Talk on Economic Misperceptions, March 2011

Economic Misperceptions Promoted by Various Political Groups

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I want to briefly consider some popular economic misperceptions advanced by either the political left or the political right. On the political left, many people and their followers in the national media believe that profits are bad and non-profit institutions including the government are inherently good. The left also tends to believe that corporations are inherently bad. On the right, many people believe that a gold standard is preferable to our Federal Reserve, which clearly has not done its job of preventing inflation. Others believe, dangerously as I will point out, that a federal balanced budget requirement is necessary to restore fiscal solvency and economic health in the country.

Profits vs. Non-profits (for details see my website "statements")

Profit Pros and Cons—Profits only occur when a producer can purchase labor and resources for a price better than their best alternative use and use those resources to produce goods and services that he or she can sell for more money that the cost of the resources purchased. Thus, the producer earns profits by adding value to our economies' resources. Because of profits, the producer may expand and produce more of the desired goods and services; furthermore other producers will be attracted to produce similar goods and services so they can earn profits also. Thus, production of goods that people value highly will automatically tend to expand as people seek to make profits. Conversely, when a producer must pay more for the resources and labor he or she employs than he or she will receive by selling the produced goods and services, he will incur negative profits(losses). At that point the producer must either learn to produce by using purchased resources more efficiently and cutting costs, or he or she must go out of business and free up the national resources for other potential uses. That, too, helps the economy use resources more efficiently and promotes economic growth. In contrast to profit-seeking institutions, non-profit institutions that incur losses have little incentive to cut salaries and work more efficiently. Instead they tend to ask their donors or taxpayers for more money so they can do their jobs better. However, without profits, there is little incentive to make sure they use their resources effectively, don't pay their executives or civil servants too much, and don't provide their

...ojects with too many perquisites. While many non-profit institutions perform very well, there is no automatic incentive for them to use resources efficiently as there is with profit making entities.

The main con regarding profit-seeking organizations is that they often beseech government agencies or politicians to provide them with benefits or monopoly powers to enhance their profits. This political rent-seeking can cause sections of our economy to operate inefficiently as subsidies are provided to the politically connected at the expense of consumers or taxpayers in general (see my statement on how government created the great recession and isn't solving it, in part because the big Wall Street firms and banks have showered the President and Congress with bags of money to get favorable legislation).

Pros and Cons of Corporations: Corporations provide a valuable service for the cause of economic growth because they have "infinite" lives and thus can engage in long-term research and investment projects that may pay off over many years, and are not constrained to pay off within one individual's lifespan. In addition, because of their potential longevity and long-lived assets, they can attract and employ large pools of capital to invest in potentially profitable projects, and their investors can count on obtaining potential returns over an extended period of time. An individual investor would typically have more difficulty obtaining large amounts of capital for an extended period since human lives are finite. As a "con" however, in the absence of effective controls on their behavior, the managers of corporations may use them for personal gain instead of repaying the debtors and investors in the corporation. Furthermore, unscrupulous people may be able to hide behind the corporate veil and anonymously commit acts that they would be prosecuted for if they were to do them as individuals. The potential "cons" in these cases all involve the acts of unscrupulous people who do things that they wouldn't be able to do easily as individuals —not unscrupulous corporations per se. In my experience, while some corporate managers may be unscrupulous or self-serving, most are fine people who have risen to the top of their corporations because they are competent and trustworthy. Unfortunately, the national media, in its service to the labor union interests of the left, tends to focus on the deficiencies and wrong-doings of corporate leaders and ignores the economic benefits they provide.

