

MACROECONOMICS FOR DUMMIES

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The paper, Macroeconomics for Dummies, was initially published in 2003. It was referred to in my book “5 Things I learned on the Road to the Dream” and has been requested by several readers of the book. This is an abridged version. I reproduced it because the public’s understanding of even the most basic economic principals seems to be even poorer today. This paper addresses the basic concepts of wealth creation and consumption from a layman’s perspective and illustrates why government spending does not have even the hypothetical potential of growing the economy.

Government controlled “collective economics” based on some arbitrary standard of “fairness” has failed – every single time it has been tried. There are absolutely zero historical exceptions. The largest experiment in collective economics (the communist government of the Soviet Union) imploded under the weight of its own failed economy. Even the tiny experiments (the communes of the 60s) have largely been abandoned. North Korea is economically imploding as we speak, they have a per person average yearly income of less than \$800. (And by the way, North Korea is almost identical in almost every way *except governmental-economic form* to their neighbor to the south, which is a thriving, almost western country.) China is moving toward market capitalism as fast as it can to avoid the same fate. The concept of “from each according to his abilities, to each according to his needs”, the concept of government redistribution of wealth and resources based on some more “noble” set of criteria, is fatally flawed.

Socialism, if clung to till the last, has always resulted in total bankruptcy. Always. Despite people’s best intentions, eventually, there is no

wealth left to redistribute. And yet, experiments continue. There seems to be a continuing belief that “this time” will be different. Undeterred by the fact that one cannot find a single historical success to pattern a new experiment in “sharing” and “fairness” by, we have another go at it. We take from those who have “too much” and give to those who have “too little”. And again, if unchecked, there will eventually be nothing to take and nothing to give. The well meaning among us are left wondering who is to blame and wondering why their noble attempt failed again.

The intent of this paper is to explain why.

The short answer is that socialism, even limited or partial socialism is simply impossible. Not difficult, not complicated – it is at its core, mathematically impossible. It defies the basic laws of “economic physics.” It is an attempt to build an *economic perpetual motion machine*. It assumes that the business engines that produce great wealth will continue to do so, every bit as energetically, even as we systemically confiscate their resources, even as we slowly take away the reasons business ventures began in the first place. It also assumes that government systems to redistribute those

confiscated resources will be frictionless and perfectly efficient. These concepts: the indefinite conservation of momentum, perfect efficiency, and the complete elimination of friction, are as impossible in economies as they are in physics. Just like a perpetual motion machine, a socialist economy will eventually come grinding to a halt under its own weight.

Unfortunately, these seem to be difficult concepts to convey to the American public at large. The concept of wealth creation in business is a difficult one to wrap ones brain around. The understanding of what wealth actually is and where it comes from is just as complicated. It is just too easy to see those who have “too much” and see those who have “too little” and believe the thing to do is spread the wealth around a little.

There are those in our government who support socialism, in one form or another, who already understand everything we are going to discuss. These people support socialism without believing in it. They change its name (progressive has a nice ring, doesn't it?) and then seek to convince you and I of things that even they themselves don't believe. There are a variety of motives for this, none of which I am going to address here in much detail. Socialism can allow people in government power over wealth and assets that they would never earn, or earn the right to manage. Socialism is a great political tool in “dividing and conquering”.

“You poor, poor thing! See that mean ol' guy with too much stuff over there? That just isn't fair, is it? Some of that stuff should be yours, shouldn't it? Wait right here, I'll go over there and get it for you! Now I'm your hero, aren't I? Vote for me and I'll get you more stuff!”

This paper is not written to address these people. Perhaps at some point I'll write on the art of promising to use political power to give you someone else's stuff, but that is not my intent here. This work is directed toward the “true believer”. My point is to begin the process of showing those who actually believe that socialism can be made to work, why it is flawed to the point

of mathematical impossibility as an economic theory and to do so in a reasonably palatable way.

The economic birds and the bees: (*Daddy – where does wealth come from?*)

Wealth CREATION – We will start with the math part and get that over with. This really isn't very complicated at all. You won't even need your pencil and you can leave the calculator in the desk. Let's look at a business equation. Let's say that I am a building contractor. I am a businessperson who contracts the building of homes and then sells them. Let's say that I purchase a lot of land for \$50,000 and that I pay fair current market value for the land. I purchase building materials for \$50,000 (again, at fair market value) and that I hire carpenters at their fair market value and that they are paid a total of \$50,000 for their efforts. Let's say that this activity builds a home that is worth \$200,000. I sell the home for \$200,000.

