

THE PROGRESS REPORT

Keep It Real

By Fred E. Foldvary

In economics, we keep it real. Economics is not so much about money or how prices get set, but about appearance and reality. The main reason for learning economics is to understand the reality beneath the superficial appearance of everyday life. Things are not what they seem to be.

An example of keeping it real is interest income. The bank or money market fund may say they are paying 5 percent, and for every \$100 in your account, you get \$5 in interest. But that's only the appearance. The 5% is the "nominal" interest rate, in name only. To get your real gain, you need to subtract out inflation, since part of the gain is to make up for the increase in the level of prices. If inflation was 3 percent, your real gain was only \$2. The real interest rate is the nominal rate minus the inflation rate.

Another example of economic reality concerns profits. If you are self-employed, your accountant would calculate your profit as revenues minus your explicit costs, the costs to pay in cash to others. But that is only the appearance of profit, the accounting profit. To get the real profit, you also need to subtract the implicit costs. For example, if instead of being self-employed, the best wage you could get as an employee is \$60,000 a year, that is really a cost of being in business. You have given up \$60,000 in order to be self-employed. That \$60,000 is a cost that should be subtracted from your revenue, the implicit wage you are paying yourself out of revenues.

If you own the real estate your business uses, then that is also a cost. You could have rented the premises for, say, \$40,000 per year. That rental you are not getting is a cost of using the real estate, and should be subtracted from revenues as an implicit cost. In economic effect, you are paying a rental to yourself, as you are a tenant as well as a landlord.

Only after subtracting all these implicit costs, the costs of foregone opportunities, do we get the real gain, the economic profit. When you make decisions based on economic rather than accounting profits, you are keeping it real.

Another way economists keep it real is when they compare national income from one year to another. Say the US economy grows from \$5 trillion to \$12 trillion. That is the nominal increase. But the dollars are not the same, because of inflation. To get the real increase, we need to take out the inflation. We do this by using "constant dollars" based on one year. Then if \$2 trillion of the increase was just an increase in prices because of inflation, the real GDP (gross domestic product, or total output) is \$10 trillion based on constant dollars, say the year of the \$5 trillion. Economists keep the GDP real by deflating out the inflation.

Appearance and reality. If you buy a stock for \$60 and it is now priced at \$40, do you not sell it because you don't want to take a loss? Then you are not dealing with reality, because you have already really lost the \$20, and a rational financial decision should only take into account the chance of future gains or losses. The \$20 is a sunk cost.

If you think of rent as the money a tenant pays a landlord, you aren't keep it real. You are thinking like an accountant, not like an economist. Rent is an implicit reality. It is there no matter what a particular tenant may pay and regardless of who owns the place. Rent is what the land would fetch to highest bidders. You can't see the rent, but it is as real as gravity and radio waves.

If you think that your wage comes from your employer, you aren't keeping it real. The consumer really pays your wage, because your wage really comes out of the product you produce. Do you think government spending can provide jobs and stimulate the economy? Get real! The spending comes from taxes, money that if not taxed would have provided the jobs and goods anyway.

Are taxes a burden on the economy? The money the government takes is not the real burden! This just shifts resources around. The real loss comes from the "excess burden," the waste beyond the money paid to government, due to the reduction in production and the redirection of resources from where they are most wanted by consumers if they could choose.

In your personal life, keeping it real means recognizing that the opportunity costs, what you have to give up to get something, is the real cost. In policy, keeping it real means recognizing that taxing labor and capital creates excess burdens, a needless waste, and that we can avoid this loss by taxing the real estate, the rent so real it can't hide or run away.

Get real, politicians. Untax our wages and tap the land rent. That would create real prosperity.