HOW DID WE GET HERE?

BY

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PRESENTED TO THE CHIT CHAT CLUB

SAN FRANCISCO, CALIFORNIA

OCTOBER 13, 2008

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Good evening. First, I thank Bill Riley for introducing me to the Chit Chat Club and sponsoring my membership, and I thank all you for kindly admitting me.

During last month's meeting when Al and I were conversing, I mentioned that I was finishing a paper for next month's meeting, and so he naturally asked about the topic. I told him, "I can't give you that, but the title is, "How Did We Get Here?" So obviously the first question is what is "Here?" After an attempt to answer this question, the paper will explore the road of how we ended at "Here".

"Here" is the financial and economic dilemma in which we find ourselves as individuals and as citizens of local, state and national governmental entities. Let's look at a few examples.

A familiar phenomenon are times when so-called leaders, often called politicians, frequently communicate false information, and it's difficult to know if they do this naively or purposefully with the intent to mislead citizens in order to achieve their own personal and political objectives. Crude oil prices have increased dramatically this past year, peaking at nearly $150 per barrel and now have receded to less than $90. In response to these upward price movements, the two presidential nominees and numerous senators and congressmen irrationally shouted and cried that "speculators" were manipulating the oil futures market, without presenting any evidence. Congress held forty hearings on "speculation" this summer and threatened to "sue" foreign sovereigns for managing their own oil production and to tax oil companies for impossible to define "excess profits." Basic economic theory and every day business understanding concludes that in all futures trades, there are buyers and sellers who think the prices will go in different directions, up, down or stay the same, so one trader's gain is another's loss and that the ultimate price is wholly dependent on the actual supply from producers and demand from consumers at the time the product is contracted for delivery. The Commodity Futures Trading Commission conducted an authoritative study this summer on the drivers of the price moves by analyzing millions of trading tractions valued at billions of dollars for January to June, 2008. The study found, according to the Wall Street Journal, "index traders and swap dealers actually reduced their stake in crude oil futures as prices spiked..." The net result was that these traders retreated from the market because they collectively believed the price was going to fall and thus were "were driving the future price of oil down." The self-interested politicians were looking for a scapegoat for the rising prices in place of the real answer, the Law of Supply and Demand, a most basic concept of economics. Unfortunately, the politicians misinformed the American public and unnecessarily created trauma.

Living in the Bay Area, all of us know the tone of our daily newspapers' articles and editorials and almost every politician supports smart growth, urban growth boundaries, green belts, protecting open space, and annual limits on building permits. But, how often have you read about the costs and tradeoffs that these policies inflict on the citizens and local economies? Do you think people even think there is an impact or are even able to think rationally about the issues and weigh the benefits and costs? Well, yes, there are substantial costs. Randal O'Toole in "The

Planning Penalty How Smart Growth Makes Housing Unaffordable," evaluates its impact in a study of national scope and to make my point simply, I primarily use results from the Bay Area to delineate the impact in consideration of time. In 1969, Bay Area housing was as affordable as the nationwide average as measured by the home price-to-income ratios; thus medium-income families could spend 25% of their income for a medium-priced house. Since that time, Bay Area cities and counties implemented housing policies and growth boundaries. As a result, by the 1990 and 2000 Censuses, the Bay Area was the least affordable urban housing market in our nation and to compound this tragedy; housing prices grew 14% annually between 1999 and 2005. O'Toole estimates the "planning penalty" in 2005 increased an average house's cost $850,000 in San Francisco, $400,000 in Oakland, and $513,000 in San Jose. In 2005, according to Coldwell Banker, a 2,000 square-foot house would cost about $836,000 in Walnut Creek and $152,000 in Houston. Earlier this year while on a business trip, my commercial real estate broker and I estimated that houses in Atlanta cost only 25-30% of comparable houses in Marin County. In the event the populace understood the benefits and costs of the planning restrictions, would they make the choice between (a) to never be able to afford a home and maintain the current restrictive policies or (b) to modify policies so housing supply would increase and homes would become more affordable? Why don't people understand the Law of Supply and Demand and its implications on society and their everyday lives?

Surveys of national business executives by Development Counselors International named California as having the "least favorable business climate" among all states in its tri-annual surveys of 2008, 2005, and 2002, and the second most unfriendly business climate in its 1999 and 1996 surveys. In the 2008 survey, an amazingly high 72% of executives named California for this adverse distinction: 58% of the respondents considered California having "too much regulation and an anti-business climate", 37% cited "high costs," and 28% said "taxes". Large and midsize company executives and business location consultants all agreed on their negative opinion of California. The importance of these opinions is that taxes and ease and cost of doing business effect economic behavior, such as making California unattractive to business investment and job creation. About two-thirds of the twenty-nine states' approximately $48 billion 2008 accumulated budget shortfalls are held by the five states considered "least friendly to business." In Arthur Laffer's "Rich States Poor States" paper, California ranked twenty-ninth in the ALEC-Laffer State Performance Index for 1996-2006 based on Absolute Domestic Migration, Per Capita Personal Income growth and Employment growth. For example, the nine states with no personal income tax significantly outperformed the nine states with the highest personal income tax rates in their 1996-2006 10-Year Economic Performance: GDP increased 86% versus 62%, Personal Income Growth: 79% versus 60%, Population Growth 17% versus 8%, and Net Domestic Migration 4% versus -2%. Net Domestic Migration is an important measure because it demonstrates how people are living their true preferences and "voting with their feet" by moving from less to more desirable areas. The latest 2005 Census information reports more than 239,000 native-born Americans exited California than moved in, as also was the case for 2004 and 2003. In the forward looking ALEC-Laffer State Economic Competiveness Index, California ranked forty-first. The sixteen policy variables influencing the migration of investment and human capital in and out of states are directly created by their legislative processes. These policy variables include: first, tax rates on personal income, corporate income, property, sales, and estates, secondly, debt service as a share of tax revenue, thirdly public employees per 10,000 residents, fourthly quality of states' legal system, fifthly workers'

