Economic Flaws & Fallacies

Common Flaws & Fallacies Found in Economic Thought.

REFERENCE: File named: Common Economic Fallacies by Jim Berger 5-11-2007.pdf

The following comments in response to Jim Berger's assertions regarding "Austrian Enginomic" logic in the above file are organized by topic. This effort by both Jim and myself will help clarify the "Austrian Enginomic" logic; its differences with alternate macroeconomic theories, and offer guidance to enhance the theories.

Fallacies of Averages and Aggregates

Response by Russ Randall:

I believe most people grasp the mathematical average concept without difficulty. The challenges you rightfully point out are related to scope and non-homogenous goods and services. My intent is to define scope by use of the word "one". If a writer stated: "One" may remain healthy by eating, the implied scope is generally meant to include humans (many "Ones") since the beginning of their existence and into the future ad infinitum. I would rather stay with this simplistic default rather than risk attempting to define limits of scope that can move the thought process into extraneous debates.

Regarding savings = production less consumption… In an "enginomic" context, savings represents labor (work) applied to produce capital goods and services rather than consumable goods and services. It must be one or the other, otherwise it is not work that will contribute to the production of real wealth in an economic context (e.g. the work activity of cooking dinner at home is not recorded as GDP).

When I state: "On average, one cannot consume more Goods and Services than one can produce in a lifetime, assuming inventory is not depleted." it directs the analysis to "real wealth" and eliminates distortions associated with "financial wealth". If one was able to consolidate and total all "real wealth" that has been produced and sold since the beginning of human existence and into the future as far as one may care to model utilizing any defined price measuring stick, then divide that quantity by the total number of humans in the same scope of time, my conclusion is that the "average" human will not consume more goods and services than he produces assuming inventory is not depleted. To the extent comparative valuations of "real wealth" non-homogeneous units OR THE VALUATION OF THE MEDUIM OF EXCHANGE OR REPAYMENT ITSELF (i.e. MONEY as fiat currency, gold, silver, chicken feed, or etc.) vary over time, debtors and creditors will win or lose, but the axiom is still valid. I find it easier to project a model of worldwide production and consumption for the next 20 years, then from this future point in time look back over the past 20 years and ask the question: "Have we consumed more than we have produced?" Regardless of the measuring stick of value or price, or the relative valuation dynamics of non-homogenous goods and services the answer is always the same for any infinite number of models one may attempt… NO!

Aggregate Wealth

Response by Russ Randall:

I believe Carl Menger's definition of wealth that you provided does not apply in the context of "enginomics". *i.e. "Wealth can therefore also be defined as the entire sum of goods at an economizing individual's command, the quantities of which are smaller than the requirements for them".* Carl's definition excludes delivered services, which I regard as "real wealth". They require work or natural resources, are sold, and are recorded as Output (GDP).

Generally, I agree that there are many flaws in attempting to measure wealth or output. To minimize these flaws I utilize ratios and percentages whenever possible (e.g. debt relative to output, year-to-year output increase per unit of labor, etc.). Thus, if the magnitude of a government data flaw were consistent over time, then the comparison would be reasonably valid in a relative (ratio) context.

Aggregate Debt

Response by Russ Randall:

To grasp physical real limitations to debt that may possibly be repaid an aggregate summary of debt must be recognized. All debt must have terms (e.g. period, interest rates, etc.) and a defined medium of repayment (e.g. dollars, oz. of gold, etc.). A bondholder believes he is going to receive his entire principle plus interest over time as repayment for his initial sacrifice to purchase the bond. If there is no defined creditor committed to transfer an incremental unit of wealth (e.g. a taxpayer who is of the mindset "taxes will not be increased") to the bondholder for repayment, or a defined reduction in government spending elsewhere, then the bonds are an illusion of wealth and may as well have been "dropped from heaven".

A great example of this illusion is the Alternative Minimum Tax (AMT). The Congressional Budget Office (CBO) is required to forecast via static budgeting methodology. Therefore, if existing law includes a six-fold increase in the number of taxpayers subject to the AMT this year (2007), then the CBO budget projections will assume the associated massive increases in tax revenues. The reality is the AMT has been modified regularly to effectively push the dramatic increase out each year. There were 3.5 million taxpayers subject to the AMT in 2006. If the regular ritual of AMT modification does not come to pass, approx. 23 million taxpayers will be subject to the AMT this year (2007) inevitably triggering a tax revolt. It would be political suicide for Congress and the White House NOT to follow through with the AMT delay "ritual". On the one hand, the bondholders believe their Treasury bonds guarantee real redemption (i.e. expecting the AMT tax will increase dramatically). On the other hand, the taxpayers (i.e. NOT expecting the AMT tax will increase dramatically) have been promised "no tax increases" and would certainly reject a surprising incremental AMT increase, if they were subject to it. Finally, with their hands tied by statute, the bean counters in Washington are merrily doing their jobs forecasting a balanced budget by 2010, hence delaying the discovery of the illusion. The magnitude of bonds associated with the anticipated increase in AMT revenues may as well have been "dropped from heaven" as there are no taxpayers committed to repay them via future tax increases.

Mises distinguished between two types of credit: "commodity credit" and "circulation credit." Given an unchanged stock of money in the economy, credit represents a transfer of money from one market agent to another; overall monetary demand does not change. If, however, the increase in credit is accompanied by a change in the money stock which, in turn, is decoupled from the economy's productive capacity (as is usually the case under a government-controlled money-supply regime), the granting of credit de facto increases the monetary demand over existing resources ("circulation credit"). See Mises, L. v. (1996), <u>Human Action</u>, 4th Revised Edition, Fox & Wilkes, San Francisco, pp. 433.