Land	\$50.000
Materials	\$50.000
Labor	<u>\$50.000</u>
Total	\$150.000
Sale Price	<u>\$200.000</u>
Profit	\$50,000

Don't worry, this is not an exercise in basic math, we are coming to a very important point:

The \$50,000 profit in this equation is **created wealth** - it is new money. It was not transferred to me by anyone else; this \$50,000 did not exist at all, in any form at the beginning of the equation. It is new wealth in the economy; it is what is meant by

“economic growth”. It is not simply a profit made by transferring resources to myself from elsewhere by buying something at less than its value or by selling something a more than its value. It is not merely buying at wholesale and selling at retail, it is not merely making a commission. This is the actual creation of new value, of new wealth. Absolutely everyone involved in this transaction profited. Each of the players in this equation received full value for their sale, purchase or labor. No one lost so that I could win. The original land owner and lumber yard owner received full, profitable, value for their sales. The carpenters received full value for their work, and the person who paid \$200,000 for the home, still has an asset worth \$200,000. They simply traded a liquid asset (money) for a tangible asset (the home). They could (and at some point, probably will) trade again. In fact, that asset may well increase in value while in their possession.

\$150,000 in resources was assembled in such a way so as to create a \$200,000 asset.

Not only did my bank account grow by \$50,000, but, because the money was not transferred to me from elsewhere, it was created by my activity; the *entire economy* grew by \$50,000 as well. This, in a nutshell, is how wealth creation works. This is economic growth. This is the engine of our economy.

Wealth Creation is an economic transaction where the sum of the wealth at the end of the transaction is greater than the sum of all the wealth invested in the transaction.

At the heart of all collective economics is the misperception that economics is a “zero sum game”, that there is a fixed quantity of wealth and that all economic transactions are simply movement of wealth from one place to another. Socialists believe that for one person to profit, another must lose. Socialists believe that it is their responsibility to redistribute the finite quantity of wealth according to a “more fair” standard of their own making.

As we discuss wealth creation, it is important to touch on what wealth actually is. It is important

not to confuse actual created economic wealth with physical resources or currency. A country cannot become rich just by printing more money. Money itself has no value. Paper dollars (or electronic dollars) are only a *store* of wealth, they are just scorecards, they are not wealth itself. “Money” is just a convenient way that societies have invented to store and exchange value that has been created in the economy. Having a paper dollar in your pocket is only one, of many ways for you to have a dollar. When value is created or lost in the economy, it does not mean that currency is printed or burned. Money, be it paper or electronic, is only one of many types of stores of value in our economy.

Building on that concept, here is an even more challenging one. Tangible things, things that would seem to be vested with value in and of themselves, are also just stores of economic value. Even something as seemingly tangible as food is only a store of units of value within an economy. Let’s look at an example. Let’s say you are a carrot farmer. After harvest, you have 100,000 pounds of carrots. Their initial value to you is that you can eat some of them. Quickly, however, you will have all the carrots you can consume and they will have no more value to you in that form. Next, perhaps, your neighbors would like to eat some carrots, and perhaps they have something you would like in exchange. Your carrot’s value in that form ends when your neighbor has all the carrots he can eat, or when you have all of whatever he is trading for carrots that you want. As you can see, this type of direct barter stops being practical very quickly when one is looking at any significant volume of trade. The real value of your carrots is the value stored in them by the economy as a whole, and the ability of the economy to transition those carrots into a car payment or baby clothes. In a stable, free economy you can exchange the value in your carrots for things you want with people thousands of miles away, who you will never meet who may not even like carrots. (Typically, this exchange is affected by exchanging your carrots for a currency, and then exchanging that currency for the things you want.) If the economy placed no value in your carrots, they would be worthless, beyond your ability to eat them or directly barter with them. If

the economy loses value, so do your carrots. If the economy gains value, again, so do your carrots.

In the great depression of the 1930s, piles of food rotted while people 200 miles away starved. The great depression was not a lack of resources; it was a lack of economic value in those resources. The depression was not a lack of “stuff”; it was a collapse of the ability to exchange stuff for other stuff. It was a loss of created wealth in the economy as a whole. People had carrots and people wanted carrots, there just wasn’t value in the economy to make the exchange. Carrots stopped being worth the time and gas it took to grow them and get them to market.

The strength of a national economy is based less on the amount of “stuff” in that country than it is based on the ability of “stuff” to absorb and transfer economic value in a consistent and predictable way. Many of the poorest countries in the world have lots of resources, in some cases more than they need. They just don’t have economies that can process, transfer or absorb those resources. Resources rot or collect dust just down the road from where those same resources are desperately needed. In many cases, Americans send emergency food shipments to countries that have food or the ability to produce food. Very often, the issue is that the economy of the receiving country is so weak and unpredictable that it is more cost effective for us to fly food 3000 miles than it is for them to grow, harvest and process food and put it on a truck and drive it 50 miles. These countries are not poor in “stuff”, they have “stuff” or they could make stuff. They are poor in economically created wealth; therefore their own stuff is worthless to them.

