

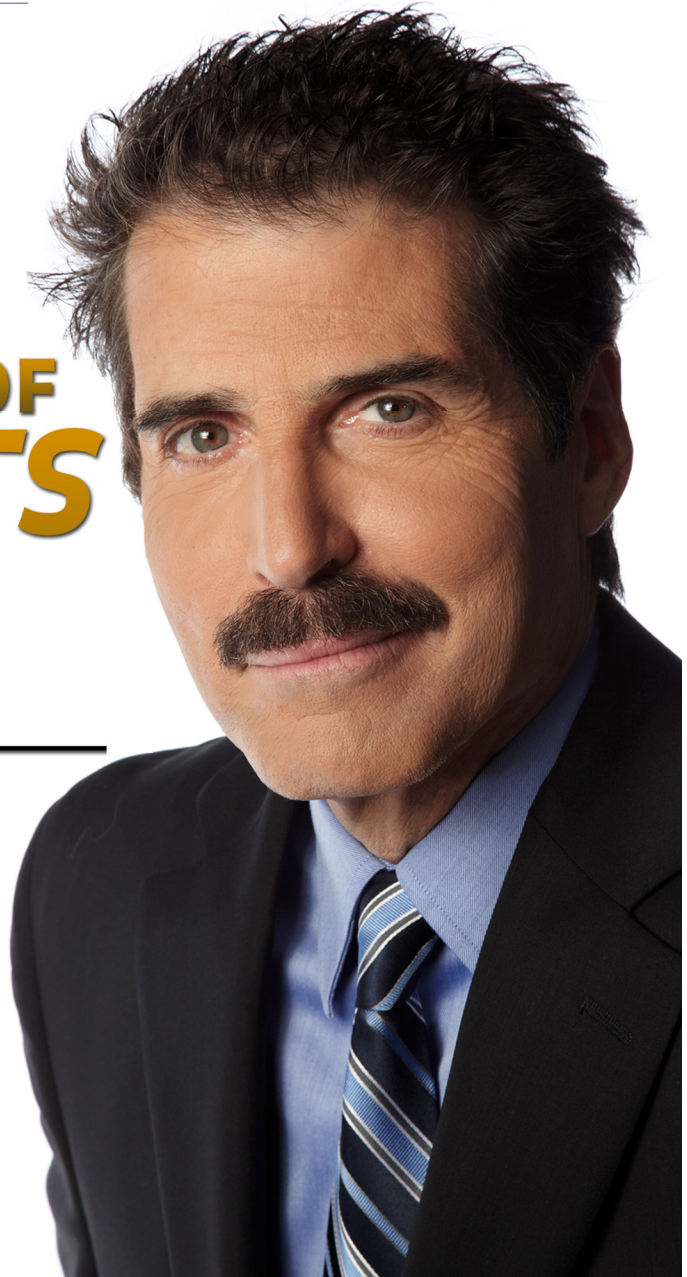
**Stossel**  
IN THE CLASSROOM

**THE POWER OF  
MARKETS**  
VS  
**the Failure  
of Regulation**

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**WITH  
JOHN STOSSEL**

**INSTRUCTOR'S  
MANUAL  
to Accompany  
Video Clips**



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## How to use the video clips effectively

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This manual provides teachers with materials that will help them use the video clips effectively. The manual contains the following items for each of the 16 clips in this edition:

1. a list of the concepts covered and lesson objectives
2. a preview question to introduce the clip in an exciting manner
3. a brief description of the video
4. discussion and analysis questions
5. an extension activity

The 16 clips are divided into five parts. A test bank of multiple-choice questions covering each of the parts is provided as a separate document (in PDF format) on the DVD. A slideshow presentation related to the material in the videos is also provided in a separate file on the DVD.

The preview questions are designed to attract interest and challenge students to think about important topics considered in the video. Many preview questions encourage the students to share their opinions prior to viewing the video. After the video is shown, the discussion and analysis questions provide suggested focal points for additional discussion. Suggested answers are included, but they are intended to help teachers focus on key points rather than provide definitive answers to the questions. These questions may also be used to assess student understanding of the topics covered in the video. The extension activity can be used to reinforce the content of the clip. In some cases, this material is also appropriate for use as a homework assignment.

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A Spanish version of this Instructor's Guide, a Test Bank of multiple-choice questions divided into six separate tests for Parts 1-5 (English and Spanish versions), and a slide presentation (English version only) are contained in accompanying files on the DVD.

# Part 1: The Role of Markets

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## Clip 1: The Fairness of Market Outcomes

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**Length: 3:56**

**Concepts Illustrated:**

- Fairness
- Equity
- Income distribution
- Economic freedom
- Markets

**Lesson Objectives:**

1. Recognize that in nations that have high levels of income, equality may not be beneficial for the poor in terms of income.
2. Identify the key characteristics of economic freedom.
3. Analyze data to identify the relationship between levels of economic freedom and levels of income for poor people.

**Preview Question:**

What do you judge to be best for the poor—income inequality or income equality? Why? (Write the students' answers on the board, but do not comment on the answers.)

**Description:**

John Tomasi compares two types of societies. The first has income disparities that are small, because it focuses on income redistribution. The second focuses on market distribution and allows for greater income disparities. He argues that the second one grows faster and creates more wealth so that the poor people become better off. Over time, the second produces outcomes that are fairer, especially for the poor, than the first.

**Discussion and Analysis Questions:**

1. What is widely regarded as the primary characteristic of a fair or just society?  
*A fair society is often regarded as one that is characterized by an equal distribution of income. In such a society, income is redistributed from rich to poor.*
2. If people care about the poor, what sort of society should we have?

*A society that cares about the poor would be one where the poor are better off—have more income—rather than one that may have equality of income but leaves the poor less well off.*

3. What does John Tomasi mean when he says people should be authors of their own lives?

*He is referring to the idea that people should be free to unleash their creativity and work for themselves. Individuals should seek happiness by becoming better “cake bakers.”*

### **Extension Activity: Are Poor People Better Off in Nations with More Economic Freedom?**

Explain that societies that have more economic freedom are better for the poor. Poor people have more income in societies that are marked by high levels of entrepreneurial activity. Distribute the handout on the following page to the students. After they have had a chance to read it, discuss the questions at the end. Ask:

1. What are the characteristics of economic freedom?

*Economic freedom stresses the importance of individuals being able to choose what is in their own best interest. Economic freedom stresses the idea that individuals should be free to make voluntary exchanges with others with little interference from government, that they should be free to start businesses and compete in markets, and that the government should protect their property from invasions by others.*

2. According to the *Economic Freedom Annual Report*, what are some of the benefits of economic freedom?

*People who live in economically free nations tend to live longer and have stronger political rights and liberties.*

3. What is the relationship between the level of economic freedom and the level of income of the poor?

*Poor people who live in the most economically free nations have nearly 10 times as much income as poor people living in the least economically free nations.*

## **HANDOUT: Economic Freedom and the Poor**

### **What Is Economic Freedom?**

Many people are familiar with political freedoms such as freedom of religion, speech, and assembly. People are less familiar with economic freedom. Some economists, such as Nobel Prize-winning economist Milton Friedman, argue that economic freedom is the primary freedom from which all other freedoms are derived.

So what do Friedman and other economists have in mind when they are referring to economic freedom? The key ingredients of economic freedom are:

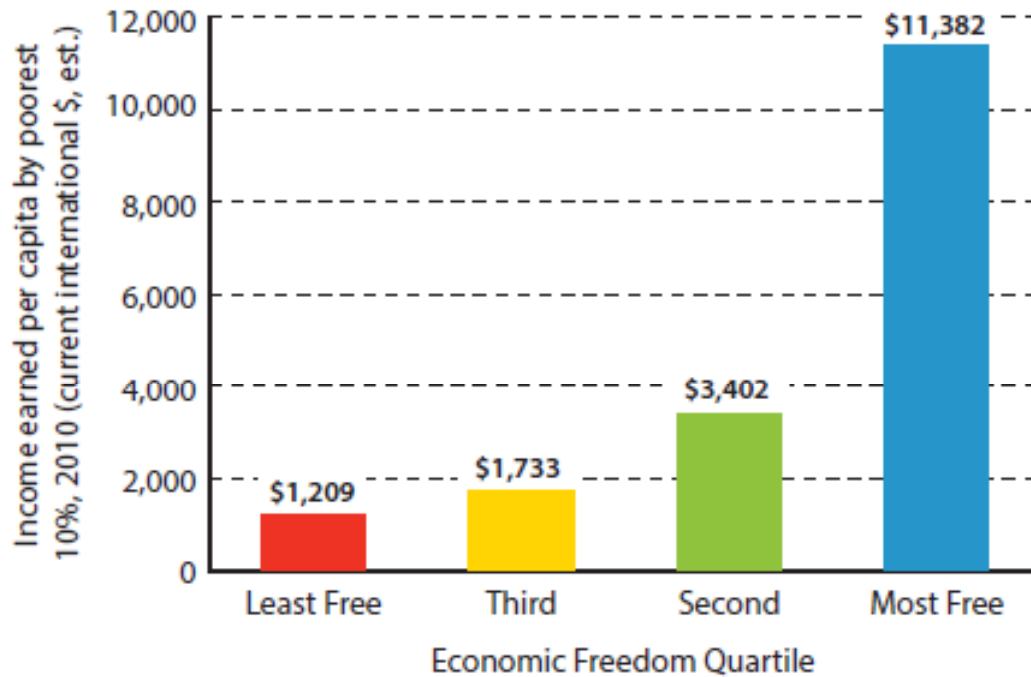
- Personal choice
- Voluntary exchange between businesses and individuals in markets where prices are established by the forces of supply and demand rather than by government rules
- Freedom to start businesses and compete in markets
- Protection of persons and their property from aggression by others

Economic freedom is present when individuals are permitted to choose for themselves and engage in voluntary transactions as long as they do not harm the person or property of others. While individuals have a right to their own time, talents, and resources, they do not have a right to those of others. Thus, individuals do not have a right to take things from others or demand that others provide things for them. Use of violence, theft, fraud, and physical invasions are not permissible but, otherwise, individuals are free to choose, trade, and cooperate with others, and compete as they see fit. In an economically free society, the primary role of government is to protect individuals and their property from aggression by others.

The *Economic Freedom of the World Annual Report* published by the Fraser Institute has for several years reported on levels of economic freedom for nearly all nations. The 2012 report noted that people who live in nations that are more economically free have higher per capita incomes than do people who live in nations that are less economically free. People who live in economically free nations also tend to live longer and have stronger political rights and liberties. But are poor people better off in nations with more economic freedom?

Figure 1 on the next page is a chart reported in the 2012 Economic Freedom of the World Annual Report published by the Fraser Institute. It shows the relationship between the level of economic freedom and the level of income of the poorest 10 percent of the population. What does this figure suggest?

