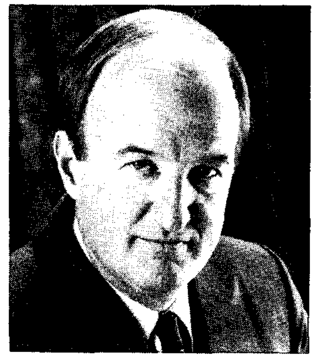
The Age of Confusion



"There's a great deal of agreement among economists, contrary to what people may think."

—Milton Friedman, interview in *Reason*, June 1995

Is the economics profession moving toward consensus or away from it? In a recent interview in *Reason* magazine, Professor Friedman happily proclaims that most economists agree on certain fundamentals. "You won't find much difference of opinion on the proposition that raising the minimum wage will cost jobs. You won't find much difference of opinion on the desirability of free trade."

I wish Professor Friedman were right, but unfortunately, I'm afraid the profession is moving further away from consensus toward an Age of Confusion. Judging from recent conflicting studies, they apparently can't even agree on the evils of the minimum wage and protectionism.

Will increasing the minimum wage cost jobs? Economic theory asserts that if you raise the cost of labor, the demand for workers will decrease. Yet in a recent study of the minimum wage at fast-food restaurants in New Jersey and Pennsylvania, economists David Card and Alan Krueger claim just the opposite. Surprisingly, they conclude, "We find that the increase in the minimum wage increased employment."[1] Both teach at Princeton University, and Professor Card was recently honored with the John Bates Clark Award for the most outstanding economist under the age of 40. The article has created a furor, however, with counter-studies questioning the reliability of the Card-Krueger data, which was based entirely on telephone interviews with restaurant managers. A similar study based on actual payroll records contradicts the Card-Krueger conclusions.[2] Nevertheless, the Clinton administration's support for an increase in the minimum wage is based in part on the controversial Card-Krueger study.

Academic economists are also taking pot shots at another sacred cow, the virtue of free trade. A recent work by Paul Bairoch, professor of economic history at the University of Geneva, claims that protectionism is not at all bad and in fact has generally had a positive impact on economic growth. After surveying the relationship between tariff rates and GDP data for industrial nations since 1846, he asserts that many industrial nations often suffered recessions when free trade was adopted and recovery when protectionism was imposed. Great Britain is the only major exception, he notes.[3]

The Flaw in Empirical Studies

The problem with these historical studies is not just the data, but the whole issue of linking one set of data with another. In logic, it's known as the *post hoc ergo propter hoc* fallacy. Just because one observation occurs at the same time as another doesn't necessarily mean one causes the other. It is sheer folly to isolate one factor among the complex mix of factors playing a role in economic activity. Correlation does not mean causation.

For example, several years ago, in the

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midst of a recession, the state of Utah raised taxes. Since then, the economy has boomed. Did the tax increase cause the recovery in the Utah economy? In fact, it was outside forces that stimulated economic growth—in particular, a huge transfer of people and wealth from California to Utah and other Western states. Earthquakes, bad weather, crime, taxes, and a host of other problems caused Californians to flee the state. California's loss was Utah's gain. In other words, Utah recovered in spite of, not because of, the tax increase. No doubt Utah's economy would have grown faster had it not raised taxes.

The debate over deficit spending is another example of the *post hoc* fallacy. Sound economic theory states that deficit spending by the federal government raises interest rates and crowds out private investment, thereby retarding growth. Yet apologists for the deficit, including some supply-siders, use the 1980s to repudiate this view. During the 1980s the deficits ballooned but interest rates fell. Therefore, they argued, deficits don't matter.

They miss the point. Crowding out still took place. The economy could have grown significantly faster in the 1980s if government spending had been cut sharply, eliminating the deficit and even running a surplus. Interest rates could have fallen much more than they did, thereby stimulating more growth.

The Battle Enjoined

Back to the minimum wage issue. Even if we accept as valid the data from Messrs. Card and Krueger, how is it possible for employment to rise following an increase in the minimum wage? One possible explanation—and I emphasize the word "possible" because there could be a variety of explanations—is that New Jersey raised its minimum wage in early 1992, just when it was emerging from a recession. A sufficiently strong recovery in the New Jersey economy could easily mask the ill-effects of an 18 percent jump in the minimum wage.