In the AMT example "commodity credit" and "circulation credit" are decoupled. In my view the "circulation credit" (government issuance and sale of bonds backed by nothing) does not represent real wealth.

Aggregate Inflation

Response by Russ Randall:

Given fiat currency, any increase in the monetary base will provide a root cause for inflation. I certainly agree that the injection of the incremental money into the general economy is NEVER uniform, thus necessarily distorts pricing and signals for business calculations. Aside from the malinvestments launched from these monetary machinations, there will be an aggregate impact of more money chasing fewer goods. Whatever form and quantity the goods and services may take, if the monetary base and associated monetary aggregates increase at a faster rate than the goods and services output, inflation will result.

Comment About Fallacies of Averages and Aggregates, & Fallacies in Value & Pricing, & The Subjective Theory of Value

Response by Russ Randall:

It is important to separate values (precisely because it is subjective and speaks to individual motive, purpose, etc.) from price (result of an exchange agreement consummated between buyer and seller). As I have stated and written many times, my focus is upon price. I utilize the "white elephant party" story to contrast the difference between value and price. Such parties are useful, but do not create or increase real wealth in an "enginomic" context.

Pricing and Catallactics

Response by Russ Randall:

Money and all financial assets are at best contracts to acquire real wealth. They are not real wealth. If we lived in a fully backed currency with no fractional reserve (e.g. gold is money), then valuations and economic calculations would be based upon real-wealth money rather than wildly fluctuating massively manipulated fiat currency and financial assets. Since we live in a fiat currency world today, the method I attempt to consistently apply is to analyze in ratios. If, for example, Debt cannot increase greater than Output in the "real economy", then financial debt incurred in excess of output represents the magnitude of the illusion of wealth for the creditors. I will often utilize reported asset market values and compare them to fundamentally calculated values to enable absolute dollar comparisons that offer a perspective of the distortion magnitude.

Fallacies in Systems Thinking

Confusing Causal Relationships

Response by Russ Randall:

If we fully backed currency with a commodity, then the assumption I often make to be conservative is that as productivity increases, the volume of commodities increases as well. If, for example, the monetary backing is gold, then the supply of this "money" may expand as well. Thus, if the employment hours increased 2% due to a population increase, and the productivity increased 2%, then logically the "money" supply might expand 4% in concert with all other goods and services. Further, a 4% increase in total market capitalization would be rational. In this case inflation would be "0" assuming total credit market debt maintained a logical relationship with Output.

Clearly, gold's scarcity and the increasing barriers to its extraction will prevent its output from keeping pace with the output of all other real wealth production increases. Thus, if gold is the money, then nearly all other goods and services will decline in value relative to gold. The result is a healthy market-driven deflation adjustment.

I believe productivity, employment hour changes, and monetary aggregate changes are independent drivers of the economic output and asset valuations, and can be analyzed as such by modeling independently or in aggregate. Also, see the next series of comments regarding government's calculation methodology (basket of goods) of inflation.

Reinforcing and Balancing Processes

Response by Russ Randall:

In reviewing your graphs I believe, if you injected incremental money into the markets via monetizing debt (monetary base increase), and did not expand credit, the total money in the system chasing the same level of goods would remain at the higher level, hence a predictable total inflation rate. Will the first point of monetary injection, say house prices, increase sooner than the second or third areas affected (shirts, suits, etc.)? Yes, they will be relatively distorted until the economy has balanced the impact of the monetary injection. In either event the overall aggregate inflation rate will be the same.

Government assumes an increase in the base money supply and credit equal to a combined increase in employment hours and productivity as "0" inflation because they utilize a "basket of goods" calculation methodology. e.g. If employment hours increase 10% and the associated output increases 10%, and the money supply and credit expanded 10%, prices would remain the same, or 0% inflation. Alternately, if productivity, the associated output, and money and credit all increased 10%, then again prices would remain the same (0% inflation). I ACCEPT this basis of logic because it has a close parallel to use of a real wealth commodity as money in my non-fiat analyses. It also enables me to utilize government CPI and GDP deflator data directly. I do not agree with their logic in calculation inflation metrics, but ACCEPT it for the reasons noted.

Regarding the 1985 starting point on my graphs… I needed a logical starting point from which to measure imbalances. Through my research, I concluded 1985 was a point in time where U.S. stock and Real Estate valuations were not in an overvalued (bubble) condition. The bond market was already in a bubble but data prior to 1985 was limited for my analyses. Therefore I compromised upon the 1985 as a reasonable starting point. Yes, during the 70's inflation "went crazy", but most asset valuations "went crazy" along with it. Then by 1985 markets and monetary expansion were more stable

Comparing Stocks (Levels) and Flows (Rates)

Response by Russ Randall:

The reconciliation evaluations are in their infancy. The logic you offer will be helpful guidance.

Fallacies in Understanding Freedom

Response by Russ Randall:

Well stated…. I am certainly an advocate of freedom. However, my interest is to ensure transparency and integrity. ***Assuming we have government***, the expense for it must be budgeted and levied in a fashion for all citizens to see and openly judge. The real, irreversible tax upon society is the actual work activity directed to a government purpose. I believe this must be visible to taxpayers. The noted "work activity" has a high correlation to government spending; hence government spending is the real tax imposed upon the society at the time it occurs. The distribution of the tax burden should be in the same time period as the real tax is experienced except under extraordinary circumstances (e.g. WW II). If such circumstances warrant issuing and selling bonds, then government must announce the plan for increasing taxes later (or reducing planned expenditures; hence services) to collect revenue and fully compensate the Treasury bondholders in real terms.

Your note: "…the power to tax", to me is synonymous with "the power to spend". I believe an honest and more effective means to limit this insidious looting is to first recognize it. A balanced budget could aid in this effort.