compensation costs, and lastly right-to-work law status. I am personally experiencing that a state's competitiveness and business friendliness effects investment decisions as I have personally moved 100% of my investable, liquid capital out of California into investments in number 2 ranked Arizona, number 8 ranked Georgia, number 9 ranked Idaho, and number 10 ranked Texas. States compete, whether or not politicians acknowledge it, with other states for investment and human capital that create jobs and new business opportunities for its citizens and its tax base. How could politicians place California in such a disadvantageous position so much so, that other states' economic develop organizations gleefully solicit businesses and residents to move to their states, even by advertising on television?

Here's a future crisis that we all know about, the unsustainable Ponzi schemes of Social Security and Medicare that transfer income and wealth from a younger generation to an older generation. Social Security was somewhat financially feasible when there was five workers for each retiree in the 1960's, but with only three workers to each retiree today and with the trends going to only two workers for each retiree in 2030, the system is financially unsustainable, as the Social Security Trustees have stated in their annual reports since the 1990's. And, Medicare is in even worst financial condition as it faces a long-term <u>thirty-four trillion</u> dollar deficit. In essence, politicians made unsustainable promises to curry short-term favor and votes from their electorate without meaningful consideration of the promises' future implications, and they continue to ignore the dire annual warning from these programs' Trustees. There is no need to outline these entitlement dilemmas in more detail as we're all familiar with them.

Economic issues are focused on because these considerations are at the center of most public policy disputes: regulation, taxes, labor law, entitlements, subsidies for farmers, alternative energy, relations and trade with other nations, and social issues like welfare, the environment and health care.

<u>How does our democracy foster uniformed opinions, predicaments, and failing policies?</u>

One common answer to this question is that politicians must satisfy the demands of "special interests" which is more important in winning the next election than fulfilling the general public's needs because elections are a weaker deterrent to misconduct than is often presumed. A position complementary to the first answer is that the typical voter is "deeply ignorant about politics" and this ignorance motivates politicians to pursue personal goals and to "sell themselves to donors."

I propose an alternative theory why democracy fails to seriously address economic issues in a rational, knowledgeable way. I attribute much of my thoughts to my oldest son's friend Bryan Caplan's book, <u>The Myth of the Rational Voter</u>. Voters are not only ignorant about economics and economic issues but confidently and religiously embrace many misconceptions that lead to irrational opinions, votes, and public policies.

First, we will review a little simplified voting theory. Most economist and political scientist conclude that the average voters' political knowledge is extremely low, as verified by numerous studies. And, it also is concluded that this condition really does not matter because democracy can work well under most any level of voter ignorance. How? Assume that 99% of the voters are

ignorant and 1% is well informed. Voting theory postulates that the uniformed will vote between two candidates on a random basis so each receives 49.5% of the vote, which is not enough to win. Thus, the candidates must focus on the 1% of well informed voters and the winner of this small minority wins the election. This process is fittingly called the "miracle of aggregation." Wow, an almost completely ignorant electorate makes the same decision as if fully informed. Unfortunately, the "miracle of aggregation" assumes that voters do not have any "systemic" errors that would bias the randomness of the votes. This underlying randomness assumption is critical to evaluating the validity of the "miracle of aggregation" and has important political and policy significance. For example, if voters choose their policy preferences on faulty models of the economy, government will perform its primary everyday tasks poorly. Figure 1 with the bell curves shows how a systemic bias moves the voters' from a socially optimal to a less than optimal decision.

