



Mary Hanson



## About the Business Advisor

The Business Advisor is written and published by Mary Hanson, a business attorney in Torrance, California.

Mary Hanson has a law degree from the University of Wisconsin and an MBA from the University of Southern California. She has practiced business law exclusively for 30 years.

She provides legal services related to owning, operating, buying, selling, and structuring businesses. Her clients are business owners in many different industries. She handles corporations, LLCs, new businesses, new ventures, and a broad range of contracts and business decision-making.

Her interests include flying and World War II.

Her law office is located in the Del Amo Financial Center, 21515 Hawthorne Blvd. #885, Torrance, California. She can be reached at (310) 543-1355 or by e-mail at [mhanson@bizadvisor.com](mailto:mhanson@bizadvisor.com)

## TEN BASIC RULES OF ECONOMICS

by Mary Hanson

**I**t seems that many Americans, and too many American politicians, have limited knowledge of economics. Perhaps they choose to ignore economics. Like other basic principles, we ignore them at our peril.

Here's a review of some fundamental principles of economics:

(1) Competitive markets (where buyers and sellers compete for goods and services) are amazingly effective in establishing the appropriate quality, supply, and price for goods or services. Having active and healthy markets is a key feature of a healthy economy. The competitive market benefits and encourages the most efficient provider and weeds out the inefficient and undesirable. Consumers benefit from the lower prices resulting from competition.

(2) A key job of government should be to provide an environment in which competitive markets thrive without obstacles, interference, manipulation, or favoritism. Regulations should be geared toward enhancing markets and promoting competition.

(3) International trade has brought greater prosperity to all countries that have implemented free trade policies or have made their trade policies more free. It benefits consumers, benefits exporting countries, and unleashes the power of competitive markets.

A country that has an advantage in education, climate, geography, or other resources, can reap rewards for providing goods or services efficiently while consumers of the goods and services get the benefit of the goods or services at competitive prices. Money not spent by consumers on overpriced protected domestic goods goes back into the economy. Consumers and the economy benefit.

(4) Government spending is likely to be remote and disconnected spending, influenced by special interests, political biases, protection of government jobs, and lack of information. Government lacks the efficiency and motivation of private business. Private business has "skin in the game" and is motivated to be effective and efficient in meeting customer needs.

(5) Economic activity involves trade-offs. First there is the basic trade-off in spending money. If you spend money on one thing, you don't have it to spend on another. If the government spends taxpayer money on one thing, the government does not have the money to spend on other things, and neither does the taxpayer. There are many other economic trade-offs that are more complex and more challenging. Increasing U.S. gas taxes would reduce our dependence on foreign oil, but such taxes would impose burdens on consumers and businesses, impairing economic growth. Mandated employee

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benefits help workers and families, but they also reduce wages and create disincentives to hiring. There are always trade-offs and some are NOT obvious. EVERY economic choice must be checked for all consequences and the trade-offs must be weighed.

(6) The law of unintended consequences thrives in economics. Because economies today are huge, complex, interconnected, and constantly changing, one can be certain that an action taken will have some effect not intended. It is frequently noted that taxpayers will respond to increased taxes by taking actions that result in a decrease in tax revenues. This is obviously an unintended consequence of tax increases. But it is not completely unforeseen. Other economic actions, whether in taxes, regulations, or economic changes, may have consequences both unintended and unforeseen. Don't underestimate the ability of consumers, suppliers, distributors, employers, global competitors, lenders, and other governments to respond and react to economic changes in some unforeseen way.

(7) Government spending can “crowd out” private spending. When governments take up too much in taxes, they leave too little in the private hands for fruitful investment and economic growth. When government (or aid programs or any program) provides a subsidy, assistance, payment, or tax credit, it can crowd out other economic activity that would have occurred in the absence of the program. Instead of making better market choices, farmers, workers, and businesses

drift toward the subsidized activity. Worthy competitors with superior products or services may be unable to compete with the subsidized alternative.

(8) Attempts to make economies “more fair” – by redistribution, reallocation, subsidies, entitlements, set-asides, etc. impede economic growth and reduce the overall size of the economy. Total fairness is never achieved; greater fairness may be achieved. Countries that impose requirements that promote economic equality bear the consequences of a smaller total economy.

(9) Government regulations will usually impede economic activity. The trade-offs involved in any regulatory proposal must be considered. Will the benefits of proposed regulations outweigh the burden on and reduction in economic activity? Will the regulations be effective? Efficient? Followed? Enforced? Highly regulated financial products and services were at the heart of the recent financial crisis. Can different or greater regulation really prevent future economic crises? Do we really know what all the consequences of proposed regulations will be?