Let’s return to our wealth creation example and flesh it out a little. Not only did our real estate investment create \$50,000 for me directly (that will find its way in to the economy, both in the form of my consumption spending, and in the form of other wealth creation projects), but everyone involved gained as well. The lumberyard owner, who sold me the supplies, sold them at a profit. I created a job for the carpenter who will then go out and spend

the money buying groceries and having his coveralls cleaned. The economy actually grew by even more than the \$50,000 in our original equation.

If we were in a classroom, I could see the hands in the back of the class. I am sure that there are those who are shouting at this page that in our example it is the carpenter, the individual worker, who actually created the wealth, not the contractor. This, in fact, is a key premise of socialism. It is, however, not at all true. Our carpenter cannot wake up in the morning, go out, find a pile of lumber in the street, nail boards together indiscriminately and expect that money will fly into his pocket. The wealth was produced by the project itself. Our carpenter was offered a profitable role in our contractor’s wealth creation project. Our carpenter could exert those same efforts elsewhere with no gain at all. The carpenter did the work, but the contractor enabled the work to be financially productive.

Three things are required to create wealth:

A Plan – Someone must envision a way that wealth can be invested so that at the end of the day, the wealth has increased.

Investment – the wealth must be obtained to invest

Risk – There is almost never security above a wealth creation project. Because wealth creation is the top of the economic food chain, there is no one to appeal to for fairness or justice. To create wealth, one must accept that if the plan fails, one will lose. There will be no one to appeal to.

These are the differences between a wealth creating entrepreneur and a wage-earning employee. The key among these differences is risk. Wealth is created at the point where wealth is risked. Our carpenter will expect to be compensated even if the wealth creation project fails. If the bottom falls out of the housing market, and my \$150,000 investment produces a house worth only \$100,000, our carpenter will still expect

to be paid. A big part of our carpenter's salary is insulation from the economic risk associated with the project he is a part of. An employee is compensated based on *efforts expended*. If an employee does what he is told, he is compensated. An entrepreneur, on the other hand, is compensated based on accomplishment or success. It does not matter how hard the entrepreneur tried, it doesn't matter how much effort was expended, the plan has to work. If the plan fails to be productive, his fault, someone else's fault or no one's fault, not only will there be no compensation, but the investment may be lost as well. The difference between an employee of a wealth creation project and partner in a wealth creation project is that employees do not typically share in the risk of loss.

Consumption – Economic transactions for the rest of us.

The reason that the concept of wealth creation seems so arcane to most Americans is that it rarely happens in their direct field of view. There is a characteristic about a wealth creating transaction that doesn't exist in the vast majority of our personal financial transactions. For a project to be wealth creating, both sides of that transaction must continue to have economic value after the transaction. (*In our example, the two sides are: the house created by the contractor and the money brought to the table by the new homeowner.*) Both must be vehicles to continue to move the wealth it stores through the economy. The reason I chose real estate for our example of a wealth creating transaction is that real estate is one of the extremely few examples of something that we (typical consumers) might purchase that will (or at least could) continue to move our wealth through the economy. Most wealth creation is at the upper levels of business and is multi-step and extremely complicated. The vast majority of our spending (us normal people) is *consumption*, not investment, not wealth creation.

Most of the time, when you and I make a purchase, the economic value of our purchase depreciates to zero while in our possession. Most of what we purchase ceases to be a vehicle for the

movement of wealth at the moment we acquire it. This will be a lot easier to understand with an example:

For comparison, let's look, one more time, at our real estate '**wealth creation**' transaction:

- Our contractor brings a \$150,000 investment to the table, and he uses that to create a \$200,000 asset.
- Our future homeowner brings \$200,000 to the table and purchases the home.
- At the end of our transaction, the contractor has \$200,000 that will continue to move through the economy and the homeowner has a \$200,000 asset that will also continue to move through the economy as it is resold or borrowed against.
- \$350,000 came into this transaction from the economy and \$400,000 left this transaction and continued moving through the economy.
- More wealth came out of this transaction than went into it and then all the wealth continued to move.

Now, let's look at what the rest of us do. Let's look at a **consumption** transaction.

I go to the store to buy a box of disposable diapers. I take \$10 – boxes of diapers cost \$10. The storeowner and I each come to the table with \$10 assets. The storeowner and I exchange our \$10 assets, now I have the diapers and he has the \$10 bill. O.K. folks, watch this, this is the interesting part. Once I put the diapers in my cart, their economic value immediately becomes zero. This is now \$10 in wealth that is no longer moving in the economy. The diapers will be useful, but not in an economic way. They will go on my baby's butt; they will not go back into the economy. I will not sell those diapers. The box of diapers stops representing a store of \$10 in value at the point I place them in my shopping cart. I exchanged one store of \$10 in wealth (a \$10 bill) for another (the diapers) and at that point the wealth is "consumed". The diapers were a \$10 asset as they set on the shelf; they ceased to be so as soon as they came into my possession. The \$10 bill I gave

to the store will continue to move through the economy, but that is only half of the wealth brought into this equation. \$20 came into this transaction; only \$10 came out and continued to move in the economy. This transaction consumed half the wealth that went into it.