Figure 1: Economic Freedom and the Income Level of the Poorest 10 Percent



### Questions for Discussion

1. What are the characteristics of economic freedom?
2. According to the *Economic Freedom Annual Report*, what are some of the benefits of economic freedom?
3. What is the relationship between the level of economic freedom and the level of income of the poor?

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## Clip 2: How Market Forces Temper Greed

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**Length: 3:19**

**Concepts Illustrated:**

- Greed
- Self-interest
- Markets
- Competition

**Lesson Objectives:**

1. Distinguish between selfishness and self-interest.
2. Explain how and why self-interested behavior can have positive outcomes for an economy.
3. Explain how the invisible hand of the market brings about cooperation without coercion.

**Preview Question:**

Why do you expect to find food you like when you go to a supermarket? (Write the students' answers on the board, but do not comment on the answers.)

**Description:**

Competition tempers greed by offering consumers choices about where to buy. If one seller raises prices, consumers will switch to relatively cheaper alternatives. Markets temper greed by encouraging people to cooperate to earn money. John uses the example of a steak getting to New York through the cooperation of thousands of people. Although each person is really only looking out for his or her own paycheck, they must work together in order to actually earn their pay.

**Discussion and Analysis Questions:**

1. What causes so many people to work together to bring steaks to New York City?

*It happens because of the incentives created by markets. Sellers produce steaks because consumers want to buy them. The most efficient producers survive because they compete with other producers. People work as farmers, transporters, butchers, and supermarket clerks because they earn salaries or profits. It takes thousands of people to produce a steak. Most likely, these people do not know each other, never communicated with each other, and may not even like each other. Yet these differences did not keep them from cooperating through the incentives and information generated by markets.*



2. Should governments or markets produce the goods and services most important to people's lives?

*People often think positive economic outcomes can occur only from a well-planned and orderly government-directed system. They often think that the more important the good or service is to people's lives, the more central planning by government is needed. However, every centrally planned economy has failed. The more market-oriented an economy is, the more successful it is. This is because only markets communicate millions of decisions in a price, and these prices organize and allocate resources to producers of the goods and services consumers demand. The invisible hand of the marketplace works better than the visible boot of government.*

3. Which does more to temper greed: voluntary exchange in the marketplace or government regulations?

*People have blamed markets for a long list of horrors such as unbridled greed, corrupt institutions, and an unequal distribution of income. However, history shows that with a system of justice, markets align people's personal interests with society's interests. Markets are based on voluntary exchange, and people don't make those exchanges unless both parties believe they will gain. This is why both the buyer and seller say "thank you" after a transaction. Markets are impersonal, while government decisions can be very personal. Markets provide the incentives that encourage self-discipline, honesty, tolerance, cooperation, courtesy, enterprise, and responsibility.*

4. What is the "invisible hand"?

*The "invisible hand" is a metaphor for describing movements within markets. It refers to how prices based on supply and demand guide people in making their own economic choices.*

### **Extension Activity: Have You Ever Made a Pepperoni Pizza from Scratch?**

John's "How Steak Gets to New York" and the activity that follows owe their intellectual roots to "I, Pencil," authored by Leonard Read and first published by the Foundation for Economic Education in 1958. In his introduction to a reprint of the article, Milton Friedman wrote, "I know of no other piece of literature that so succinctly, persuasively, and effectively illustrates the meaning of both Adam Smith's invisible hand—the possibility of cooperation without coercion—and Friedrich Hayek's emphasis on the importance of dispersed knowledge and the role of the price system in communicating information that will make the individuals do the desirable things without anyone having to tell them what to do." It is difficult for students to understand how markets can be more efficient than central planning. After all, their experience is the family, and most families are centrally planned and are based on altruism more than self-interest. Here is another activity to show the power of the market.

1. Ask your students: "Have any of you made a pepperoni pizza from scratch?"

*Some students will probably say they or their parents have done so.*

2. Follow up by asking these students how they did it.

*Answers will all concern the actual making of the pizza.*

3. Now tell the students that none of them has made a pizza from scratch and no one ever could. Although we take a pizza for granted, it really takes millions of people to make it, and although the process seems unorganized, the unplanned market creates spontaneous order better than any overarching plan could.
4. Allow the students to suggest some of the millions of actions it takes to make a pizza. Here are a few examples.

1. The Crust

- a. Growing wheat involves building tractors and harvesters, which involves making steel and plastic, which involves mining iron ore and drilling for oil. Somehow, the machinery must get to farmers who are trained to use it.
- b. Farmers must plant, harvest, and ship the wheat to flour mills.
- c. The mills turn the wheat into flour and ship it to wholesalers who ship it to food manufacturers, stores, and restaurants.

2. The Cheese

- a. Farmers must raise cows and milk them.
- b. Trucks must ship the milk to market.
- c. Cheese makers must produce the cheese.
- d. The cheese must be shipped to stores and restaurants.

3. The Sauce

- a. People must grow all the vegetables and spices that go into pizza sauce.
- b. If the sauce is prepared, the company that makes the sauce must purchase the necessary vegetables and spices, combine and process them, package the sauce, and ship it to stores and restaurants.
- c. If the sauce is prepared at home, the cook must buy and combine all the ingredients.

4. The Pepperoni

- a. Cows and pigs must be raised.
- b. Cows and pigs must be butchered, and some cuts used for pepperoni.

- c. Spices for the pepperoni must be grown and harvested.
  - d. The ingredients must be shipped to the pepperoni producer.
  - e. The pepperoni must be shipped to wholesalers, stores, and warehouses.
5. Putting It All Together. This is a small part of the total process. Still, there must be metal for the pan and baking tools, an oven, fuel for the oven, and the skills to cook it.
6. Ask the students what they think is the point of this activity.

Markets create spontaneous order that central planners cannot duplicate. As extensive a list as you compiled, it included only a few of the decisions, skills, and resources needed to make a pizza. Multiply this by the production of millions of goods and services and think about all the ways the market allocates resources to make goods and services people want most.

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## Clip 3: Debunking Common Economic Myths

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**Length: 4:48**

**Concepts Illustrated:**

- Scarcity
- Comparative advantage
- International trade
- Poverty

**Lesson Objectives:**

1. Identify the benefits of free trade.
2. Recognize that it is free markets, not population size, which account for a nation's prosperity.
3. Explain how market prices help account for why we have more oil reserves today than we did in 1977.

**Preview Questions:**

Do you think that we should favor American products over those from other nations? Do you think "buying American" makes Americans better off? Do you think overpopulation explains the poverty that exists in many nations in Asia and Africa? Do you think we are running out of oil? Or are these things we "know" that may not really be so? (Write students' comments on the board, but do not comment on the answers.)

**Description:**

Along with Art Carden, John debunks several economic myths: the U.S. should produce all of its own goods, overpopulation causes poverty, and the world is running out of oil. Using data and economic thinking, these claims are shown to be false.

**Discussion and Analysis Questions:**

1. Why is "buying American" inefficient?

*Americans should buy goods and services according to the lowest cost. It is cheaper for Americans to trade soy beans with China, which Americans can produce at a lower opportunity cost, and for Americans to buy Olympic uniforms from China, which China can produce at a lower opportunity cost. In this way, voluntary trade makes both sides are better off.*

2. Is it likely that overpopulation explains why some nations in Asia and Africa are poor? Why?

*No. Denmark and Hong Kong have much higher population densities than do Nigeria and Pakistan. Denmark and Hong Kong, however, are very wealthy. People are a valuable resource. The reason that some nations in Asia and Africa are poor is because they lack free markets.*

3. Jimmy Carter predicted in 1977 that we were running out of oil. Today, we have more reserves of oil and natural gas than we did in 1977, even after consuming large quantities of fuel over the past 35 years. Why haven't we run out of fuel?

*Higher energy prices create an incentive for profit-seeking energy companies to explore for more energy resources and develop new production technologies. That is why reserves of oil and natural gas are increasing even as we consume more.*

### **Extension Activity: A Thought Experiment: Should LeBron James Cut His Own Grass?**

Review the meaning of each of the following concepts with your students:

- **Absolute advantage:** The ability of a business or an individual to produce more units of a good or service than another producer using the same resources. It is a comparison among producers of a good or service, according to their productivity.
- **Opportunity cost:** The value of the next-best alternative, or what someone gives up by choosing one alternative over another.
- **Comparative advantage:** The ability of a business or an individual to produce a good or service at a lower opportunity cost than another producer. It is a comparison among producers of a good or service according to their opportunity cost.

Pose the following problem to the class:

“LeBron James is a great basketball player, but maybe you didn't know that he is also a great lawn mower. That's right. LeBron can mow his lawn in two hours. But does it make economic sense for him to do so?”

Ask:

“What is LeBron's opportunity cost of mowing his own lawn?” (LeBron's opportunity cost was whatever else he might have done with his time. Let's assume that LeBron's next best choice was taping a television commercial that would have paid him \$25,000.)

Now add this information:

“LeBron has a 17-year-old neighbor named Scotty who is not yet very skilled. He can mow LeBron's lawn in four hours.”

Ask:

1. What is Scotty's opportunity cost for mowing LeBron's lawn?

*Scotty's opportunity cost is whatever else Scotty might have done with his time. Let's assume Scotty's next best choice was working at McDonald's for \$7.25 an hour. He could have earned \$29 in gross pay working at McDonald's.*

2. Who should mow LeBron's grass?

*While it is clear that LeBron has an absolute advantage over Scotty in lawn mowing and in making commercials, LeBron should make the commercial and hire Scotty to cut his grass. They should engage in voluntary exchange. Why? Lawn mowing has a high opportunity cost for LeBron, a commercial not made, a cost of \$25,000. As long as LeBron pays Scotty more than \$29 for his time, Scotty is also better off if he cuts LeBron's grass. Let's assume that LeBron pays Scott \$8.50 an hour or \$34. Now, working at McDonald's has a higher opportunity cost for Scotty than cutting LeBron's lawn. Scotty should cut LeBron's grass.*

## Part 2: Entrepreneurship and Creative Destruction

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### Clip 4: The Role of Venture Capital in Creating New Products

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**Length: 3:54**

**Concepts Illustrated:**

- Entrepreneurship
- Venture capital
- Risk-taking

**Lesson Objectives:**

1. Describe the characteristics of an entrepreneur.
2. Distinguish between an entrepreneur and an inventor.
3. Describe the role venture capital plays in creating new companies.
4. Analyze the effects of entrepreneurs and venture capitalists on job growth, consumer satisfaction, and economic growth.

**Preview Question:**

Are there great new products to be invented, or have most of the really important discoveries already been made? (Write students' comments on the board, but do not comment on the answers.)

**Description:**

Dayna Goldfine and Dan Geller, directors of the film *Something Ventured*, describe the role venture capital plays in creating new companies and products. They use the example of the video game Pong to illustrate how hard it can be to create a product that people later take for granted. Many companies that are large today were only able to grow from the money obtained from venture capitalists.