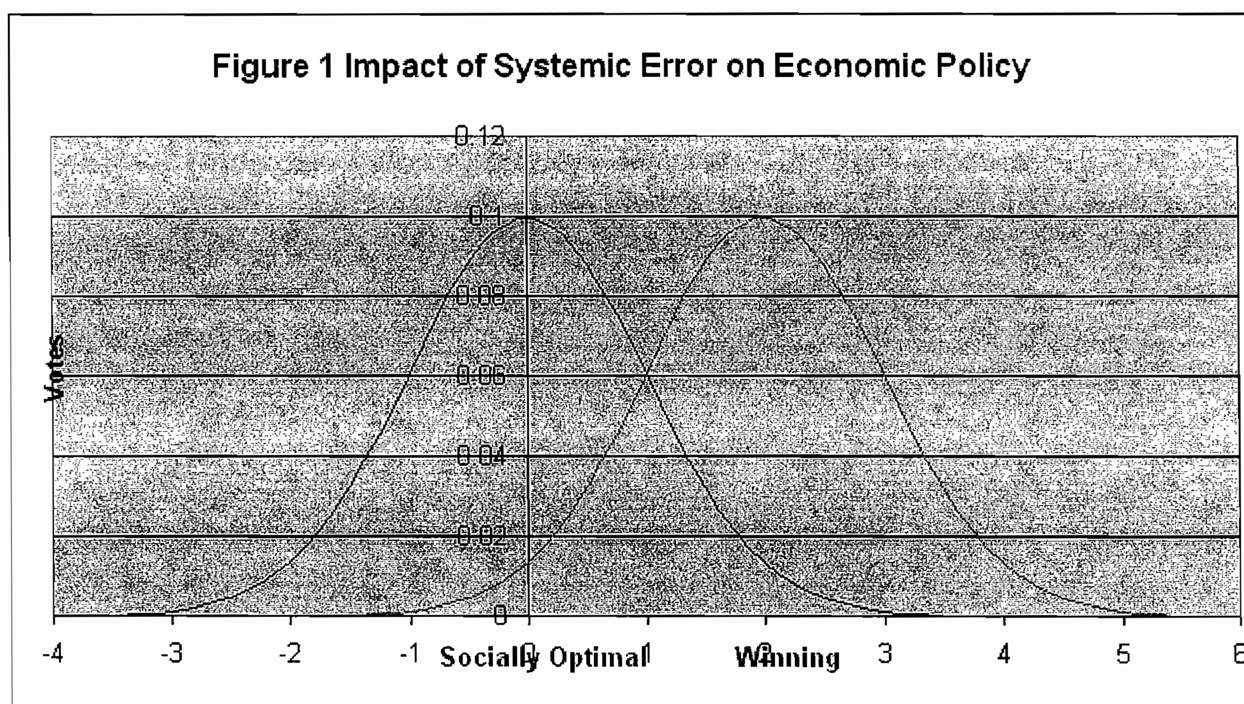


Figure 1 Impact of Systemic Error on Economic Policy

<u>Does a systemic bias exist?</u> In other words, are there differences between the economic models and beliefs about the economy between the typical voter and trained economists? The "Survey of Americans and Economists" (SAFE) completed by the Washington Post, Kaiser Family Foundation and Harvard University helps answer this question. This survey asked thirty-seven distinct questions about how the economy works to 1,150 members of the general public and 250 Ph.D. economists. SAFE verifies the conclusion that economists and the general public possess different visions how the economy operates in distinct and foreseeable ways. It is important to note that as members of the general public's education increases, the more educated individuals' opinions diverge from the general public's and align more closely to the professional opinions of the economists. We'll call this segment the "enlightened public." Economists' professional opinions are not politically biased by a right-wing perspective as most are moderate Democrats. Due to their rigorist educations, economists are people who believe in the functionality and benefits of markets but also acknowledge circumstances in which markets fail.

SAFE clearly documents four fundamental biases of the general public compared to the knowledge of the economists and the enlightened public.

The general public possesses an "**anti-market bias,** a tendency to underestimate the economic benefits of the market mechanism. The general public fails to understand how profit-seeking businesses can create beneficial outcomes for society. Typically, many politicians play this card by calling businesses "Greedy." It is human nature to look after one's self interest, as even young babies protect their rattles from siblings. This "greed" focused outlook completely disregards the discipline and social benefits imposed by market competition. The "anti-market outlook" fails to understand that successful businesses' goal is to understand consumers' current and future needs and to innovate and produce products to fulfill these needs in the most cost effective manner possible. And if a firm fails to deliver this objective, it knows it that it will fail. A truism for all modern economists is Adam Smith's concept of the "invisible hand,"

> Every Individual is continually exerting himself to find out the most advantageous employment for whatever capital he can command. It is his own advantage, indeed, and not that of society, which has his view. But, the study of his own advantage naturally, or rather necessarily leads him to prefer that employment which is most advantageous to society.

Although this thesis is a truism for economist, it remains counterintuitive today and heresy for many. Economists recognize there are conditions in which market results are less than optimum and thus formulate means to address these situations. Also, since the days of Adam Smith, economists understand it is mandatory to have effective and just rule of law, but also know market incentives undeniably motivate people to dream up new products, to reduce production costs, and to move human and financial resources from less-valued to more-valued uses.

In SAFE, respondents were asked why the economy was not "doing better than it is." As shown on Exhibit 2, the public considered "Business profits too high" as a major reason whereas this reason was not important to economists or the enlightened public. The public's error is partially a result of it wildly overestimating the typical profit margin as 50% of sales, a completely unrealistic belief. In addition, the general public is unable to evaluate a firm's profitability on more meaningful measures such as return on assets, return on equity invested, net present value, internal rate of return, or risk/return metrics. Besides being naive, there are deeper misunderstandings as the public considers profit as a "lump-sum" transfer to business. Conversely, economists consider profit as a reward for supplying the market with desirable goods for which people will trade their earnings and as a motor for progress and adaptability to a dynamic world.

