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Econ 101 is killing America

Forget the dumbed-down garbage most economists spew. Their myths are causing tragic results for everyday Americans

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In the Middle Ages, people looked to the Church for certainty. In today's complex, market-based economies, they look to the field of economics, at least for answers to questions concerning the economy. And unlike some disciplines, which acknowledge that there's a huge gap between the scholarly knowledge and policy advice, economists have been anything but shy about asserting their authority.

As we can see from the current dismal state of economic affairs, economies are incredibly complex systems, and policymakers who are forced to act in the face of this uncertainty and complexity want guidance. And over the last half century, neoclassical economists have not only been more than happy to offer it, but largely been able to marginalize any other disciplines or approaches, giving them a virtual monopoly on economic policy advice.

But there are two big problems with this. First, despite economists' calming assurances, we still know little about how economies actually work and the effect of policies. If we did, then economists should have sounded the alarm bells to head off the financial collapse and Great Recession. But even more problematic, even though most economists know better, they present to the public, the media and politicians a simplified, vulgar version of neoclassical economics — what can be called Econ 101 — that leads policymakers astray. Economists fear that if they really expose policymakers to all the contradictions, uncertainties and complications of "Advanced Econ," the latter will go off track — embracing protectionism, heavy-handed "industrial policy" or even socialism. In fact, the myths of Econ 101 already lead policymakers dangerously off track, with tragic results for the economy and everyday Americans.

Myth 1: Economics is a science.

The way economists maintain stature in public policy circles is to present their discipline as a science, akin to physics. In Econ 101, there is no uncertainty, only the obvious truths embedded in supply and demand curves. As noted economist Lionel Robbins wrote, "Economics is the *science* which studies human behavior as a relationship between given ends and scarce means, which have alternative uses." If economics is actually a science, then policymakers can feel more comfortable following the advice of economists. But if economics is really a science – which implies only one answer to a particular question — why do 40 percent of surveyed economists agree that raising the minimum wage would make it harder for people to get jobs while 40 percent disagree? It's because as Larry Lindsey, former head of President Bush's National Economic Council, admitted, "the continuing argument [among economists] is a product of philosophical disagreements about human nature and the role of government and cannot be fully resolved by economists no matter how sound their data."

Myth 2: The goal of economic policy is maximizing efficiency.

Economists have one overarching principle that shapes their advice: maximize "efficiency." As economist and venture investor William Janeway notes, "Efficiency is the virtue of economics." But the goal of economic policy should not be to maximize static efficiency (the "right" allocation of widgets), but to create inefficiency — in the sense of disruptive innovation that makes widgets worthless. For it is the development of new widgets and better ways to make them (e.g., innovation), rather than efficiently allocating existing widgets, that drives prosperity. As noted "innovation" economist Joseph Schumpeter pointed out: "A system which is efficient in the static sense at every point in time can be inferior to a system which is never efficient in this sense, because the reason for its static inefficiency can be the driver for its long-term performance."

Myth 3: The economy is a market.

In the world of Econ 101, "the economy" is usually treated as a synonym for "the market." But an enormous amount of economic activity takes place outside of competitive markets dominated by for-profit, private firms.

In the industrial nations of the OECD, government spending at all levels on average accounted for 46 percent before the Great Recession. Even in capitalist countries, the government is usually the largest employer, and the largest consumer of goods and services in areas like defense, education and infrastructure. Other non-market sectors responsible for goods and services production include the household (your chores are economic activity too, even if Econ 101 ignores them) and nonprofits like religious institutions, colleges and universities, charities and think tanks like ours. Markets, then, account for around half of a modern nation's economic activity — maybe less, if uncounted household production is as big a part of the real economy as some have claimed.

Myth 4: Prices reflect value.