**Discussion and Analysis Questions:**

1. What are the differences among inventors, entrepreneurs, and venture capitalists?  
*Inventors discover or produce novel ideas and devices. An invention may be a completely new idea or the production a completely new device or process. Entrepreneurs may be inventors, or they may just apply inventions and processes in new ways. Their goal is achievement-oriented. Venture capitalists provide the funding to develop new ideas and bring these ideas to market.*

2. Why do venture capitalists finance individuals and firms with new ideas?

*Venture capitalists are seeking to earn a profit.*

3. How does the economy benefit from venture capitalists?

*Venture capitalists have financed some of the greatest and most innovative companies in the world such as Apple, FedEx, Intel, and Microsoft. In some cases, initial investments have created new industries such as personal computers and video games.*

4. Describe an economy without entrepreneurs and venture capitalists.

*It would be static. Entire products and industries that we rely on today would not exist. Future innovations that most of us cannot even imagine today would not exist in the future.*

### **Extension Activity:**

In this activity, the students will research famous American entrepreneurs and report on their contributions to the country and the characteristics that were important to their success. Many more people could be added to the list below, but it shows the vastly different contributions of entrepreneurs—ranging from new products, new technologies, innovative markets, and new types of entertainment. In their reports, the students should answer the following questions.

1. Why is this person considered to be an entrepreneur?
2. In what ways did the world change because of this person's contribution?
3. What risks and obstacles did this entrepreneur face before becoming successful?
4. What are some of the mental, behavioral, and psychological characteristics that made this entrepreneur successful?
5. What factors drove this person to be successful?
6. In what ways did consumers, workers, industries, and the economy benefit from this entrepreneur's activities?

List of Some of America's Great Entrepreneurs:

- Benjamin Franklin
- Henry Ford
- John D. Rockefeller
- Oprah Winfrey
- Steve Jobs
- Bill Gates
- Thomas Edison



- W.K. Kellogg
- Milton Hershey
- Sam Walton
- John H. Johnson
- Levi Strauss
- Phil Knight
- Walt Disney
- Steve Case
- Larry Page
- P.T. Barnum
- Ray Kroc
- Andrew Carnegie
- J.P. Morgan
- Mary Kay Ash
- Madam C.J. Walker
- Eli Whitney
- Frederick W. Smith

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## Clip 5: Debating the Role of Greed

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**Length: 8:36**

**Concepts Illustrated:**

- Greed
- Self-interest
- Economic growth
- Private property
- Common property

**Lesson Objectives:**

1. Draw distinctions between greedy behavior and self-interested behavior.
2. Recognize how self-interested behavior can provide positive social outcomes.

**Preview Questions:**

Some people claim that greed is good. What might they mean by that? Is there a difference between people acting in their own self-interest and acting in a greedy or selfish way? (Write the students' answers on the board, but do not comment on the answers.)

**Description:**

Don Boudreaux and Sally Kohn debate the role of greed and self-interest in economic decision-making and the role of government to minimize the effects of greed. Boudreaux contends that property rights and markets will better serve the public interest and minimize greed while Kohn argues that government needs to play a vital role. They use cakes to illustrate their points.

**Discussion and Analysis Questions:**

1. Why did the participants in the fish bowl experiment grab all the dollars in the first two rounds?

*It wasn't clear who owned the dollars. If an individual did not grab what dollars he or she could, someone else would. This illustrates that greedy behavior results when property rights are uncertain or poorly defined.*

2. Why did the later rounds of the experiment go better?

*The participants defined their property rights. They determined how dollars could be distributed to each other and still leave more in the fish bowl to be replaced in later rounds. This illustrates civil behavior in the presence of well-defined property rights.*

3. What are the main arguments posed by Sally Kohn bolstering her confidence in government action?

*Sally Kohn argues that competition is insufficient to restrain markets. Inequalities will result. Government promotes the common good by providing schools and roads—programs not well suited to markets. She believes that Mother Teresa did more social good through her charitable work than did Michael Milken who created high-risk bonds.*

4. What are the main arguments posed by economist Donald Boudreaux?

*Donald Boudreaux believes self-interested behavior in markets will produce socially positive outcomes. He argues that government policies reward the greed of businesspeople seeking special favors from government. He believes that Michael Milken did more social good through his business innovations, which created income for thousands of workers, than did Mother Teresa through her charitable work for the poor.*

### **Extension Activity: A Thought Experiment: The Fight for the Overhead Bins**

Economists often observe that self-interested behavior in markets results in good social outcomes. Markets encourage people to be enterprising and productive. Economists stress that it is the absence of markets that tends to bring out greed and rude behavior, not the presence of markets.

Read the following thought experiment to the class.

"For years, passengers and flight attendants have complained about the uncooperative and rude behavior of airline passengers. Air travelers try to smuggle on board more bags than are permitted or drag on oversized bags. The same travelers who moments earlier kissed their loved ones good-bye battle others for space in the overhead bins. Some passengers with seats in the rear toss their bags into the front compartments to be sure they get a spot. People with oversized bags cram them into the narrow bins, pushing the bags, coats, and hats of passengers with correctly sized luggage into the corners. Why are people who, minutes ago, were kind to loved ones now so rude and aggressive?"

Ask:

1. Why do people wish to bring bags on board the airplane?

*They do not wish to pay the fee for checking their bags. They also do not wish to risk losing their bag or spending time waiting for their bag to appear in the baggage claim carousel.*

2. Why do people grab the first spot available or try so hard to cram their bags into the bins?

*The overhead bins are a commons. Nobody "owns" the space in the overhead bins as they would if a market with defined property rights was in operation. People can't trust*

*strangers to act with cooperation or courtesy. Like the fish bowl example in the clip, if one person does not grab the space, someone else will.*

Explain:

Could things be different? Yes. Creating an overhead bins market would bring out the best of people. Here's how. Most of today's airplanes charge people extra to check a bag and offer the overhead bins for "free." It should be just the reverse. People should be charged a rental fee for the overhead compartment above their seat and be allowed to check their bags at no cost. Charging rental fees would create an overhead bins market by defining and enforcing individual ownership rights. Business travelers, people in a hurry to see clients and not wishing to spend time waiting for bags, would be willing to pay the extra amount and would feel more secure knowing that their bin space would be waiting for them when they arrived onto the aircraft. No need to push or shove. Tourist travelers would happily check their bags knowing that they are saving money. They would have an incentive to bring on board only what they need for the flight, say, a book or a laptop computer. Cooperation and courtesy would be the order of the day.

It was not the presence of markets but rather the absence of markets that contributed substantially to the human suffering of the last century. Gerald Scully (1997), for example, studied the human cost in the last century resulting from widespread experimentation with socialism and communism. Scully reports that communist states killed millions of their own people in the twentieth century, far more than were killed by the Nazis.

- The Soviet Union killed 54.7 million between 1917 and 1987.
- China killed 35.6 million between 1949 and 1987.
- The Khmer Rouge killed 3 million between 1975 and 1979 (one-third of the population of Cambodia).

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## Clip 6: Creative Destruction in Media

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**Length: 4:57**

**Concepts Illustrated:**

- Creative destruction
- Entrepreneurship
- New business methods

**Lesson Objectives:**

1. Recognize that creative destruction refers to the idea that market economies are constantly churning. Entrepreneurs create new jobs and industries even as old jobs and old industries are being eliminated.
2. Predict how changes in the Internet may change viewing of traditional television programming.

**Preview Question:**

Are your television-viewing habits changing as a result of the Internet? In what ways? (Write the students' answers on the board, but do not comment on the answers.)

**Description:**

Glenn Beck discusses his new Internet service GBTV and uses the example of how the "Internet eats TV" to describe the process of creative destruction. Combined with new Internet technology, cameras and studio equipment are less expensive and better today, allowing online programming to replace traditional television.

**Discussion and Analysis Questions:**

1. What is "creative destruction"?

*Creative destruction refers to the idea that market economies change and adapt to changing technology. Entrepreneurs create new jobs and industries even as old jobs and industries are being eliminated.*

2. What are some examples of creative destruction in action?

*Kodak Company held a dominant position in photographic film but lost out due to its failure to adapt to digital technology. Similar developments took place in the music industry and the communications industry. It appears that the Internet is now changing how people view television programming.*

3. The Industrial Revolution fundamentally changed the American way of life. The average standard of living more than doubled between 1870 and 1910. Business itself changed as new forms of business organization emerged. New jobs were created as others were destroyed. Is it possible that the changes of the Internet Revolution will be as big as the changes in the Industrial Revolution?

*Accept a variety of responses. A case could be made to support such a claim. The Internet made possible the creation of previously unknown sorts of companies including Amazon, Google, and Facebook, to name just three. New millionaires appeared overnight. Information technology is making the economy more productive. The Internet reached widespread adoption in the mid-1990s. The information age has only recently begun.*

### **Extension Activity: Creative Destruction in Transportation**

The American economy has experienced several waves of creative destruction. The purpose of this exercise is to illustrate creative destruction as it applies to changing modes of transportation in the past.

1. Explain that the economist Joseph Schumpeter (1883-1950) coined the term “creative destruction” to describe a key feature of market economies. “Creative destruction” refers to the idea that market economies are endlessly churning. New jobs and industries are being created even as old jobs and industries are being eliminated. On the one hand, creative destruction causes real problems—people lose jobs and whole industries vanish. On the other hand, businesses become more productive, consumers receive new goods and services, work weeks become shorter, and better jobs are produced. All of this results in higher living standards.
2. Ask: “What are some examples of new goods and services that have been developed in recent years that have changed your lives?”

*Accept a variety of responses. Some examples might include smart phones, electronic books, iPads, iPods, wireless reading devices like the Kindle and the Nook, social media of all sorts, HD television, and widespread use of GPS systems.*

3. Explain that each of these new products also changed the industries involved. On the one hand, new jobs were created for software designers and manufacturers of these new devices. On the other hand, old jobs were destroyed. For example, as more and more electronic books are being downloaded to wireless reading devices like the Kindle and the Nook, the book industry is changing. Less demand for printed books will result in fewer jobs in logging, printing, book manufacturing, and book sales. This is the creative destruction process at work.
4. Explain that transportation presents another example of creative destruction. At many points in our history, a new form of transportation overwhelmed an older form.

5. Divide the class into small groups. Give each group the Creative Destruction in Transportation table on the next page. (At the end of this section, you'll find a version filled in with some sample answers.) Ask the students to write in as many examples as they can think of regarding the types of new jobs created and old jobs destroyed as a result of creative destruction in transportation. The automobile and horse and buggy example is partially completed.

**Creative Destruction in Transportation**

New Mode of Transportation	New Jobs Created	Old Mode of Transportation	Old Jobs Destroyed
Automobile	Assembly line workers	Horse and buggy	Blacksmiths
	Car designers		Stable workers
Airplane for long-distance personal travel		Railroads and ocean liners for long-distance personal travel	



6. Place the Creative Destruction in Transportation table on the board or another display device in the front of the room. Ask the students in whole group discussion to share their observations from their small group discussions and complete the table.
7. Conclude by explaining that what occurred in transportation has been repeated in one industry after another throughout American history. Students might wonder, “Why do new jobs always get created?” The Internet is a good example of a new technology that created millions of jobs for computer manufacturers, computer designers, computer repair people, software designers, web page designers, and email system designers. Jobs were created that simply did not previously exist.