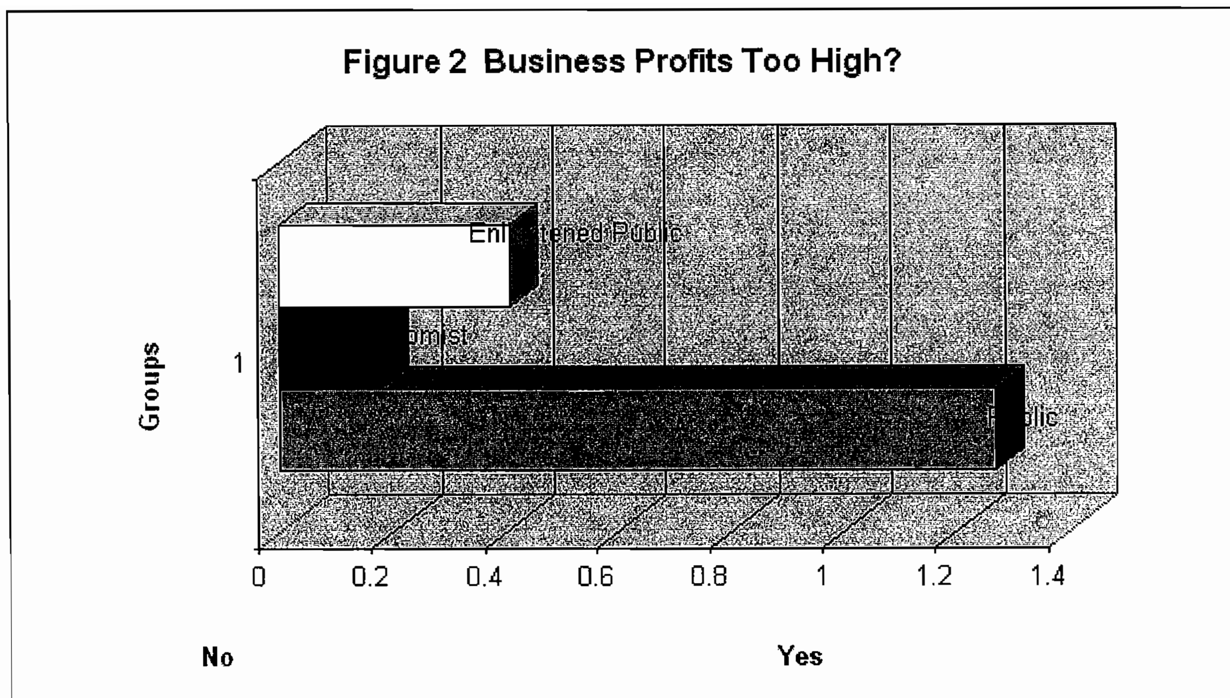
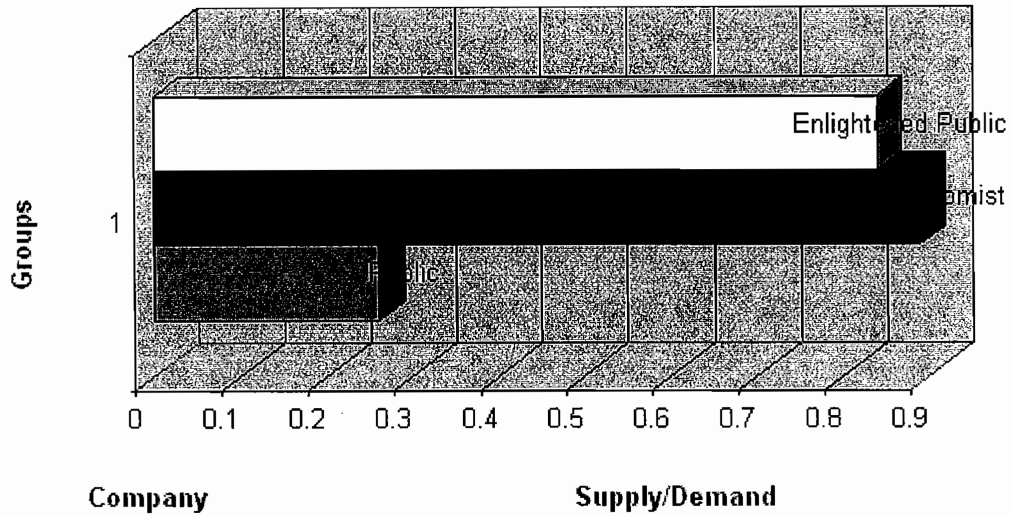


Figure 2 Business Profits Too High?