Pros and Cons on the Federal Reserve vs. the Gold Standard

The Federal Reserve was authorized by Congress in late 1913. Since then, the purchasing power of the dollar has fallen by at least 95%. Clearly, the Federal Reserve has not achieved its supposed objective of keeping the dollar value stable. In contrast, before the Federal Reserve was formed, the U.S. was basically on the Gold Standard, with the dollar backed by gold, and inflation over time tended to be minimal. Thus, many people want to return to the Gold standard—the last vestige of which was abandoned by Nixon in 1971. However, there are problems with a gold standard. First, it is cumbersome to contract in gold rather than in electronic money. Second, when the gold standard applied, the value of the dollar was stable over time but varied widely from year to year as the economy ... numerous severe recessions, as growth in the economy caused periodic money shortages. Third, adopting a gold standard would enhance the wealth of countries that held gold—such as Russia, Canada, and South Africa, not all of whom are our friends. The big problem with the Federal Reserve is that in the absence of a Gold Standard, it can create as much money as it wishes by "fiat." Milton Friedman, a famous Libertarian leaning economist, suggested that the Fed be constrained to increase fiat money by no more than 3% per year—a rate that should accommodate most economic growth with out causing inflation or money shortages. Others have proposed that the dollar value be pegged to market prices—either for a certain basket of real goods or for price indexes in general (the problem with general price indexes is that they are compiled by the government who may bias the compilation at times, whereas market prices for most real goods are readily available at almost all times). Personally, I favor any approach that would not allow the Fed to increase the money supply (i.e., the monetary base—which is what the Fed really controls) at its discretion, like it is doing now. By letting the Fed have a "dual mandate" to control both prices and unemployment, Congress has effectively let the Fed do whatever it wants. It switches from expanding money rapidly saying it is worried about unemployment to contracting money when it says (too late, usually) that it must control the emerging inflation that has resulted from its past monetary stimulus. The Fed has only one tool (monetary policy) and those who know math know that you can only solve for one unknown when you have one equation. Congress needs to require that the Fed control the rate of inflation, period, and make provisions to fire the Fed members , like New Zealand has, if inflation gets out of control. The Fed does provide some value in allowing for the creation of electronic money that can be created, used, and cleared at little cost—but, in the past and over time, it has harmed the economy by expanding or contracting the monetary base at its own discretion, in part because it says it is following its "dual mandate."

Pros and Cons on a Balanced Budget and a Proposed Amendment

At the moment this issue is very pertinent, and I urge you to immediately call, write, wire, or otherwise contact you state representatives and tell them to vote no on the proposed balanced budget amendment to the U.S. Constitution, Not only is that amendment a bad idea, and I'll tell you why, but also, if a Constitutional Convention were convened, people could end up trashing our nation's Constitution—which is what has made our nation exceptional over the years. It is bad enough to have a President, several members of the Supreme Court, and many Congressmen who want to ignore our Constitution because it limits their power and authority. However, that is its intent. Our founding fathers were very experienced in government—having run local governments both under the British and in the first years after the American Revolution— andwise in the ways of men. Thus, they created a system of checks and balances in our Constitution to protect citizens from the potential abuse of power by their political "leaders." Our leaders would like nothing better than to remove those constitutional limits on their authority so they could potentially exercise more control over our lives. Thus, it is essential that we not convene a Constitutional convention where they might be able to do so.

Now, as to the pros and cons of a balanced budget amendment, per se. First, while a balanced budget is wise for individuals, it is not necessarily wise for a government. Economic cycles always will exist. In a downturn incomes and tax revenues will tend to fall. Under a balanced budget requirement, a government would have to cut spending when taxes fell, thereby making the downturn worse. Loopholes to prevent this problem, such as by letting the government run a deficit if the unemployment rate exceeded a certain level, might be exploited constantly (remember, the government calculates the unemployment rate, and the "full employment" level is debatable anyway) so the budget might remain unbalanced. Second, it appears that the "right" has been suckered by the "left" in promoting a balanced budget. The left would like nothing better than a periodic excuse to raise taxes (to "balance the budget") rather than cut government spending. Raising taxes is easier for a Congressman (especially one who says it is absolutely necessary to do so in order to balance the budget) than cutting favors or spending granted to favored constituents who might complain about the loss—and not vote for or fund the Congressman in the future. Since the left wants the government to exercise ever-expanding control over peoples' lives and the economy, what better way to do so than to get conservative Congressmen to go along with their tax-raising plans. Third, while we have a problem in that the government spends too much, the problem is not the deficit but total government spending. Studies in Europe show that the countries where government spending is a higher percentage of total GDP tend to grow less rapidly than countries where government claims a lower percentage of national resources. These studies are based on total government spending, not deficits per se. Thus, it is clear that the big problem is excessive government spending, not deficits, per se. What we need is a law that limits total government spending. For many years, even under Bill Clinton's presidency, the federal government spent no more than 19% of our total national income (GDP). Under Bush2 and now Obama, federal government spending has grown to exceed 25% of GDP. Rather than pass a balanced budget amendment, Congress needs to pass a law to ensure that total spending not exceed 20% of GDP except in the possible case of a declared war that threatens our country (Congress hasn't had the guts to do its Constitutional duty and declare war since world war II). Finally, to help keep the budget in balance over time, Congress needs to require that the federal government use the same accounting procedures as it requires that private companies use--particularly regarding the treatment of future federal pensions, social security, and medicare costs that may impact th government. It needs to stop hiding the actuarial insolvency of all these programs so that future liabilities of the federal government can be taken into account before they become overwhelming, as they presently are about to do.