### Creative Destruction in Transportation (with sample answers)

New Mode of Transportation	New Jobs Created	Old Mode of Transportation	Old Jobs Destroyed
Automobile	Assembly line workers	Horse and buggy	Blacksmiths
	Car designers		Stable workers
	<i>Mechanics</i>		<i>People hired to drive buggies and carriages (teamsters)</i>
	<i>Road builders</i>		<i>Harness makers</i>
	<i>Car sales people</i>		<i>Horse trainers</i>
	<i>Gas station operators</i>		<i>Breeders of pull horses</i>
	<i>Other</i>		<i>Other</i>
	<i>Other</i>		<i>Other</i>
Airplane for long-distance personal travel	<i>Airline pilots</i>	Railroads and ocean liners for long-distance personal travel	<i>Railroad engineers</i>
	<i>Flight attendants</i>		<i>Porters</i>
	<i>Airplane assembly workers</i>		<i>Railroad construction workers</i>
	<i>Airplane mechanics</i>		<i>Railroad mechanics</i>
	<i>Air traffic controllers</i>		<i>Ship builders</i>
	<i>Airport workers: security people, baggage handlers, gate workers, and so forth</i>		<i>Ship hands</i>
	<i>Other</i>		<i>Other</i>
	<i>Other</i>		<i>Other</i>

## Part 3: Interfering with Markets

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### Clip 7: Price Gouging Isn't So Bad

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**Length: 4:28**

**Concepts Illustrated:**

- Supply and demand
- Price controls
- Rationing

**Lesson Objectives:**

1. Explain why price ceilings (anti-price-gouging laws) cause shortages and long lines to buy goods and services.
2. Explain how changes in market prices allocate goods and services to people who put the goods and services to the highest valued uses.
3. Analyze how an increase in a market price motivates businesses to supply more of that good or service and consumers to buy less of it.

**Preview Question:**

Is it immoral to raise prices of essential goods and services during a natural disaster? (Write the students' answers on the board, but do not comment on the answers.)

**Description:**

Thirty-one states enforce “price gouging” laws, which restrict the amount sellers can increase prices after a natural disaster. Art Carden suggests these laws interfere with market signals, distort resource allocation, and actually harm the people they are supposed to help. By artificially holding prices down, the incentives to produce and bring those items to the people who need them are also lowered.

**Discussion and Analysis Questions:**

1. How do price increases ration goods and services and allocate resources?

*Initially, prices increase ration existing goods and services by creating incentives to use substitute products. People who want a good or service more and place a higher value on it will get it first. People with less need will not buy it. There is also an incentive to conserve the good or service. Some poorer people will not be in the market, because they cannot afford the good or service. However, the higher price sends a signal to producers to increase production, so more of the good or service will be available in the future. Because higher*

*prices lead to higher profits, goods and services (such as ice, electric generators, and flashlights) in other parts of the country will be shipped to the disaster area, where people want them more.*

2. When Superstorm Sandy hit New Jersey, Governor Chris Christie said, “During emergencies, New Jerseyans should look after each other, not seek to take advantage of each other.” If a business doubles the price of flashlights, is it helping fellow New Jerseyans or taking advantage of them?

*Free-market economists argue that raising prices would limit the use of scarce items and provide incentives for suppliers, many in distant places, to provide the goods and services needed in the storm’s aftermath. A price is not “just” or “unjust”; it simply indicates the values suppliers and demanders have put on the goods and services they exchange. Some commentators oppose price increases because they believe greed is a vice and at odds with the civic virtue of shared sacrifice. This is not an economic argument.*

3. Do laws against price gouging help the poor?

*At first, it may seem like poorer people are helped when they try to get food, water, ice, and gas. However, the low prices also make it easier for richer people to buy these items. If prices rise, people will conserve and buy less. This means more is available for other people. Even if one store runs out of an item such as flashlights, other stores are more likely to have it. And at a higher price, items such as water, ice, and gas will be shipped into the disaster area. Increases in supply will reduce future prices.*

4. If economics shows that price ceilings cause shortages, why do so many states have anti-price-gouging laws that take effect if there is a natural disaster?

*Some people believe that the best policy is the one that most improves people’s lives. It is the outcome that matters. These people would not favor price controls during a disaster. Price increases save lives. For others, raising prices at a time of disaster violates their sense of fairness and prevents people from working together. Market-oriented policies usually value freedom and choice more. Command policies emphasize “virtue, justice, and the common good.” Nevertheless, it is hard to argue that policies that help more people are not virtuous or just.*

### **Extension Activity: A Disaster Role-Play**

In this activity the students will compare and contrast the actions of businesses and consumers following a disaster in a state that has an anti-price-gouging law and a state that does not.

1. Explain the scenario. A hurricane has hit two neighboring states hard. State A has a law that prohibits sellers from raising prices of any product more than 10 percent during the recovery period. This state’s governor has vowed to enforce this law rigorously and declared that the citizens of the state “don’t need vendors to take advantage of people’s misery.” Breaking the law can result in large fines or even jail time. The governor of State B, which does not have an anti-price-gouging law, says people are free to take any

legal action, but asks the people to come together to revive the economy of the state and help people in need.

2. Set up five groups, and have each group discuss how they will respond to the disaster. These are the five groups:

- State A, Local Businesses
- State A, Local Consumers
- State B, Local Businesses
- State B, Local Consumers
- Out-of-State Businesses

3. Here are some points for the groups to consider:

#### **Local Businesses**

- Will you raise prices of essential items? If you do, how will you decide how much to raise them?
- If you do not raise prices, how will you determine who gets the goods and services?
- How quickly will you order new items when you run out of something?
- Will you keep your store open even if costs of cleaning, electrical generation, and water increase?

#### **Consumers**

- How do you expect to get the items you need? What strategy will you use?
- Will you try to stock up on essential items even if you don't need them right now?
- If you already had enough essential items such as ice and flashlights, would you keep all of them, try to sell some of them, or give some of them away?

#### **Out-of-State Businesses**

- Will you incur increased shipping costs to send certain products to the disaster area?
- If so, will you send them to State A or State B?

4. Ask each group what they would do and why.

5. Ask the class as a whole the following questions:

1. Which state will recover more quickly? Why?

*Economic thinking suggests that State B will recover more quickly. The incentive of higher prices will attract more providers of goods and services needed by people hurt by the destruction.*

2. Which state's policy is fairer to the poor? Why?

*Some students may suggest that fairness calls for equal sacrifice. Economic thinking suggests that higher prices will attract producers to provide more goods and services, which soon will increase supplies and bring prices down. At the same time, store shelves will tend to stay full. There will be less panic and hoarding. Only people who really desire the goods and services needed in an emergency will buy them. Thus, even people of low income are likely to have access to the goods and services they require more quickly than they would under a system that prevents prices from legally rising quickly.*

3. Will there be any difference in the amount of charitable activity in the two states? Why?

*Charities might think people in state A require less help. After all, they might think prices are being kept low with the intention of preventing shortages. Charities might be more willing to act for people in state B, knowing the government is not trying to interfere with prices.*

4. Do you favor or not favor anti-price-gouging laws? Why?

*Accept a variety of answers. Some students may still insist that high prices are unfair. Everyone should suffer equally. Others might be able to recognize how high prices provide the correct incentives to both producers and consumers.*

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## Clip 8: Efficiency of Private Sector Versus Government

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**Length: 6:04**

**Concepts Illustrated:**

- Incentives
- Efficiency
- Government spending

**Lesson Objectives:**

1. Describe the *Yellow Pages* test.
2. Analyze why individual businesses produce goods and services more efficiently than governments do.
3. Analyze why the Trabant was one of the worst automobiles ever built.
4. Explain why the Indiana Toll Road was operated more efficiently by a foreign private firm than by the Indiana state government.

**Preview Question:**

True, false, or uncertain and why? Governments should produce the goods and services that are most necessary for improving people's lives (e.g., health care, education, transportation, and food). (Write the students' answers on the board, but do not comment on the answers.)

**Description:**

Goods and services produced by government agencies cost more and aren't as good as those same goods and services offered by private sector businesses. Former Indiana governor Mitch Daniels uses the example of a toll road to illustrate the differences in incentives and outcomes to compare government to private production.

**Discussion and Analysis Questions:**

1. What is the *Yellow Pages* test?

*If a good or service is listed for sale in the Yellow Pages, it should not be provided by government, because the privately sold good or service will be of higher quality and made more efficiently.*

2. Are politicians and government officials less greedy than private businesses?

*No. Private businesses try to maximize profits, while politicians and government officials try to maximize power.*

3. What happened when the state of Indiana leased its toll road to a foreign private firm to operate?

*Indiana received billions of dollars for the lease and built and repaired other roads. The firm also improved the toll road and its services. This attracted more vehicles and made higher profits for the firm.*

4. Why do private firms produce goods and services more efficiently than governments do?

*To survive, private firms must earn profits. They risk their capital, ideas, and organizational skills to earn a possible profit on a good or service. Consumers want to buy goods and services. Competition means businesses must continue to innovate and be price competitive to survive. Government substitutes politics for market verdicts. Political calculus is different from market calculus. Businesses have incentives to keep costs low. Government has incentives to increase power and its own size and to please special interests and constituents. Investors risk their own money, while government spends other people's money, obtained by taxation. When political enterprises fail, the politicians and government officials rarely suffer. Finally, market prices reflect widely dispersed information and send signals to businesses and consumers. This coordinates actions in a dynamically changing economy.*

### **Extension Activity: A Government Car Story**

This activity is a story about the Trabant, a notoriously poorly built automobile produced by the East German government. Have the students read the case study and answer the questions at the end. Then discuss the students' answers and apply them to comparing the efficiency of markets and government.

Distribute the handout below to the class and then discuss the questions at the end.

1. Why didn't the East Germans build a better car?

*The main client of the Trabant manufacturers was the state, not the consumer. The goal of the Trabant producers was to meet government quotas and follow government rules. Consumer satisfaction was a matter of little or no concern.*

2. Why didn't the East German government try harder to please its citizens?

*The East German government was a brutal police state with little desire to please its citizens. Under such repression, few citizens even dared to complain. Few people openly expressed their displeasure regarding the Trabant or much of anything else. The costs of such actions were high, including imprisonment or worse.*

3. What does this story tell us about the relative efficiency of government decisions compared to market-oriented decisions?

*Government dominated production ignores the interests of consumers. It substitutes government power—rules and requirements—for consumer choice. Market-oriented decisions focus on pleasing customers. A car manufacturer in a free market can only sell cars by pleasing customers. That is the only way a manufacturer has any hope of earning a profit.*



### **Handout: A Government Car Story**

The Trabant was a car produced by the Communist East German government from 1957 to 1991. It was the most common vehicle in East Germany and was also exported to other nations in the Soviet bloc. More than 3,000,000 Trabants were produced.