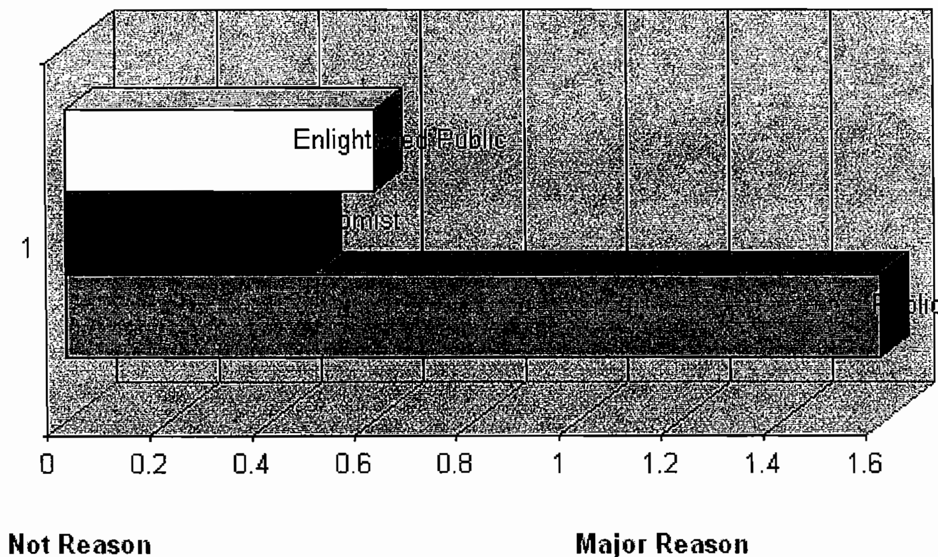
Another belief underlying the anti-market bias is that firms establish prices as monopolists and that the public attributes any scarcities to monopoly power, as many politicians did during the recent oil price fluctuations . The public finds it very difficult to accept that supply and demand usually determines prices. SAFE addressed this issue with a question, "Which do you think is more responsible for the recent increase in gasoline prices?" As you can see in Figure 3, the public attributed the price increase to monopoly or collusion whereas the economists and enlightened public credited supply and demand. Economist know that the public's theory of collusion is inoperable because collusion is a "prisoner's dilemma" and will not stand the test of time. And, the allegation that capitalist "greed" cultivates widespread "deceit, unfairness, dishonesty and discourtesy" is not possible. It is possible these behaviors will work in "one-shoot" business transactions, but these behaviors will kill an ongoing business because they will obliterate its reputation and brand as few, if any, business can succeed if no one steps in the store twice. Economists acknowledge that monopolies and oligopolies exist, as do other market failures such as the moral hazards, tragedy of the commons and public goods, for which non-markets remedies are necessary.

Figure 3 Which do you think is more responsible for the recent increase in gasoline prices?



The general public also suffers from an "**anti-foreign bias**, a tendency to underestimate the economic benefits of interaction with foreigners." Several questions in SAFE demonstrate this bias rather dramatically. When asked "why the economy is not doing better than it is," the public said "Companies send jobs overseas" as an important factor whereas the economist and enlightened public did not, as seen in Figure 4. When asked have "trade agreements between the United States and other countries helped create jobs in the U.S., or have they cost U.S. jobs, or haven't made much of a difference?", the public responded that these agreements cost U.S. jobs whereas economists, who know the statistics, and the enlightened public said U.S. jobs have been created, Figure 5.