(10) Economic growth arises from productivity. Government can't mandate productivity and make an economy grow. It can only provide a legal and regulatory environment which encourages productivity and growth. Productivity requires efficient and effective use of capital and other resources. Historically U.S. productivity has been boosted by the building of railroads, invention of the cotton gin, the telephone, creation of interstate

## TEN BASIC RULES OF ECONOMICS

highways, the use of computers, and development of the Internet, to name some economically significant innovations. These major innovations by private industry multiplied workers' output without an equal increase in input. The additional revenues generated by the additional output funded additional investment, higher wages for workers, and overall economic growth. If taxes or government regulation consume the additional revenues generated by productivity (especially if the government use of funds is to service debt), even greater productivity may not result in economic growth.

### Lessons

U.S. businesses and U.S. politicians need to deal with economic reality. They must understand basic economic principles and recognize that markets for a large portion of goods and services are now global. The greatest growth is to be expected from developing countries that have a long way to develop further, using technology and information from the developed economies of the world. The U.S. may find it harder to achieve economic growth than economists and politicians predict.

The consequences of global markets and competition from less developed countries must be considered in any economic picture.

As workers in developing countries develop skills and levels of productivity that compete with U.S. workers, U.S. wages will face downward pressure, until the wages of workers in those developing countries rise to levels similar to

U.S. wages. Downward pressure on wages may appear as "no jobs" in industries most affected by global competition.

The Greek financial crisis provides a number of warnings on government financial management. Government spending in Greece was "out of control." Government workers received jobs, compensation, and benefits that were unsustainable. The Greek government manipulated financial information to misrepresent the amount of debt and the growth of large budget deficits. Many government obligations were "off the books." Corrupt practices magnified the inefficiency of government expenditures.

Trends in the U.S. – toward increasing government, increasing entitlements, promotion of unionization, protection of government jobs, and treating some large government liabilities as if they were not debt – move us in the direction of Greece's situation. Increasing debt and deficits for government programs were the seeds of the Greek financial crisis and are likely the seeds for future problems in the U.S.

Financial experts think the crisis may be "contagious" – likely to show up in other countries. Other countries – not just Greece – have overspent and have debt that cannot be repaid without crippling changes. The debt of countries ("sovereign debt") has been a major investment for banks all over the world. Even some strategically important banks risk significant losses in the event of defaults on sovereign debt. Banks hold large amounts of sovereign debt because government regulations




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## Publisher's Note

Even if we could afford greater government spending, attempts to replace private business or free markets with government spending or government control ultimately disappoint for several reasons:

(1) Government action crowds out private enterprise. Government does not pay taxes, does not report to shareholders, does not reward employees on performance, and does not need to make a profit from its endeavors.

(2) Government has no need to satisfy its customers – especially if competitors are crowded out of the marketplace.

(3) Government inefficiency makes the costs too high and/or the services delivered inadequate. Government cannot collect a dollar of taxes and put that dollar to use elsewhere. Even the most efficient charities find that their overhead and marketing consume 20% or more of contributions, leaving only 80% for the charitable activity. How much of a dollar is left after all government overhead has been applied?

(4) Government picks winners and losers – often based on special interests, inadequate information, defective analysis, and biases of personnel. If you are a winner, you may like the government program, but everyone else, including the American taxpayer and the American economy, pays the price.

Mary Hanson  
Attorney/Publisher

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designate sovereign debt as a safe investment (another example of regulations being ineffective and offering unintended consequences).

I see a benefit in sovereign financial crises, if they will discredit Keynesian economic theory that promotes government spending as an effective replacement for private economic activity. Evidence abounds that countries cannot spend their way out of financial problems, but because the theory was promoted by a highly regarded economist, John Maynard Keynes – and because governments love spending money – Keynesian theory encouraging government spending, including deficit spending, has not (yet) been soundly rejected by economists and governments.

Government “stimulus” programs are, in my view, a poor substitute for private activity. First, government collection of taxes to support government programs is inefficient and pulls funds from otherwise fruitful economic activity (especially when taken from the most productive or entrepreneurial taxpayers). Second, the government and our lawmakers are inefficient (if not biased or entirely corrupt) in determining what programs to support, promote, or subsidize. In addition, the employees of government agencies created to implement the programs are likely (You may look up the statistics on this!) to receive compensation and benefits that are 40% higher than equivalent workers in private industry would receive. **BA**

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