The Trabant was quite a piece of work. Powered by a two-stroke, 18-horsepower engine, its speed maxed out at 18 miles per hour. Its fuel was a mixture of gasoline and oil, which produced a smoky and polluting exhaust. It lacked a fuel pump, brake lights, and turn signals. Its body was made of recycled worthlessness. Production was so slow that people waited years to receive the cars they ordered. East Germans had hundreds of Trabant jokes such as “What’s the best feature of the Trabant? There’s a heater in the back to keep your hands warm when pushing it.”

As soon as the Berlin Wall fell, thousands of East Germans drove their Trabants to the West and abandoned them. This made the destruction of the wall a kind of automobile liberator.

### **Questions for Discussion**

1. Why didn’t the East Germans build a better car?
2. Why didn’t the East German government try harder to please its citizens?
3. What does this story tell us about the relative efficiency of government decisions compared to market-oriented decisions?

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## Clip 9: Natural Disasters, Government Stimulus, and Economic Growth

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**Length: 3:13**

**Concepts Illustrated:**

- Broken window fallacy
- Opportunity cost
- Primary effects
- Secondary effects
- Stimulus spending

**Lesson Objectives:**

1. Recognize the opportunity costs associated with natural disasters.
2. Predict the primary and secondary effects of specific policies and regulations.

**Preview Question:**

Some people claim that natural disasters like Hurricane Sandy, which damaged large parts of the East Coast in 2012, may have an unexpected silver lining. What positive outcomes could come from all that destruction? (Write the students' answers on the board, but do not comment on the answers.)

**Description:**

Some people claim that natural disasters such as hurricanes "are not harmful to the economy because there's so much extra work involved in reconstruction." John dispels that myth by interviewing Sallie James and David Henderson, who point out that the money spent on reconstruction could have been spent on producing a new item instead of replacing an existing item. The same principle applies to government stimulus spending. While government spending does create new items, the taxes used to produce those items could have been directed at other activities to create wealth. With either reconstruction or government stimulus, the spending only redistributes jobs and production; it doesn't create them.

**Discussion and Analysis Questions:**

1. Why does it appear that the repairs following natural disasters are good for the economy?  
*The spending on repairs is obvious. It is easy to observe all the economic activity that will take place to recover from the damage of a hurricane or other disaster.*

2. Is it economically correct to claim that repairs from natural disasters are good for the economy? Why?

*No. The resources that are used for recovery from a disaster have alternative uses. They could have been used to improve schools, roads, or for other purposes. These resources are shifted from one use to another.*

3. The federal government provided funds that helped General Motors and Chrysler survive the financial crisis. What would have been the alternative to government spending to help these corporations?

*The resources used to help General Motors and Chrysler had alternative uses. The resources could have been used to help achieve other objectives such as increasing national defense, assisting the poor, or reducing the deficit. Allowing these businesses to go through normal bankruptcy procedures would have meant that the companies themselves would have emerged financially stronger and that the federal government would still have funds for uses other than helping out car companies.*

4. Do you think it is sound economy policy for government to favor the manufacturing sector over the service sector?

*It is not widely understood that the United States is manufacturing more than ever before. Manufacturing remains healthy in terms of production. This is a sector that does not appear to be in need of special favors from government. The economy itself has changed. Today, the United States is characterized by having more jobs in the service sector, and service sector jobs often pay well.*

### **Extension Activity: The Broken Window Fallacy**

Frédéric Bastiat was a French economist who wrote the parable of the broken window in 1850. It led to what is called the “broken window fallacy.” In modern economic terms, this parable is an illustration of the concepts of opportunity cost, primary effects, and secondary effects. Review with your students the meaning of each concept:

- Opportunity cost: The value of the next-best alternative; or what someone gives up by choosing one alternative over another.
- Primary effects: The immediate and visual effects of an action.
- Secondary effects: The unexpected or indirect effects of an action that become known over the passage of time

Distribute the handout on page 37. Remind the students of the essay’s 1850 origins. The author’s prose differs from today’s prose. Allow the students a few minutes to read the essay and then discuss the questions which follow. Ask:

1. The essay states that “everybody must live, and what would become of the glaziers if panes of glass were never broken?” Is this an example of a primary effect or a secondary effect?

*This is an example of a primary effect. The money used to repair the window is income to the glazier. As a result, the glazier is better off.*

2. The essay states that “it is not seen that as our shopkeeper has spent six francs on one thing, he cannot spend them on another.” Is this an example of a primary effect or a secondary effect?

*This is an example of a secondary effect. The money used to repair the window had different uses. It could have been used to buy shoes or a book. The shopkeeper could have had both a window and a new pair of shoes.*

3. What is the opportunity cost of the broken window?

*The money used to repair the window had different uses. The opportunity cost would be the alternative use preferred by the shopkeeper such as a new pair of shoes or a book.*

Remind the class of the damage done by Hurricane Sandy and pose a similar set of new questions. Ask:

1. A reporter in the clip stated that “sometimes these things [Hurricane Sandy] are not harmful to the economy because there is so much extra work involved in rebuilding, reconstruction, and rehabilitation.” Is this an example of a primary effect or a secondary effect?

*This is an example of a primary effect. The resources used for rebuilding and reconstruction provide immediate income to those doing the work and those who supply them with the materials.*

2. Sallie James states that “when you replace things, it looks like it might add to the economy, but the resources used to repair things might otherwise have been used for more creative, more constructive reasons.” Is this an example of a primary effect or a secondary effect?

*This is an example of a secondary effect. The resources used to pay for the recovery from Hurricane Sandy had alternative uses. If the hurricane had not hit, the business and home owners who suffered would still have their homes and businesses, and they could use the resources used in reconstruction for other valuable purposes.*

3. What was the opportunity cost of Hurricane Sandy?

*The resources used to rebuild from Hurricane Sandy had different uses. The opportunity cost would be the alternative use of the resources preferred by those people who were hurt and by the taxpayers and the volunteers who helped them out.*

## Handout: The Broken Window

By Frédéric Bastiat

Have you ever witnessed the anger of the good shopkeeper, James B., when his careless son happened to break a square of glass? If you have been present at such a scene, you will most assuredly bear witness to the fact, that every one of the spectators, were there even thirty of them, by common consent apparently, offered the unfortunate owner this invariable consolation—"It is an ill wind that blows nobody good. Everybody must live, and what would become of the glaziers if panes of glass were never broken?"

Now, this form of condolence contains an entire theory, which it will be well to show up in this simple case, seeing that it is precisely the same as that which, unhappily, regulates the greater part of our economical institutions.

Suppose it cost six francs to repair the damage, and you say that the accident brings six francs to the glazier's trade—that it encourages that trade to the amount of six francs—I grant it; I have not a word to say against it; you reason justly. The glazier comes, performs his task, receives his six francs, rubs his hands, and, in his heart, blesses the careless child. All this is that which is seen.

But if, on the other hand, you come to the conclusion, as is too often the case, that it is a good thing to break windows, that it causes money to circulate, and that the encouragement of industry in general will be the result of it, you will oblige me to call out, "Stop there! your theory is confined to that which is seen; it takes no account of that which is not seen."

It is not seen that as our shopkeeper has spent six francs upon one thing, he cannot spend them upon another. It is not seen that if he had not had a window to replace, he would, perhaps, have replaced his old shoes, or added another book to his library. In short, he would have employed his six francs in some way, which this accident has prevented.

Let us take a view of industry in general, as affected by this circumstance. The window being broken, the glazier's trade is encouraged to the amount of six francs; this is that which is seen. If the window had not been broken, the shoemaker's trade (or some other) would have been encouraged to the amount of six francs; this is that which is not seen.

And if that which is not seen is taken into consideration, because it is a negative fact, as well as that which is seen, because it is a positive fact, it will be understood that neither industry in general, nor the sum total of national labour, is affected, whether windows are broken or not.

Now let us consider James B. himself. In the former supposition, that of the window being broken, he spends six francs, and has neither more nor less than he had before, the enjoyment of a window.

In the second, where we suppose the window not to have been broken, he would have spent six francs on shoes, and would have had at the same time the enjoyment of a pair of shoes and of a window.

Now, as James B. forms a part of society, we must come to the conclusion, that, taking it altogether, and making an estimate of its enjoyments and its labours, it has lost the value of the broken window.

### **Questions for Discussion**

1. The essay states that “everybody must live, and what would become of the glaziers if panes of glass were never broken?” Is this an example of a primary effect or a secondary effect?
2. The essay states that “it is not seen that as our shopkeeper has spent six francs on one thing, he cannot spend them on another.” Is this an example of a primary effect or a secondary effect?
3. What is the opportunity cost of the broken window?

## Part 4: Costs of Regulation and Fraud

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### Clip 10: Shortcomings of Financial Regulation

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**Length: 5:31**

**Concepts Illustrated:**

- Externalities
- Financial markets
- Government failure
- Regulation
- Primary effects
- Secondary effects

**Lesson Objectives:**

1. Identify externalities as examples of costs or benefits imposed on non-payers.
2. Predict the primary and secondary effects of specific policies and regulations.

**Preview Question:**

What might be some of the costs of government regulation? Benefits? (Write the students' answers on the board, but do not comment on the answers.)

**Description:**

Cliff Asness from AQR Capital Management argues that many regulations don't actually achieve the objectives they're supposed to meet. He specifically addresses the Dodd-Frank financial regulations that were passed after the financial crisis of 2008-09.

**Discussion and Analysis Questions:**

1. When should government regulate economic activity? (Hint: It may have to do with what Cliff Asness calls negative externalities.)

*A regulatory role for government may be justified in the case of a negative externality. Externalities are costs or benefits imposed on others without their consent. Air pollution is frequently identified as a negative externality. A company that emits pollution into the air is able to sell its product at a price that does not take account of the damage the emissions do to the environment. Since the price does not reflect the full cost of production, there may be a role for government to tax or regulate the company.*

2. Cliff Asness suggests that some politicians see negative externalities everywhere and many set out to fix them. What does he mean by that? Why is the meaning important?

*People often impose minor negative externalities on others. Your neighbor might cut the grass too early in the morning. A crying child might reduce your enjoyment of a movie. Cliff is suggesting that politicians search for negative externalities and then call for new government rules to somehow address the problem. His point is that many of these minor negative externalities do not rise to the level of requiring some sort of government action. Importantly, many of these “corrective” actions will not achieve the intended result.*

3. What incentives might motivate politicians to seek to increase regulations?

*Cliff Asness suggests that some politicians seek fame. Others might sincerely think that a new regulation might correct a given problem. Students might add that some politicians enjoy the additional power and influence that comes when government imposes or even threatens to impose new rules.*

4. What is the problem with excessive regulation?

*Excessive or unnecessary regulations are inefficient. The costs imposed by such rules are greater than the benefits.*

### **Extension Activity: A Thought Experiment: How Well Does Government Really Protect Endangered Species?**

Explain to the class that government policy fails when the costs of a specific regulation outweigh the benefits. The problem is that the costs of a new government regulation are not always immediately obvious. The primary effect of a regulation may be an immediate change in the behavior of producers in the targeted industry. However, secondary effects, the unexpected or indirect effects of an action, may be negative but will not become known until some time has passed. The following is an example of government regulation having to do with endangered species.