Figure 4 Companies are sending jobs overseas



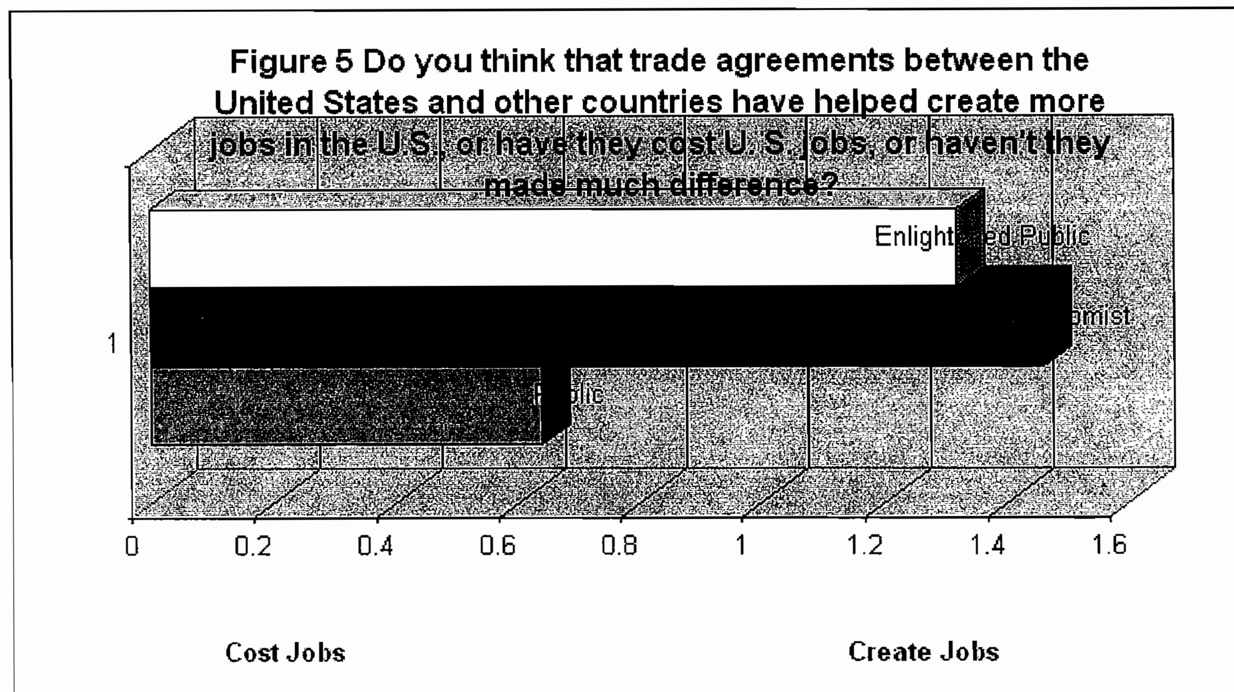


Figure 5 Do you think that trade agreements between the United States and other countries have helped create more jobs in the U.S., or have they cost U.S. jobs, or haven't they made much difference?

Economist diverge strongly from this public's anti-foreign viewpoint because it conflicts with the most fundamental economics, the Law of Comparative Advantage, and secondly, history clearly demonstrates that cities and counties developed though trade with one another from the earliest civilizations to the most recent: from the Babylonian, Egyptian, Greek, Roman, Enlightenment societies to the recent re-development of Japan, China and the dozens of other developing countries. The Law of Comparative Advantage shows that even if one nation is less efficient than another, mutually beneficial trade is still possible. Assume an American can produce 10 computers or 5 tons of apples and a Columbian can produces 3 computers or 3 tons of apples. If one American switches from apples to computers and two Columbians switch from computers to apples, the production of computers goes up by four (4) and apples increase by one (1) ton. People accept trade between different regions of the same county, between cities, and between families because all can see the advantages of the division of labor and specialization. Various groups specialize in providing food, clothing, housing, education, automobiles, legal services, roadways, steel, computers and the list goes on and on. Only when the group includes a foreign nation does an issue arise. Not understanding this concept leads to less production and poorer living standards in the world due to the implementation of counterproductive duties, tariffs, and import and export restrictions.

The general public frequently believes that it is better to use labor, even if inefficiently, than to implement labor saving technology, and "**make work bias** is the tendency to underestimate the economic benefits of conserving labor." Overall, increasing living standards for society is dependent on increasing the efficiency of the work force, in other words, the improving the "ratio of effort to result." The classic cases of the make-work bias were Luddite fear of machines and Howard Scott's "technocracy" movement during the Great Depression. Scott believed that increasing productivity would outstrip job opportunities and result in growing, permanent unemployment until capitalism collapsed. Recent fears are people's concern when companies downsize operations by implementing new technology or when automobile factories automate to improve efficiencies, decrease costs, and compete with new competitors, see Figure 6. Conversely, new technology has and will continue to displace some workers but will create new, higher productivity jobs and provide incentives for people to learn and implement new skills, as has occurred over human history. This "churn" process is often very traumatic for individuals and families, who often will need assistance but is necessary to increase our nation's competiveness in the dynamic world and our living standards. In 1800, about 95% of the work force was required to feed the county, which decreased to about 40% in 1900. Now, less than 3% is required. The Americans no longer on farms have and are continuing to create our life styles that could not have been imagined during our Club members' childhoods, much less those of our parents or grandparents.

