

## **Common Sense Economics Part I. Twelve Key Elements of Economics**

### **Element 9. Production of goods and services people value, not just jobs, provides the source of high living standards**

*Consumption is the sole end and purpose of all production; and the interest of the producer ought to be attended to only so far as it may be necessary for promoting that of the consumer.*<sup>i</sup>

—ADAM SMITH (1776)

As Adam Smith noted more than 230 years ago, consumption is the objective of all production. But, goods and services cannot be consumed until they are produced. Moreover, income and living standards cannot increase without an increase in the availability of goods and services that people value.

Clearly, destroying commonly traded goods people value will make a society worse off. This proposition is so intuitively obvious that it almost seems silly to highlight it. But misguided politicians have often followed this course of action. In 1933, Congress passed the Agricultural Adjustment Act (AAA) in an effort to reduce supply and prevent the prices of agricultural products from falling. Under this New Deal legislation, the federal government paid farmers to plow under portions of their cotton, corn, wheat and other crops. Potato farmers were paid to spray their potatoes with dye so they would be unfit for human consumption. Healthy cattle, sheep, and pigs were slaughtered and buried in mass graves in order to keep them off of the market. Six million baby pigs were killed under the AAA in 1933 alone. The Supreme Court declared the act unconstitutional in 1936, but not before it had kept millions of valuable agricultural products from American consumers. Moreover, under modified forms of the Act, the government continues to pay various farmers to limit their production. While the political demands of those benefiting from the policies are understandable, such programs destroy valuable resources, making the nation poorer.

The 2009 “Cash for Clunkers” program provides another example of politicians attempting to promote prosperity by destroying productive assets – used cars in this case. Under the Cash for Clunkers program, car dealers were paid between \$3500 and \$4500 to destroy the older cars that were traded in for a new automobile. Dealers were required to ruin the car engines with a sodium silicate solution, then smash them and send them to the junkyard, assuring that not even the parts would be available for future use. The proponents of this program argued that it would stimulate recovery by inducing people to buy new cars. But the money consumers used to buy new cars was unavailable for the purchase of other goods. Thus, while it temporarily stimulated auto purchases, it reduced spending in other areas. In essence, taxpayers provided \$3 billion in subsidies for new car purchases, while destroying approximately 700,000 used cars valued at about \$2 billion. New car sales plunged when the program expired and used cars became more expensive because of the reduction in their supply.

If destroying automobiles is a good idea, why not require owners to destroy their automobile every year? Think of all of the new car sales this would generate. All of this is crackpot economics. You may be able to help specific producers by making their products more scarce, but you cannot make the general populace better off by destroying marketable goods with consumption value.

A more subtle form of destruction involves government actions that increase the opportunity cost of obtaining various goods. For example, the federal government has subsidized the production of ethanol even though it costs about \$1.50 more per gallon than the energy equivalent of gasoline. These subsidies increase our cost of obtaining energy and most also believe that they exert an adverse impact on the environment. But they help corn farmers in the important presidential primary state of Iowa, and therefore they will be difficult to repeal.

Politicians and proponents of government spending projects are fond of bragging about the jobs created by their spending programs and they shamelessly exaggerate program benefits. Given this widespread deception, economic literacy in this area is particularly important. While employment is often used as a means to create wealth, we must not forget that it is not simply more jobs that improve our economic well-being but jobs that produce goods and services people value. When that elementary fact is forgotten, people are often duped into acceptance of programs that reduce wealth rather than create it.

The focus on jobs can be extremely misleading. This point is highlighted by the apocryphal story of an engineer who, while visiting China, came across a large crew of men building a dam with picks and shovels. When the engineer pointed out to the supervisor that the job could be completed in a few days, rather than many months, if the men were given motorized earthmoving equipment, the supervisor said that such equipment would destroy many jobs. "Oh," the engineer responded, "I thought you were interested in building a dam. If it's more jobs you want, why don't you have your men use spoons instead of shovels?"

Does government spending create jobs? When thinking about the answer to this question, consider the following two points. First, unless you believe in the tooth fairy, the funds for the spending will have to be either taxed or borrowed from the private sector. This will mean either higher taxes or higher interest rates, both of which will reduce private sector employment. This reduction in private employment will largely, if not entirely, offset the jobs generated by the government spending.

Second, the government spending itself will crowd-out private spending and employment. When the government spends more on education, health care, charitable activities and so on, households and businesses spend less. Similarly, when the government subsidizes some firms, for example, General Motors, Chrysler, Citigroup, or wind and solar energy producers, the subsidized firms will expand, but rival firms will lose market share and reduce their employment. Again, the increased government spending in one area will lead to offsetting reductions in employment in others.

The employment supported by the government spending can be easily seen, but the employment eliminated by the higher taxes, increased government borrowing, and reduction in demand for the products of the unsubsidized firms is largely unseen. This also helps to explain why deception is so widespread in this area. Nonetheless, the offsetting reductions in employment are real.

Remember how the so called “stimulus spending” of both the Bush and Obama Administrations was going to create and save millions of jobs? However, as the stimulus programs spent hundreds of billions of dollars during 2008-2009, employment fell and the unemployment rate soared. How could this be? Answer: As the government spent more, it crowded out private spending and therefore there was no net increase in employment. In fact, the programs generated uncertainty and probably made the situation worse.

The politicians supporting such programs, and those benefiting from the government spending, will not tell you about the offsetting reductions in private sector employment. Further, the fact that these programs do not utilize primarily voluntary trading, genuine market signals and incentives, and decisions by those personally facing the program costs, give us good reason to expect that the government-induced employment will be less productive than the private sector employment that it eliminates.

If a society is going to reach its potential, resources must be used to produce things people value more than the cost of their production. As previously discussed, profits and losses perform this function when resources are allocated by markets. The political process does not have anything like profit and loss that will consistently direct resources into productive, and away from counterproductive, projects. Worse still, when governments become heavily involved in granting favors to some at the expense of others, this incentive structure directs resources away from productive activities and toward the schmoozing of politicians (lobbying, high paying jobs for those with political influence, and other forms of favor-seeking including bribery.)

The use of taxpayer funds to grant business, labor unions, and other well organized groups with subsidies and other forms of funding in exchange for political favors has become the major activity of government. This crony capitalism is not only reducing our income levels, it is corrupting the political process. Businesses and other interest groups continue to open offices in Washington, D.C. and more and more resources are directed toward the “looting” of the public treasury for private gain. Moreover, while the process reduces the living standards of ordinary Americans, the “looters” are doing quite well. It is no coincidence that the counties surrounding Washington now have the highest incomes of any in the country.

The bottom line is this: while consumption is the objective of all economic activity, goods and services must be produced before they can be consumed. When programs (1) destroy goods, (2) squander resources on projects that cost more than the value delivered to consumers, and (3) encourage individuals, businesses and organized groups to enrich themselves at taxpayer expense, they will reduce

both production and consumption, making us worse off as a society. When we analyze how the political process works in Part III, this issue will be considered in more detail.

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<sup>i</sup> Adam Smith. *An Inquiry into the Nature and Causes of the Wealth of Nations*, Volume II Glasgow Edition, (Indianapolis: Liberty Fund, Inc., [1776] 1981): 660. Also available at: <http://www.econlib.org/library/Smith/smWN.html>