Present the following “thought experiment” to the students.

“In order to protect endangered species, the government enacted the Endangered Species Act (ESA) in 1973. The law allows government officials to deny landowners the use of their property if an endangered species is found to be present. The ESA makes it illegal to ‘harass, harm, pursue, shunt, shoot, wound, kill, trap, capture, or collect’ or to attempt any of these activities in regard to a plant or animal listed on the Endangered Species List.”

Ask:

“What is the primary effect of the Endangered Species Act?”

*The primary effect is to stop landowners from harming in any way critters or plants on the Endangered Species List.*



“Now, imagine the following. You own 40 acres of land in northern Wisconsin with valuable hardwood trees that are 30 years old. You have been planning to wait another five years to harvest the timber and use it to help pay for your daughter’s college tuition.

“Your trees are the perfect habitat for an endangered species called the silver-nosed squirrel. The squirrel roams widely. It needs about ten acres on which to survive.

“Now, your neighbor tells you that silver-nosed squirrels have been spotted on a wood lot ten miles from your land.”

Ask:

1. What might you do with your timber?

*You might be tempted to harvest your timber right away and set the money aside for the college tuition rather than risk losing your ability to harvest the timber due to the presence of the silver-nosed squirrel.*

2. What is a secondary effect of the ESA regulations in the case of the silver-nosed squirrel?

*Fearing you might be “caught” with an endangered species on your land, the ESA gives you an incentive to destroy the habitat before it becomes available to them. This is exactly the opposite of what the ESA meant to accomplish.*

3. Can you think of other regulations that might have secondary effects that would wipe out any of the hoped-for benefits?

*Accept a variety of responses. Some students might mention that children’s lemonade stands are being shut down in some cities due to government regulations. Schools face new food-safety rules regarding bake sales intended to raise money for school field trips. In Santa Monica, California, it is illegal to smoke in your own home. Monks in Louisiana who produce handmade wooden caskets must become fully licensed as funeral directors and convert their monasteries into licensed funeral homes before they will be allowed to sell their caskets. President Obama could not teach high school civics in most states, because he does not have a teaching license. He would need to complete several college education courses and do student teaching before he would be legally eligible.*

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## Clip 11: Causes and Consequences of Taxi Licenses

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**Length: 2:15**

**Concepts Illustrated:**

- Licensing
- Unintended consequences
- Political incentives

**Lesson Objectives:**

1. Recognize how government regulations can reduce competition and harm consumers.
2. Identify new examples of excessive government regulations that hurt people of low income and minorities.

**Preview Question:**

In New York City, few taxicabs are owned by African Americans, while in Washington, D.C., most taxicabs are owned by African Americans. Why do you think that is the case? (Write the students' comments on the board, but do not comment on the answers.)

**Description:**

John talks with Walter Williams about the reasons why cities impose taxi licenses and the effects they have on taxi ownership by African Americans. Instead of an example of unintended consequences, Williams argues that the consequences are intended by the politicians who create the license requirements. The cost to own a taxicab is much higher, which keeps out potential new owners.

**Discussion and Analysis Questions:**

1. Why might local governments wish to regulate taxicabs?

*They might wish to make sure that taxicab drivers have clean taxicabs and charge market rates for their services.*

2. What might be an unintended consequence of taxicab regulations?

*Additional regulations drive up the price of buying a taxicab license. As a result, many low-income people who in a low-regulatory environment might be willing to own and drive taxicabs are priced out the market.*

3. Who benefits from excessive licensing?

*Individuals who already own taxicab licenses are better off. They use the government regulations as a device to reduce competition and raise prices.*

**Extension Activity: How State and Local Governments Use Regulations to Reduce Competition**

Explain that the Institute for Justice is a civil liberties law firm. One of its goals is to litigate cases that it believes deny basic economic liberties. Invite students to check it out at <http://www.ij.org/>.

The Institute for Justice has filed numerous lawsuits against state and local governments, which it believes are using the regulatory power of government to protect existing producers from competition, prevent new producers from entering markets, and ultimately harm consumers.

Ask the students to read the handout below, and discuss the questions which follow. Ask:

1. What do each of these cases have in common?

*All three cases—hair braiding, eyebrow threading, and the Milwaukee cap on taxicabs—involve government imposing what appears to be excessive regulations to prevent people from entering an industry or starting a business.*

2. What claims would regulators likely make to defend their actions?

*Almost certainly, the regulators will claim that they are simply enforcing existing regulations intended to protect consumers.*

3. Do you think the regulators are acting in the interest of consumers or in the interest of existing producers?

*Accept a variety of responses. Some students might argue that regulators are simply following the rules. Others might say that the excessive nature of the rules and their application in these cases is an unintended consequence of government rules. Still others might suggest that there might be some sort of an unwritten agreement between existing businesses, their regulators, and elected officials to protect existing providers from increased competition by freezing out new producers.*

## **Handout: How Regulations Hurt Entrepreneurs**

### **Case 1: The State of Utah Takes on African Hair Braiders**

Jestina Clayton is a college graduate, wife, mother of two, and refugee from Sierra Leone's civil war. She wants to use her skills as a hair braider to earn income for her family. But the State of Utah says she may not be paid to braid hair unless she first spends thousands of dollars on 2,000 hours of government-mandated cosmetology training—not one hour of which actually teaches her how to braid hair. She argues that these government rules are excessive. She joined with the Institute for Justice to file a lawsuit against the State of Utah. The Institute for Justice argues that these licensing rules protect existing providers of hair services from competition and do nothing to help consumers.

### **Case 2: The State of Texas Takes on Eyebrow Threaders**

Eyebrow threading is a booming business in Texas, but state regulators make it very difficult to enter the business. Threading is booming because it's cheaper, faster, and less painful than waxing. Plus, it doesn't involve any chemicals, dyes, or sharp objects. In addition to pleasing consumers, the industry is creating good-paying jobs for numerous Texas entrepreneurs.

The Texas Department of Licensing and Regulation (TDLR) demands that eyebrow threaders obtain expensive cosmetology licenses. The TDLR expects threaders with up to 20 years of experience to immediately stop working and spend approximately \$20,000 obtaining up to 1,500 hours of instruction in government-approved beauty schools that do not even teach threading. Further, threaders must pass government-approved cosmetology exams that do not test for threading. Inspectors have already begun imposing \$2,000 fines on threaders who do not immediately comply.

The Institute for Justice argues that these licensing rules protect existing providers of cosmetology services from competition and do nothing to help consumers. It has filed a lawsuit on behalf of eight Texas threading entrepreneurs.

### **Case 3: Want to Own A Taxicab in Milwaukee? Not So Fast!**

The City of Milwaukee, Wisconsin, allows only 321 taxicabs on its streets. Almost half are owned by a single owner. That is about one cab for every 1,850 residents, one of the highest people-to-taxicab ratios in the country. If willing entrepreneurs want to start their own taxicab business, they have to find a holder of one of the 321 permits and, if the holder is willing to sell, buy a permit.

A permit today costs about \$150,000. That high price puts the idea of owning a taxicab business out of most people's reach. Ghaleb Ibrahim is a Milwaukee entrepreneur who wants to own and drive his own taxicab. He has the means to operate safe and insured taxis, but the cap on the number of cabs prevents him from doing so. Ghaleb contends that Milwaukee's cap on the number of taxicabs violates his right to earn a living, which is protected by Wisconsin's Constitution. He and two fellow drivers teamed up with the Institute for Justice to file a civil rights lawsuit against the City.

### **Questions for Discussion**

1. What do each of these cases have in common?
2. What claims would regulators likely make to defend their actions?
3. Do you think the regulators are acting in the interest of consumers or in the interest of existing producers?

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## Clip 12: The Actual Effects of the Minimum Wage

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**Length: 4:30**

**Concepts Illustrated:**

- Minimum wage
- Discrimination
- Welfare

**Lesson Objectives:**

1. Explain why the minimum wage is a price floor and why price floors cause surpluses.
2. Discuss the purpose of a minimum wage.
3. Analyze the primary (intended) and secondary (unintended) consequences of a minimum wage on employment, consumer behavior, and poverty.
4. Analyze why the minimum wage is responsible for disparities in income and employment among racial groups.

**Preview Question:**

Do all Americans deserve a living minimum wage so they cannot be exploited by business?  
(Write the students' comments on the board, but do not comment on the answers.)

**Description:**

Walter Williams explains why the welfare state in general and the minimum wage in particular are largely responsible for income and unemployment disparities among racial groups. The intentions behind the minimum wage are good, but the actual effects have been devastating for some groups.

**Discussion and Analysis Questions:**

1. Why hasn't the minimum wage eliminated poverty?

*A minimum wage higher than the market wage has many unintended consequences. Higher labor costs increase prices, which means consumers will buy less of the product. Businesses offset the increased costs by laying off the least productive workers, cutting employee benefits, cutting the hours employees work, and substituting capital (machinery, computers, etc.) for labor. The least skilled workers are laid off first and lose the opportunity to learn skills that would make them more productive.*

2. Why is the unemployment rate of Black teenagers almost twice as high as the unemployment rate of White teenagers?

*Because of a poorer educational system and a higher dropout rate, Black teenagers have fewer skills than White teenagers. Although they could be employed at a lower wage, they are not employed at higher minimum wages. Before minimum-wage laws were in effect, Black and White teens were employed at about the same rate.*

3. The minimum wage is a price floor. The price of labor (wages) is fixed by government above the market price. What are the effects of a price floor?

*The higher wage attracts more people who want to work (demand for jobs). However, employers hire fewer workers at the higher price (supply of jobs). Therefore, there is a surplus of workers, that is, greater unemployment.*

4. If minimum-wage laws cause unemployment, why are they supported by 82 percent of the public?

*People agree with the good intentions of minimum-wage laws. They like the idea of raising the standard of living of poor people. Unfortunately, the unseen and unintended consequences actually lower poor people's standard of living. Most people are not knowledgeable in economics and don't know this.*

### **Extension Activity: To Sign or Not to Sign? That Is the Question.**

In this activity, each student must write an essay supporting his or her decision to veto or not veto an actual minimum-wage bill passed by the Washington, D.C., City Council. A class discussion follows where the students can explain their points-of-view.

