy*, adding rigor to terminology and analysis of economics. He also
introduced the theory of comparative advantage.

- 19th Century: Say's Law argued that production of output and the generation of income for those producing the output were one and the same. This addressed popular fears that growing output would exceed the ability of people to buy it, leading to unsold goods and unemployment.

- 19th Century: The "marginalist revolution" allowed price theory to incorporate the demands of consumers, rather than just the costs of producers, giving rise to neo-classical economics.
  - Previously, the fact that diamonds cost more than water contradicted pricing based on consumer demand, given that water was critical to life and diamonds weren't. But this analysis compared the total utility of water vs the total utility of diamonds - arguing humans were better off with no diamonds than with no water.
  - But innovations in marginal utility resolved this issue - utility...