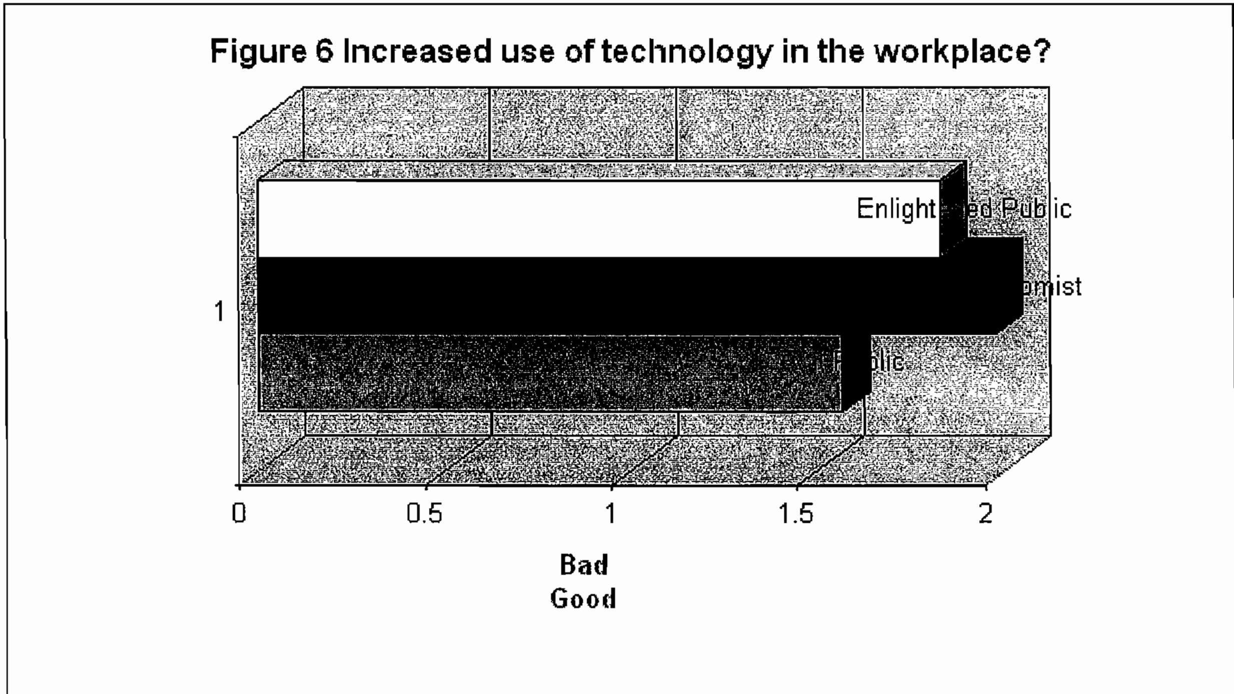
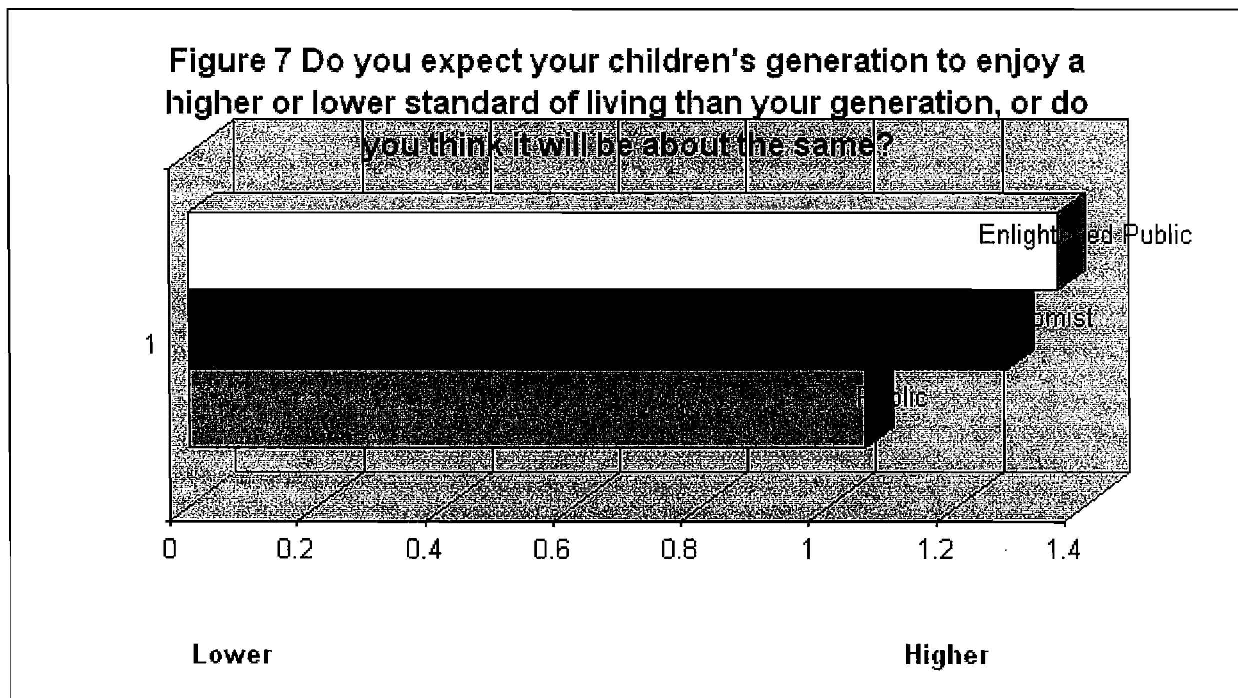


Figure 6 Increased use of technology in the workplace?