In a **wealth creation** transaction, more wealth comes out of the transaction than went in.

In a wealth **consumption** transaction, less wealth comes out of the transaction than went in.

For an economy to grow, wealth must be created faster than it is consumed.

Most of us are consumers – the wealth creation process is not something that we often see directly. Most of us receive our wealth several levels down from where it was created. Most of us are something like a piano teacher, who was paid by the laundry owner, who was paid by the carpenter who was paid by the contractor who created the wealth. The wealth comes into our possession; we consume it (by purchasing diapers, milk and pizza) and look back up the chain for more. We receive wealth, several levels away from where it was created, we spend it and it is gone. It is very easy for us to assume that this is the way that all transactions work. It is easy to assume that corporations and very wealthy people are just people and organizations with more money to *spend*, more money to *consume*. The truth is that very large sums of money are rarely “spent” or consumed. Seven figure sums are not often involved in consumption transactions. Seven figure sums are traded for other seven figure assets, which are again traded. Very large transactions are almost always investments, where the wealth on both sides of the equation continues to move. At the very top of the economic food chain are wealth creating investments where not only does the wealth on both sides of the equation continue to move, but also it actually grows in the process.

You have heard the expression “follow the money”. I would ask you to change that to follow the wealth. “Money” is just one store of wealth – you can be rich without having much money if you have other stores of value. You can follow the wealth by watching the transactions. Watch wealth as it moves from where it is created to where it is consumed. If you only look at currency, at dollars, it can seem that economies are circular. The truth, however is that our economy is a simple line segment. Wealth moves from point a, where it is created, to point b, where it is consumed. The size of our national economy is the amount of wealth that exists between point “a” and “b” at a specific point in time. For our economy to grow – wealth must be created at point “a” faster than it is consumed at point “b”.

And now folks it is brass tacks time. Here is our first look at a critical point. Here is the fundamental reason that socialism doesn’t work. Are you ready? Here goes:

Wealth has never, is never and could never be created by or through government. Government is only a consumer of wealth, and it is the most inefficient consumer of wealth imaginable.

Government is one of the only places where 7, 8 and even 9 and 10 figure sums are actually consumed. When government attempts to make things more “fair” by transferring wealth and resources from one place to another, this transfer process “consumes” far more than it “redistributes”. There has never been a governmental spending action that has not been an overall negative influence on a national economy. In absolutely every case, when we place great wealth in the hands of government, most of that wealth goes completely away – consumed by the “friction” of the redistribution system - before it again finds its way into the hands of any private individual.

It can be argued that we should take some governmental spending action to help our most vulnerable citizens. We live in the most prosperous

nation in the world, we should not let our people starve in the streets if they do not have the means to prevent that and we, collectively, do. There are also a limited number of other things (such as roads, law enforcement, national defense, etc.) that we as a civilized people need, that are difficult to accomplish outside government. We must, however, understand how enormously expensive any type of government action is. We must remember that every dime consumed by government had to be created in the private sector. We must remember that every dime consumed by government will no longer be available to create new wealth. The business of providing routine necessities of life through government distribution systems to a large segment of the population is an incredible drain on the strength of a national economy. The process of transferring wealth through government is inefficient in the absolutely ridiculous extreme. Providing someone with a \$13,000 a year food stamp type existence through government costs at least \$50,000, taxed from the private economy.

Government transfer payments always have a weakening effect on the economy as a whole. Always. The person who receives the transfer payment benefits personally – short term, but because of the enormous administrative cost associated with the transfer process itself, the overall national economy is always weakened. One could argue that in some cases, helping individual recipients who are in great need is worth the enormous cost and the damage to the economy. That is a subjective evaluation and I'll leave that to you. However, the argument that any program of government wealth redistribution could be positive to the economy as a whole is simply, logically, false. Those who propose “stimulating” the private economy with “government money” seem to forget (unintentionally or otherwise) that the government does not have any money of its own. For the government to insert money into the economy it must first extract money from the economy. The administrative costs associated with extracting and redistributing those resources grossly exceeds any potential return those resources might earn in their new, government mandated home. The

vast majority of money taxed for the purpose of redistribution simply vanishes. The apparatus of government always consumes far more than it outputs.

When government touches private resources, most of those resources are consumed and the parent economy shrinks. Every time.