1. Explain the scenario to the class. Each student is to assume he or she is Mayor of Washington, D.C., and must decide whether to veto a minimum wage bill passed by the City Council. Each student must write an essay explaining his or her decision and then participate in a class discussion.
2. Give a copy of the handout on the next page to each student, and allow him or her time to write their essays.
3. Discuss the decisions with the class. Be sure to clarify the economics of the arguments favoring and opposing the bill.
4. After the discussion, tell the students that Mayor Vincent Gray vetoed the bill. He called it a "job killer" that "would do nothing but hinder our ability to create jobs, drive away retailers, and set us back on the path to prosperity for all."

## **Handout: To Sign or Not to Sign? That Is the Question.**

Assume that you are Vincent Gray, the mayor of Washington, D.C. The City Council has passed a bill requiring big-box stores to pay their employees 50 percent more than Washington's existing minimum-wage law. Currently, the minimum wage is \$8.25 per hour, and under the new bill, big-box stores would pay \$12.50 per hour. A "big-box store" is defined as a retailer with over one billion dollars in corporate annual revenue for all its stores and a 75,000-square-foot store in Washington. Stores with union labor are exempted from this legislation. Sixty-five percent of D.C. citizens support the bill.

As mayor, you can sign the bill into law or veto it. Since the bill did not pass by a two-thirds majority in the Council, a veto would kill the legislation.

Decide whether you would sign or veto the bill. Then write an explanation of why you made the choice you did. Consider the following arguments as you decide and write your essay.

### **Arguments in Favor of the Bill—Why You Should Sign It**

1. Washington, D.C., is an expensive place and must establish a living wage for underpaid retail employees.
2. If wages are low, taxpayers will have to supplement them with government benefits.
3. The legislation is popular, and the mayor wants to be reelected.
4. The higher wages will be spent in the local economy, which would be a boon to the region.

### **Arguments against the Bill—Why You Should Veto It**

1. Minimum-wage laws increase unemployment, particularly among the poor.
2. The bill is arbitrary and discriminatory in that it applies only to big-box stores.
3. Wal-Mart has already announced that it will not build three planned stores in the area and may abandon three others under construction. Other big-box retailers have said they are unlikely to build in D.C.
4. Higher wages will be passed on in the form of higher prices for consumers.
5. The government cannot make a worker worth a given amount of money and demand a company pay him or her that amount.

I, Vincent Gray, Mayor, \_\_\_\_\_ the bill.



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## Clip 13: Exposing Disability Cheaters

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**Length: 6:01**

**Concepts Illustrated:**

- Disability fraud
- Incentives
- Insurance

**Lesson Objectives:**

1. Using an economic way of thinking, analyze why the number of people on disability is rising so quickly.
2. Describe the difference between hard fraud and soft fraud.
3. Describe the extent of the amount of disability fraud.
4. Describe how scammers hurt the economy.
5. Analyze the incentives that can reduce the amount of disability fraud.

**Preview Question:**

Why is disability fraud so widespread? (Write the students' comments on the board, but do not comment on the answers.)

**Description:**

Paul Colbert, CEO of Meridian Investigative Group, exposes several people cheating on their disability claims. The U.S. Chamber of Commerce estimates that 25 percent of disability claims are bogus, while Colbert's company finds nearly 80 percent of their investigations reveal some kind of fraud. This fraud costs taxpayers billions of dollars every year in unwarranted beneficiary payments.

**Discussion and Analysis Questions:**

1. According to the U.S. Chamber of Commerce, what percentage of disability claims is fraudulent?  
*25 percent*
2. What is the difference between hard fraud and soft fraud?  
*Hard fraud is deliberate deception, while soft fraud involves exaggeration and white lies.*

3. Why do so many people not report disability fraud when they know it exists?

*Some reasons are a sense of entitlement, a feeling that they are not paying the cost, and the belief that big corporations and insurance companies are rich enough to pay for it.*

4. How does disability fraud hurt the economy?

*The rising costs must be paid by someone, and these resources cannot be used for innovation and capital to grow the economy. People on disability are not working nor are they contributing to the economy.*

### **Extension Activity: Reducing Disability Costs**

Distribute the handout on the next page to the students. Ask them to read about disability benefits and the rapid growth in the number of recipients. After they are done, ask:

1. Just how serious a problem is this for the U.S.?

*These statistics suggest that Social Security Disability Insurance program is rapidly becoming very expensive. It also provides an incentive for people to stop working.*

2. Now, assign the students to small groups. Ask them to discuss the problem further and to explore the possible solutions presented in the handout. Encourage them to examine each policy to identify what incentives are presented.

3. Finally, ask a spokesperson from each group presents its findings to the class.

*Groups that focused on the incentives involved are likely to conclude that each policy provides ways of reducing of the problems associated with Social Security Disability Insurance program.*

## **Handout: Reducing Disability Costs**

Disability benefits are awarded at several levels. States have worker's compensation for employees injured on the job. Individuals may buy private disability insurance from insurance companies. The fastest growing disability program of all is Social Security Disability Insurance (SSDI). There are ten million former workers receiving SSDI and two and a half million are in their 20s, 30s, and 40s. Since the recession ended in 2009, more individuals have gone on disability than have joined the workforce. In 2012, Social Security paid about \$137 billion to 8.8 million disabled workers and \$2.1 billion to their spouses and children. Related Medicare expenditures were about \$80 billion. Experts estimate that the SSDI will run out of money by 2016 unless changes in funding and/or benefits are made. Only one percent of disability recipients ever go back to work again.

Disability payments are not large. They average \$13,560 per year plus Medicare, which individuals are eligible for after two years on the program.

Your job is to use economic thinking to develop a program to stop fraud and abuse, while preserving benefits for truly disabled individuals. Identify the incentives that each policy alternative presents. Be sure to justify each part of your program by explaining how and why it would work. Here are some ideas to consider.

1. Grow the economy in order to reduce the unemployment rate, raise wages, and get people back to work.
2. Require the losing side to pay all court costs if an individual appeals a disability decision.
3. Provide block grants to the states to set disability payments rather than relying on Social Security.
4. Require all people 62 years old and older to apply for Social Security benefits rather than disability benefits.
5. Instead of reducing disability payments for each dollar earned by working, reduce them by one dollar for each two dollars of work income.

## Part 5: Effects of Government Programs

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### Clip 14: What Would Happen if Welfare Ended?

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**Length: 5:50**

**Concepts Illustrated:**

- Welfare
- Social Security
- Taxes
- Charity

**Lesson Objectives:**

1. Recognize the problems associated with the unfunded entitlement spending of the welfare state.
2. Identify how young people's futures are jeopardized due to large and increasing levels of entitlement spending.

**Preview Question:**

Tom Palmer argues that the welfare state is robbing today's young people. What do you think he means by that? (Write the students' comments on the board, but do not comment on the answers.)

**Description:**

Tom Palmer discusses the major points of his book, *After the Welfare State*. Tom predicts that current welfare programs will end and describes potential replacements for those programs. He argues that organizations similar to associations that were prevalent prior to 1930 will replace government welfare and do a better job of helping people.

**Discussion and Analysis Questions:**

1. Why does Tom Palmer think the welfare state is nearing collapse?

*The government has promised billions of dollars in benefits to be paid in the future by such programs as Social Security and Medicare. These liabilities are unfunded. Meeting these obligations places an enormous financial burden on young people.*

2. What does Tom Palmer suggest that young people do?

*Young people should take more responsibility for themselves, because it is unlikely that these benefits will be there for them in the future. There is a “cascade” of possibilities, including resurrecting mutual aid societies.*

3. Do you think Tom Palmer’s solutions adequately address the problem of spending on unfunded liabilities?

*Accept a variety of responses. Some students might argue that self-help measures will be adequate. Others might argue that programs such as Social Security and Medicare should be reformed to reduce the financial burden being placed on young people.*

### **Extension Activity: Entitlement Spending and “the Olds”**

Read to the class the following quote from Ben Bernanke, former Chairman of the United States Federal Reserve Board of Governors:

“The arithmetic is, unfortunately, quite clear. To avoid large and unsustainable budget deficits, the nation will ultimately have to choose among higher taxes, modifications to entitlement programs such as Social Security and Medicare, less spending on everything else from education to defense, or some combination of the above. These choices are difficult, and it always seems easier to put them off—until the day they cannot be put off any more.”

Source: <http://www.federalreserve.gov/newsevents/speech/20100407a.htm>

Distribute the handout on page 55 to the students. Invite two volunteers to come to the front of the room. Ask the volunteers to read the script after you have read the “Scene” aloud to the group. When they have finished, discuss the questions at the end. Ask:

1. According to Albert Brooks, the author of *Twenty Thirty*, why would a cure for cancer be a bad thing?

*A cure for cancer would exacerbate the current problem of unfunded entitlement spending on Social Security and Medicare. Baby boomers living longer would require even more benefits.*

2. Jake suggests that young people are “on a treadmill.” What does he mean by that?

*Entitlement programs are “pay as you go” systems. Current workers pay taxes to support the entitlement benefits of current retirees and others who receive entitlement benefits. Today, the number of people receiving entitlements is increasing, while the number of people in the workforce is decreasing. So today’s young workers face increasing financial burdens.*

3. Do you agree that young people today ought to be concerned about increasing entitlement spending?

*Accept a variety of responses. Some students might argue that elected officials will ultimately have to trim entitlement spending. Others might suggest that voters who receive entitlement benefits are a large group. It’s hard to imagine why they would elect*

*politicians who would take action to trim back the welfare state. Still others might suggest that it is time for young people to take more responsibility for their own financial futures.*

## Handout: Jake and Emily Wonder about the “Olds”

**SCENE:** Classes are over for the day, and Jake and Emily are strolling to a local coffee shop to relax and chat over a cup of their favorite gourmet coffee. Their conversation goes something like this:

**Jake:** In my American Literature class we’re reading a book called *Twenty Thirty* by a writer named Albert Brooks. It describes what life for people like us might be like in the year 2030. It’s fiction, of course, but the book got me thinking.

**Emily:** About what?

**Jake:** The author presents a story that seems like it should be good news—a doctor discovers a cure for cancer. The doctor figures out how to use a person’s own blood to be turned into a weapon against most forms of cancer. People’s lives are saved, and he becomes rich.

**Emily:** That *is* good news, right? So many families have had a family member who got cancer. Some, like my uncle Max, went through treatments lasting months. Some people even die.

**Jake:** I get your point. Curing cancer *would* be a great thing. But it would also mean that millions of baby boomers would live even longer.

**Emily:** And what would be wrong with that? Don’t you want your grandparents to live a long time?

**Jake:** Of course I do, but think about it. We have these large entitlement spending plans that are unfunded.

**Emily:** We have these large unfunded—what did you call them?

**Jake:** Entitlements. You know. Entitlements are payments of income from current workers like us, after we graduate and get a job, to people who provide no goods or services in return. The biggest entitlement programs are Social Security, Medicare, and Medicaid. Today, spending for these programs is growing fast. They are the largest part of federal spending. Social Security is the largest government spending program in the world!

**Emily:** Okay. I’m starting to get it. So, what exactly is causing the problem?

**Jake:** Social Security and Medicare were designed years ago when people did not live as long. Retired people today spend many more years in retirement, collecting benefits well into their eighties and beyond. These programs were never designed to assist people for so many years.