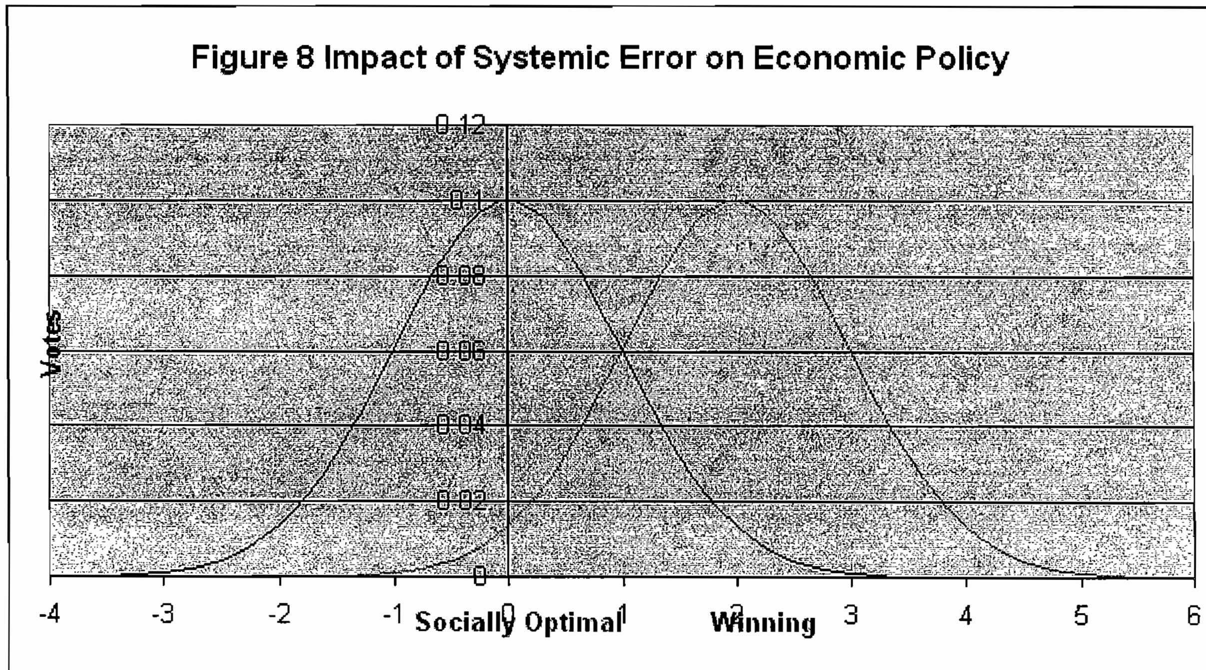
The final bias we'll review is the "**pessimistic bias**", the public's tendency "to overestimate the severity of economic problems and underestimate the (recent) past, present and future performance of the economy." The public lacks a long-term perspective and has a very short memory, a viewpoint observed by economist from Adam Smith to the present. In general, the public expects stagnation of the economy whereas economists are optimistic and the enlightened

public even more optimistic. Look at Figure 7 to see that SAFE documented this conclusion when it asked respondents, “Do you expect your children’s generation to enjoy a higher or lower standard of living than your generation, or do you think it will be about the same?” The public’s in 2006 dollars was $40,000 and grew about 50% to approximately $60,000 in 2005, not including the increases in wage earners’ non-wage benefits and the improved quality of goods. In addition, between 1980 and 2006, wages gains by women have been greater than men’s, and blacks’ wage gains that been larger than whites’. One reason for the public’s unduly pessimistic bias is attributed to people’s nostalgic memories of the past while ignoring the improvements in goods and services now taken for granted, the present pales to the “good old days.”. You probably remember as a young boy, as I do, your parents or grandparents buying you your favorite ice cream cone for five cents ($0.05), and not being able to afford buying you a milkshake for thirty-five cents($0.35). A second reason for the pessimistic bias is that people’s opinions depend on their subjective perceptions of what’s occurring in the economy instead evaluating measurable, objective conditions. The general public bases their opinions on, subjective personal experiences such as my bother-in-law is laid off, the typewriter industry I work in is losing business, or my employer’s auto factory is reducing production because it is losing business to non-union plants in southern states. The public’s negative bias from antidotal evidence is outweighed by the indisputable statistical trends measuring a dynamic, expanding economy, while recognizing there are normal business cycles and “creative destruction.”



The **anti-market bias, anti-foreign bias, make-work bias,** and **pessimistic bias** not only impact the general public’s voting preferences but also affects the elected politicians and their policy decisions. Most importantly, these biases void the “miracle of aggregation” theory, that an almost completely ignorant electorate will make the same decision as if fully informed. Instead, the voters possess a systemic bias that shifts the position of the bell curve of policy alternatives, Figure 8 so the enlightened voters no longer determine the result of an election. The decisions

are made by the uninformed general public that we now know is extremely biased and the decisions vary considerably from the economists' preferred economic policies. This shift results in irrational, populist's policy decisions for important matters involving international trade, entitlement programs, labor law, taxes, regulation, and social issues like welfare, the environment and health care. A classic example occurred this election season when candidate Obama told a blue collar Midwestern audience that when elected, he would dictate the terms of a renegotiation of NAFTA to the fellow signers, while at the same time Obama's policy advisors told Canadian diplomats in private to disregard the campaign rhetoric. Obama's oratory conveniently disregards how other nations will react to such egocentric behavior, which is to respond by in acting anti-trade measures themselves. (1)



The underlying conclusion unfortunately is that democratic government is resistant to and incapable of intelligently addressing critical economic issues until a crisis environment arises. The public in unable to intellectually understand and its elected representatives either do not understand and/or do not wish to take the risk of burning their political capital and risk reelection. We are in a crisis environment today because the political class created many moral hazards and then did not recognize the implications and did not immediately take corrective action.

(1) The classic example occurred in the 1930's when the US place a 25% tariff on eggs imported as part of the Smoot-Hawley, and Canada responded by a even more stringent 233% tariff, resulting in a US egg exports decline of about 98%, , from 11 million to 200 thousand annually.