If the economy is a market, prices are what allow goods and services to be efficiently allocated. In Econ 101, because prices are set in "free markets," the price of something must be a reflection of its real value. This principle — known as the efficient market hypothesis — was the reason why, when in the run-up to the Great Recession real house prices increased 40 percent (a more than seven-fold increase from decades prior), virtually no economist sounded the alarm, precisely because those higher prices must have reflected higher value. This is why Ben Bernanke stated in 2005 that rising home prices "largely reflect strong economic fundamentals" and Fed chairman Alan Greenspan assured us that, "It doesn't appear likely that a national housing bubble, which could pop and send prices tumbling, will develop." Had economists not been in the grip of the efficient market hypothesis, they would have realized that something was seriously amiss and helped rein in lending to reduce the bubble and subsequent collapse. But if they tell policymakers that prices don't always reflect value, then the entire foundation of Econ 101 starts to crumble.

Myth 5: All profitable activities are good for the economy.

Another axiom of Econ 101 is the assumption that all profitable activities are good for the economy: After all, Adam Smith "proved" that pursuit of self-interest maximizes economic welfare. To be sure, even Econ 101 would recognize that societies use legal penalties to discourage economic transactions like prostitution and drug use that are considered immoral, to say nothing of Mafia contract killing.

But the version of Econ 101 familiar to most politicians and pundits ignores the distinction between productive activities (e.g., making useful appliances or lifesaving vaccines) and pure rents (profiting from real estate appreciation, stock manipulation or the accident of owning mineral deposits that become more valuable). If the greatest fortunes are to be made in financial arbitrage, gambling in real estate or exploiting crony-capitalist political connections, the argument that private profit-seeking maximizes economic welfare and the public good is undermined.

Myth 6: Monopolies and oligopolies are always bad because they distort prices.

In the abstract universe of Econ 101, monopolies and oligopolies are always bad because they distort prices. Here populism, often opposed to neoclassical economics, is allied with it. The neoclassical vision of the normal economy with multiple small yeoman producers resonates with Jeffersonian antitrust policy, with its suspicion that all large enterprises must be conspiracies against the public.

In the real world, things are not that simple. Academic economics includes a well-developed literature about imperfect markets. But it is reserved for advanced students and is never encountered by those who are told only the simplicities of Econ 101. In manufacturing industries with increasing returns to scale, like semiconductor or airplane production, markets characterized by a few large producers are usually more productive and innovative than ones with many small producers. The same is usually true in industries characterized by network effects, like railroads or communications infrastructures such as wired or wireless broadband. And as Joseph Schumpeter pointed out, temporary monopolies based on technological innovation are not only beneficial but are key enablers of seeding further innovation — particularly if the "innovation rents" or super-profits are funneled back into R&D.

Myth 7: Low wages are good for the economy.

According to Econ 101, high wages are bad for an economy and low wages are a blessing. James Dorn of the libertarian Cato Institute declares that higher wages, by causing less demand for workers, mean that "unemployment will increase … No legislator has ever overturned the law of demand." High-wage countries, we are told, price themselves out of a supposed global labor market. And in the non-traded domestic service sector in which most Americans work, a higher minimum wage, Econ 101 claims, would lead to permanent higher unemployment.

When it comes to traded goods and services, this ignores the effects of relative currency values being the major determinant of prices of exports and imports. It also ignores the fact that high-wage workers who are highly productive, thanks to their machines and skills, can produce more cheaply than poorly paid workers with inferior technologies and skills. According to the Asian Development Bank, most of the high-value-added components of iPhones, which are assembled in China, actually come from high-wage nations like Germany, Japan, South Korea and the U.S. Michael E. Porter and Jan Rivkin state flatly in the Harvard Business Review: "Low American wages do not boost competitiveness," which they define to mean that "companies operating in the U.S. are able to compete successfully in the global economy while supporting high and rising living standards for the average American …" The countries that beat the U.S. in the latest competitiveness rankings by the World Economic Forum are all high-wage nations: Switzerland, Singapore, Finland, Sweden, the Netherlands and Germany.

In industries that cannot be outsourced, labor is only one of several factors of production that can be substituted for one another. Writing in defense of low-wage immigrant farmworker programs in the progressive magazine Mother Jones, Kevin Drum claims: "Most Americans just aren't willing to do backbreaking agricultural labor for a bit above minimum wage, and if the wage rate were much higher the farms would no longer be competitive." But if American farmworkers were paid better, then U.S. agribusiness would have an incentive to cut costs using technology, like automated tomato picking

machines, as the agricultural sectors of Japan, Australia and other high-wage nations have done. While transitional unemployment as a result of innovation always has to be dealt with, the effects of high wages in encouraging investment in labor-saving technology should be welcomed, not deplored.