**Emily:** Ah. I see where you’re headed. Not only are baby boomers living longer than earlier generations, but there are so many of them. They depend on us to support them. But, there are a lot fewer of us. So, we get squeezed. We pay for their benefits, and we have less left over to save for our own futures—to pay for our schooling, to get the job we want, the family we want, a car, a nice home, and our own retirement security. So, does the author say young people will get upset?

**Jake:** Yes! The author discusses how many young people come to deeply resent “the olds” as he calls them. He suggests that people our age will be on a treadmill—working to pay for the entitlements of “the olds,” while falling further and further behind in saving and investing for our own future. And remember, “the olds” vote, so the politicians don’t want to offend them by reducing their benefits.

**Emily:** Sounds like a dismal book!

**Jake:** It is. I think the author is trying to sound an alarm for our generation. We may need to take more responsibility for our own financial future rather than looking to government for help.

### **Questions for Discussion**

1. According to Albert Brooks, the author of *Twenty Thirty*, why would a cure for cancer be a bad thing?
2. Jake suggests that young people are “on a treadmill.” What does he mean by that?
3. Do you agree that young people today ought to be concerned about increasing entitlement spending?



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## Clip 15: Government Reforms in Puerto Rico

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**Length: 7:30**

**Concepts Illustrated:**

- Government spending
- Tax reform
- Business regulation

**Lesson Objectives:**

1. Describe the reforms that Governor Luis Fortuño implemented in Puerto Rico.
2. Analyze the effectiveness of Governor Fortuño's reforms.
3. Analyze why few politicians support lower government spending and lower taxes even though these policies have been shown to work.
4. Analyze why most politicians run budget deficits and increase government spending.

**Preview Question:**

When there is a budget deficit, should government leaders cut government spending or should they increase taxes to close the deficit? (Write the students' comments on the board, but do not comment on the answers.)

**Description:**

Luis Fortuño, Governor of Puerto Rico, was elected at a time when one out of three workers was on the government payroll and the commonwealth didn't have enough money to fund the first payroll checks of the year. He discusses the measures he took to implement government reforms in order to be more fiscally responsible. He reduced spending, lowered tax rates, reduced regulations, and laid off thousands of government workers.

**Discussion and Analysis Questions:**

1. When Luis Fortuño became Governor of Puerto Rico, what were the commonwealth's biggest problems?

*High government spending and large budget deficits. The government didn't have enough money to fund the first payroll checks of the year.*

2. What percentage of Puerto Rico's workers were employed by the government?

*33 percent, that is, one out of three workers*

3. What reforms did Governor Fortuño implement?

*He cut corporate and individual taxes; fired 17,000 government employees; cut government workers' salaries, including his own, by 10 percent; and reduced regulations on businesses.*

4. Did the Governor's reforms make him popular?

*No. After two years, he was very unpopular with an overwhelming majority of voters.*

5. Why do most politicians finance spending by increasing debt rather than by raising taxes or cutting spending?

*Increasing spending has an immediate political payoff. The borrowed money can be used to pay for highly visible projects, help special-interest groups, and employ more government workers—seemingly without an immediate visible cost. This helps them win elections.*

### **Extension Activity: Government Reforms in Puerto Rico: An Update**

Have the students read the essay in the handout on page 60 and answer the questions at the end. Then discuss the answers with the class. Ask:

1. Were Governor Fortuño's reforms successful? Why or why not?

*During his term, the reforms were only partially successful. The budget deficit was cut, and the government became solvent. Business activity increased. But there was little economic growth, and unemployment remained high.*

2. Are reforms such as cutting taxes and government spending more successful in the short term or in the long term?

*They are probably more successful in the long run, because people need time to respond to incentives. For example, in the 1980s, the reforms of British Prime Minister Margaret Thatcher and U.S. President Ronald Reagan were unsuccessful for at least two years. However, their economies then improved dramatically, and both were reelected.*

3. To close a government deficit, would you prefer to raise taxes or cut spending? Why?

*If taxes are raised, people lose control of their money. Economist Milton Friedman said people take much better care of their own money than someone else's money. Margaret Thatcher said socialism will end when the politicians run out of other people's money. On the other hand, President Bill Clinton raised taxes to close a deficit and was the only president in modern times to have a budget surplus. And the economy remained strong.*

4. In a time of rising budget deficits, why are so few governors and the president unwilling to cut government spending?

*The special interests that benefit from government spending will not contribute to campaigns or vote for politicians who reduce the spending. The benefits of borrowing are visible and immediate, while the benefits to the economy of cutting spending are less visible and long term.*

5. Many states, such as California and Illinois, have huge budget deficits and record levels of debt. If you were elected governor of California, would you continue business as usual or try to correct the problem? How would you correct the problem?

*This is an opinion question, but the students must back up their opinions with facts. Everyone is entitled to his or her opinion but not his or her own facts.*

## **Handout: Government Reforms in Puerto Rico: An Update**

In 2008, Luis Fortuño was elected governor of the Commonwealth of Puerto Rico on a platform of slashing government spending and reducing budget deficits. His program was designed to cut the budget deficit by reducing government spending and increasing economic growth.

How was he going to do this? He cut spending by laying off 17,00 government workers and cutting the salaries of the remaining workers, including his own. To encourage economic growth, he cut corporate and individual tax rates and reduced government regulations on business. For example, the 28 regulations involved in opening a new business were reduced to one. The time needed to get permission to open a business was reduced from one year to two weeks.

How did Puerto Ricans react to these reforms? They sparked a furious backlash. Thousands of government workers protested. Governor Fortuño's popularity plummeted. After his first two years in office, polls showed him losing a hypothetical election by 75 percent to 25 percent.

But did the reforms work? The deficit was cut dramatically. Twenty-five thousand new businesses opened, and taxpayers kept more of their money. Nevertheless, the recession that started in 2005 continued. Although the unemployment rate decreased, it still stood at 12 percent in 2012. Governor Fortuño ran for reelection and lost to his opponent, Alejandro Garcia Padilla, by less than one percent of the vote. Fortuño received 47.04 percent of the vote while Garcia Padilla received 47.85 percent.

### **Questions for Discussion**

1. Were Governor Fortuño's reforms successful? Why or why not?
2. Are reforms such as cutting taxes and government spending more successful in the short term or in the long term?
3. To close a government deficit, would you prefer to raise taxes or cut spending? Why?
4. In a time of rising budget deficits, why are so few governors and the president unwilling to cut government spending?
5. Many states, such as California and Illinois, have huge budget deficits and record levels of debt. If you were elected governor of California, would you continue business as usual or try to correct the problem? How would you correct the problem?

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## Clip 16: Pork Barrel Spending Sprees

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**Length: 5:09**

**Concepts Illustrated:**

- Diffused costs
- Concentrated benefits
- Government failure
- Pork barrel spending
- Taxes

**Lesson Objectives:**

1. Identify several examples of “pork barrel” government spending projects, where the costs of such spending outweigh the benefits.
2. Understand how economically inefficient spending is likely to occur when the benefits of a spending project are concentrated among a few and the costs are spread out over many.

**Preview Questions:**

What are some examples of wasteful government spending? Why do you think such spending seems so hard to end? (Write the students’ answers on the board, but do not comment on the answers.)

**Description:**

John documents several dubious government spending programs on projects such as blowing up beaver dams in Mississippi, removing tree snakes in Guam, studies of immune systems in shrimp, and a cowboy poetry festival. This kind of government spending benefits a small group of people at the expense of a wide group of taxpayers.

**Discussion and Analysis Questions:**

1. What is “pork barrel” spending?

*Pork barrel spending refers to government spending that benefits a few but is paid for by all taxpayers. The term is meant to be derogatory suggesting a waste of taxpayer dollars.*

2. What are some examples of pork barrel spending?

*The clip features several examples, including blowing up beaver dams in Mississippi, eliminating brown tree snakes in Guam, studying the immune systems of shrimp, supporting*

*a cowboy poetry festival, and distributing BlackBerry phones to help people stop smoking. Congress-directed spending—earmarks—involved spending for 19,000 projects in one year.*

3. Who gains the benefits of pork barrel spending?

*The benefits go to the people and agencies that receive federal funds. Elected officials take credit for bringing taxpayer dollars into their states or local districts as a way of pleasing voters. Elected officials may also benefit from obtaining campaign donations from the business owners and others who benefited directly from government spending.*

4. Who pays the costs of pork barrel spending?

*The costs are paid by taxpayers, in the form of government revenue or increased borrowing being used to pay for these spending projects. These are not new funds. They are just shifted from other purposes.*

### **Extension Activity: A Thought Experiment: Should the Oconto River Bridge Be Built?**

Explain to the students that government fails when the costs of a government policy exceed the benefits. Read the following situation to the class.

“The people of Oconto Falls are exploring the idea of building a new bridge across the Oconto River that would be paid for by local funds. A consultant was hired to research the project. The consultant concluded that the bridge would cost \$100 million dollars. The benefits, however, would only be \$10 million.

“Imagine that there are ten building contractors who would be involved in the bridge-building project. Each contractor would receive \$10 million in revenue.”

“There are 10 million Oconto Falls taxpayers. Each taxpayer would receive only \$1.00 in benefits, but the cost of the bridge to each taxpayer would be \$10.”

Ask:

1. Will the bridge be built?

*Most will say “no.” The costs to Oconto Falls taxpayers are ten times greater than the benefits.*

2. Will the contractors have an incentive to fund a lobbyist to speak with members of the City Council and advocate on behalf of the bridge?

*Yes. The ten contractors stand to gain a large benefit—\$10 million in revenue for each—if the bridge is approved by the local politicians.*

3. Will the contractors have an incentive to provide campaign donations to the local elected officials?

*Yes. The ten contractors stand to gain a large benefit—\$10 million in revenue for each—if the bridge is approved by the local politicians.*

4. Will the contractors be willing to buy advertising in the local media claiming that thousands of new jobs will be created even if this claim is dubious?

*Yes. The ten contractors stand to gain a large benefit—\$10 million in revenue for each—if the bridge is approved by the local politicians.*

5. Will the voters fund a lobbyist to speak with members of the City Council to advocate against the bridge construction?

*No. There are 10 million voters. Their interest is too diffused.*

6. Will the voters provide campaign funding to members of the City Council to oppose the bridge?

*No. There are 10 million voters. Their interest is too diffused.*

7. Will voters remember to punish elected officials for the extra costs imposed on them at the time of the next election?

*Probably not. Many might not even notice the extra cost since it was a relatively small amount.*

8. Will the bridge be built?

*Given the fact that the benefits are concentrated among a few contractors and the costs are diffused over many taxpayers, it appears the bridge will be built even though it is an economically inefficient use of taxpayer dollars.*

9. What conclusion can be drawn from this example?

*It appears that democratic processes can result in government failure. When it comes to government spending, good politics often results in bad economics.*



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