Similarly, in Professor Bairoch's defense of protectionism, the fact that Great Britain is a glaring exception to his thesis demonstrates the complexity of the issues involved. Interestingly, he chooses the period 1870–92 in the United States as his best example: the U.S. increased its protectionism while enjoying one of the most rapid periods of growth in its history. Yet he forgets that 1870–92 followed after a devastating civil war, where no growth occurred at all and over 600,000 soldiers lost their lives. During the post-war environment, the federal government shifted from an inflationary greenback period to a gold standard, interest rates fell sharply, the population grew rapidly, transportation exploded, and manufacturing output increased dramatically. How can Professor Bairoch tie tariff legislation to the vast changes in economic activity during this period, especially given the relatively small role of foreign trade in U.S. output?

Beware of False Relationships

The above challenges to free-market fundamentals demonstrate a serious flaw in the way some economists conduct their research. As I have shown, trying to prove or disprove a theory through empirical observation is highly problematic. It was Ludwig von Mises who first raised this fundamental methodological issue. "The truth is that the experience of a complex phenomenon . . . can always be interpreted on the ground of various antithetic theories."[4]

Laboratory experiments are proper in the physical sciences, but they are practically impossible to duplicate in economics. History cannot prove a theory, only deductive logic can. □

1. David Card and Alan B. Krueger, "Minimum Wages and Employment: A Case Study of the Fast-Food Industry in New Jersey and Pennsylvania," *American Economic Review* (September 1994), p. 792.

2. Richard B. Berman, "Dog Bites Man: Minimum Wage Hikes Still Hurt," *Wall Street Journal*, March 29, 1995.

3. Paul Bairoch, *Economics and World History: Myths and Paradoxes* (University of Chicago Press, 1993), pp. 44–55.

4. Ludwig von Mises, *Human Action*, 3rd ed. (Regnery, 1966), p. 41.

BOOKS

The American Economy in the Twentieth Century

by Gene Smiley

South-Western Publishing Co. • 1994 • 442 pages • $38.85

Reviewed by Mark Skousen

Uncork the champagne! It's time to celebrate! The first free-market economic history textbook is now available for college students. *The American Economy in the Twentieth Century* is written by Gene Smiley, economics professor at Marquette University, and published by South-Western, a major college textbook publisher.

There is much to applaud. Smiley's textbook is lucid, interesting, well-documented, and replete with charts and graphs.

Professor Smiley views it as a supplemental text because it covers only the twentieth century. But, as any student knows, pre-twentieth-century economic history is somewhat dry, and most professors don't spend enough time on the twentieth century, where the hot issues of economic theory and government policies surface.

Smiley doesn't just recount economic history, he addresses all the major debates. He does a masterful job of expounding on the theories and policies surrounding the two world wars, the Roaring Twenties, the Great Depression, and the post-war modern economy, giving fair treatment to all points of view.

What makes this text so different from all others? Lots of things. I particularly like chapters six through eight on government intervention in the economy during the critical period 1920–40.

- Chapter 6, "The Role of Government, 1920–1940: Monetary and Fiscal Policies and the New Deal," reveals new research on the booming 1920s, the evolution of monetary policy under a flawed international gold standard, and the pros and cons of the New Deal.
- Chapter 7, "What Caused the Great Depression?," is the most comprehensive piece ever written on the subject. It includes a full Austrian explanation, normally missing from standard textbooks. But it doesn't shortchange Monetarist, Keynesian, and other explanations. Instructors need not be concerned about bias in this textbook. Smiley really does offer equal time for all schools of thought. Moreover, he doesn't ignore any of his critics, a chronic disease among many academics.
- Chapter 8, "The American Economy During the 1940s," includes new research questioning the magnitude of the recovery during World War II, based on breakthrough research by historian Robert Higgs and others.

In addition, Smiley gives an objective analysis of public-sector unionism, the agricultural shortages and energy crises of the 1970s, and the farm debt and banking crises. In all these controversial issues, the author focuses on the role of government.

I also found fascinating his extensive coverage of the dramatic changes in technology and industry during the twentieth century. He has an entire chapter on the communications revolution, including radio and TV, often overlooked in mainstream textbooks. Another chapter is devoted to developments in retail trade. He covers finance, banking, international trade, labor, agriculture, and manufacturing. Finally, Smiley has a thought-provoking chapter on the distribution of income.

I recommend this textbook to all economic historians and students who desire a full and fair examination of what Paul Johnson labels the century of "superpower and genocide" and Carroll Quigley calls the generation of "tragedy and hope." □

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Taxation and Confiscation

with an introduction by Hans F. Sennholz

The Foundation for Economic Education, Irvington-on-Hudson, New York • 1993 • 208 pages • $14.95 paperback

Reviewed by Daniel J. Pilla

Washington lawmakers are slowly beginning to admit a fact many of us have known for some time: our tax system is broken beyond repair. The grumblings have led to a stream of major tax-change proposals such as I have not seen in 15 years. Some advocate a flat tax, and