Myth 8: "Industrial policy" is bad.

Econ 101 tells us that letting markets determine how many "widgets" to produce maximizes efficiency. The worst thing government can do is engage in "industrial policy" — a catch-all pejorative used to discredit everything from funding solar energy companies to encouraging more college students to major in science. As former Bush economic adviser Gregory Mankiw stated: "Policymakers should not try to determine precisely which jobs are created, or which industries grow. If government bureaucrats were capable of such foresight, the Soviet Union would have succeeded." In other words, how can government bureaucrats make better choices than business? Leaving aside the fact that banks issued trillions of dollars of bad loans leading to the financial crisis, for many investments private and public rates of return differ, often quite significantly. And unless society (through government) tilts investment to those activities where the public rate of return is higher (e.g., scientific research), growth will be less. If this is industrial policy, so be it.

Myth 9: The best tax code is one that doesn't pick winners.

Econ 101 disparages industrial policy, even, or perhaps especially, when it is used in the tax code. Economists call anything other than a completely neutral tax code "distortions," "special interest tax breaks," "corporate welfare" or, as the Simpson-Bowles Commission labeled them, "perverse economic incentives instead of a level playing field." Economists disdain tax incentives because in the words of the Obama administration's Recovery Advisory Board, "certain assets and investments are tax favored, tax considerations drive overinvestment in those assets at the expense of more economically productive investments." But as Canadian Treasury economist Aleb ab Iorwerth writes, "Distortions that favor the contributors to long-run growth will be welfare-enhancing." In other words, tax "distortions" like the R&D tax credit or accelerated depreciation for investments in new equipment lead to more growth since these investments are more productive than others and have significant positive externalities.

Myth 10: Trade is always win-win.

That trade always benefits both parties is perhaps the most fundamental dogma that people take away from their Econ 101 courses. In discussing trade theory with students and politicians, academic economists use fairy tales rather than history. There is the fairy tale about comparative advantage: England was good at producing wool, Portugal wine, so they trade and both are better off. There is the fairy tale about how because market transactions are always voluntary and always beneficial that trade, being simply a market transaction across borders, is always win-win.

But Econ 101 never explains how nations like America, Britain, Germany and Japan have used national industrial policies over the past century to become industrial powerhouses. And Econ 101 never explains how foreign mercantilist practices, like those China is embracing, can hurt the U.S. economy. Higher-level students are sometimes introduced to the complexities of real-world trade, but academic economists fear that sharing nuances with the general public would unleash an epidemic of know-nothing protectionism.

But for most of the production of traded goods and services, comparative advantage is meaningless – the Koreans and Japanese are not good at making flat panel displays because they have a lot of sand, they are good at it because their corporations and governments targeted it for competitive advantage. Moreover, corporations locate their subsidiaries in particular nation-states to take advantage of local government subsidies and tax breaks or increasingly because of government requirements to produce locally. Econ 101

to the contrary, the location of factories and innovative research complexes is not determined by comparative advantage. Increasingly it is the artificial outcome of negotiations among multinational corporations and territorial states. And the outcome of this “free trade” can be detrimental to the U.S. economy if it hurts, as it has, key U.S. high value-added industries.

Conclusion

When the U.S. economy faced little competition and was largely based on industrial mass production industries, it was perhaps not so bad that policymakers relied on Econ 101 as their guide to economic policy. But in a complex, global, technologically driven economy in which nation-states compete to capture markets and key links in global supply chains, relying on Econ 101 is like a physicist today relying on Newton. It’s time for economists to fess up and admit that theirs is not a science and that what passes for Econ 101 is largely misleading. But the public, the media and politicians shouldn’t wait, for it may be a long, long time coming. Rather, they need to understand that a dumbed-down Econ 101 version of neoclassical economics no longer should serve as a road map for economic policy.