

## Its the Margin that Counts<sup>1</sup>

### [The Freeman: Ideas on Liberty](#)

By Dwight R. Lee

*Dwight Lee ([dlee@terry.uga.edu](mailto:dlee@terry.uga.edu)) is Ramsey Professor at the Terry College of Business, University of Georgia, and an adjunct fellow at the Center for the Study of American Business at Washington University in St. Louis.*

Economists, like everyone, have opinions about how the world should be. And it would be disingenuous to claim that economists never let their opinions influence their conclusions and recommendations. But the power of economics is in fundamental concepts that prevent economists from letting their imaginations obscure reality. They may wish that scarcity didn't exist, that agonizing tradeoffs could be avoided, that people would subordinate their private interests to the public interest, or that world peace and global cooperation could be achieved by all joining hands and singing "We Are the World." But economists don't let such fantasies pollute their analysis because they take seriously scarcity, opportunity cost, self-interest, imperfect knowledge, market prices as necessary for social cooperation, and economic failure as necessary for economic success.

This attachment to reality strikes some as defeatist, as too hasty to dismiss proposals for making the world a better place. There is no denying that economists dismiss many proposals to improve the world. But economists see their realism as essential for genuine improvements. As Nobel-Prize winning economist F. A. Hayek observed, "For it has always been the recognition of the limits of the possible which has enabled man to make full use of his powers."<sup>2</sup> Perpetual-motion machines would be wonderful things, and it's too bad everyone doesn't have one. But the "defeatist" attitudes of physicists discourage work on them. One of the most useful economic concepts is marginalism—the effect of incremental, or small, changes. Marginalism shows how economic reasoning allows us to accomplish more by accepting limits on what can be accomplished—by focusing on marginal (some will say mundane) adjustments to make things better, rather than on more heroic attempts to solve problems totally and completely. It also shows that what many people see as objectionable outcomes and actions are actually reasonable accommodations to scarcity and that attempts to "correct" them are harmful. I illustrate marginalism with two examples. In following months I shall discuss how failure to understand marginalism reduces the good we can do, and often ends up being deadly.

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<sup>1</sup> Slightly modified for instructors and students using Common Sense Economics ([CommonSenseEconomics.com](http://CommonSenseEconomics.com))

<sup>2</sup> F.A. Hayek, *Law, Legislation and Liberty*, Vol. 3: *Rules and Order* (Chicago: University of Chicago Press, 1973), p. 8.

## **Diamonds and Water, Wrestlers and Nurses**

We have all heard arguments like these: Something is wrong with the economy when professional wrestlers are paid a lot more than nurses. Food is far more important than golf, so we are making a big mistake by converting so much prime agricultural land to golf courses. If you are going to do a job, do it as well as you possibly can. Most people enjoy their work and don't have to be bribed with bonuses and merit pay to get them to perform well. Some things, such as human life, are simply too valuable to put a price on.

Each of these sounds plausible. But all of them are flawed because they ignore the importance of marginal considerations, and if we acted on them we would end up reducing the good that can be accomplished.

For years economists and others were perplexed that the price of diamonds is far greater than the price of water, even though water is far more valuable than diamonds. This diamond-water paradox wasn't resolved until the 1870s when the Austrian economist Carl Menger and the British economist William Jevons independently recognized the difference between marginal value and total value. Price reflects the value people place on one more unit of something (its marginal value), not the value of all of it (its total value). The total value of water is obviously much greater than the total value of diamonds—we would pay orders of magnitude more to avoid living in a world without water than we would to avoid living in a world without diamonds. But because water is so plentiful (except in unusual circumstances), the amount people are willing to pay for one more gallon is close to zero—the marginal value of water is low. On the other hand, diamonds are so rare that people are willing to pay thousands of dollars for one more.

This brings us to wrestlers and nurses. Because so few have the physical attributes to satisfy the demand for wrestling performances, people are willing to pay a lot to attract one more person with those attributes into the ring. Many more have the attributes to satisfy our demand for nurses, and so people are willing to pay a lot less to attract one more person into nursing. Although the total value of nurses is far greater than the total value of wrestlers, the marginal value of nurses is far less. And it is the marginal value of people in an occupation, not total value, that is important in determining salaries in that occupation.

So there is nothing remarkable about professional wrestlers' earning a lot more than nurses, although some consider it objectionable. But what some really see as objectionable in the large ratio of wrestlers' to nurses' earnings is that people with "disagreeable" preferences have the freedom to communicate those preferences through market prices. There is nothing wrong with trying to reduce

the earnings gap between different occupations by trying to change peoples' preferences. But if people try, as some do, to reduce earning gaps with government controls over wages and salaries, they are trying to distort the price communication that benefits us all.

### **Unintended Consequences**

Government could mandate higher salaries for nurses, for example. This would send a signal that the marginal value people receive from nurses has increased, and more people should train to become nurses. Few professional wrestlers will want to shift into nursing, but many other people will. Unfortunately, the higher salary communicates the wrong information. While telling more people to become nurses, the higher salaries are telling consumers that the marginal cost of nurses is greater than their marginal value, and so fewer should be employed. The result would be that few newly trained nurses will find jobs, some practicing nurses will lose their jobs, and consumers will have fewer nurses than they want at market salaries, that is, salaries that reflect their marginal value.

Because people fail to distinguish between marginal value and total value, they believe nurses (and those in many other occupations) are suffering an injustice and recommend solutions that harm everyone, particularly nurses.

Additional pieces will be required to adequately explain the concept of marginalism and to provide examples of the mistakes people make when they confuse marginal value and total value. Consult with the other Lee pieces on marginalism to find comfort that we are not running out of agricultural land.

### **Reference:**

Lee, Dwight R. ["It's the Margin that Counts," The Freeman: Ideas on Liberty - June 2000.](http://www.fee.org/publications/the-freeman/article.asp?aid=2271) Retrieved from the World Wide Web on 15 December 2006 at <http://www.fee.org/publications/the-freeman/article.asp?aid=2271>.

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