

Chapter 2

Micro: Supply and Demand in the Product Markets

“A cool-headed analysis indicates that the minimum-wage debate centers primarily on issues of interpretation rather than fundamental disagreements on empirical findings” (S&N p. 78). The actual cool-headed analysis indicates that this is a sensitive issue that turns on ideology and on which model one applies to the problem. In their analysis, S&N use a perfectly competitive model without any imperfections (in their Fig. 4.12, p. 79). Of course, that model is completely irrelevant to the current economy insofar as there are hardly any perfectly competitive markets left. Thus, an oligopolistic model would have been the correct model to use in their analysis.

Today, the low-wage employers are almost all oligopolies such as in the fast-food industry or the “big box” stores such as Walmart, Target, or Lowe’s which earn a lot of profits. In such an oligopolistic market, an increase in the minimum wage comes out of profits and does not lead to unemployment.¹ Hence, an oligopolistic model would have been called for. It is as simple as that.

Besides, their own evidence indicates that the minimum wage has had no discernable effect on even the unemployment of teenagers, who are the least skilled and the most likely to be affected by the minimum wage laws. According to S&N’s own evidence, the minimum wage relative to manufacturing wage was halved between 1947 and 2009 (p. 78). Put another way, manufacturing wage increased twice as fast as the federal minimum wage and instead of lowering the unemployment of teenagers as one would infer from S&N’s theory (Fig. 4.12), teenage unemployment increased substantially relative to the overall unemployment rate: by about 25 %. Thus, a halving of the effective minimum wage was accompanied by a 25 % increase in teenage unemployment contradicting the deleterious theoretical effect of a minimum wage S&N described in Fig. 4.12. However, instead of pointing this out they obfuscate the issue: “There was a slight upward trend in the

¹John Schmitt, “Why Does the Minimum Wage Have No Discernible Effect on Employment?,” Center for Economic and Policy Research, February 2013. <http://www.cepr.net/documents/publications/min-wage-2013-02.pdf>, accessed February 23, 2013.

relative unemployment rate of teenagers over this period. It is worth examining the pattern of changes to see whether you can detect an impact of the minimum wage on teenage unemployment.” (p. 79) In other words, they skirt the issue and leave it up to the students to interpret the graph rather than being forthright. And a 25 % increase should not be described as “slight.”

“Inefficiencies associated with the minimum wage” (S&N p. 79). S&N claim to be scientific and promised to tell the students the truth but instead they mislead and obfuscate at every turn to suit their ideology. This is an excellent example. The matter of fact is that: There does not have to be any inefficiency associated with the minimum wage at all. That is a myth. There may be, but it does not *have* to be. That makes a world of a difference. Their analysis of the minimum wage would be applicable to a perfectly competitive labor market and with full employment. Of course, if that were the case and the wage were increased, the demand for labor would decline creating unemployment. But the last time we had full employment was in 1944! That was a long time ago. In other words, the model they apply is irrelevant to today’s economy.

Besides, the inflation-adjusted federal minimum wage has been decreasing and there is no evidence at all that employment has increased as a consequence. The federal minimum wage peaked at about \$10 in the late 1960s (in 2009 dollars) but is now merely \$7.25, a decline of some 27 %. This is so low that it is not even binding inasmuch as many states and municipalities set the minimum wage above the federal level.² Seattle just passed a minimum wage of \$15 in the city.

Minimum wage laws basically redress to a tiny extent the power imbalance that exists in the labor market with endemic underemployment. The surplus labor implies that there is a perfectly elastic supply of workers and oligopolies can take advantage of that situation and squeeze the wage to subsistence level. Thus, raising the minimum wage merely redistributes income from the shareholders of the corporations to low-skilled workers. In today’s economy in which inequality is rampant, such a policy is most certainly justified.

Discussing price controls at a time of gasoline shortage S&N suggest that: “If the free market were allowed to operate, the market would clear with a price of perhaps \$3.50. Consumers would complain but would willingly pay the higher price rather than go without fuel” (S&N p. 80). It is absurd to jump to the conclusion that consumers would be willing to pay the higher price without providing any evidence whatsoever to support that assertion. To be sure, some would be able to afford the higher price but others would not have the money to do so. Admittedly, the market might work better if incomes were equally distributed but that is far from being the case and as a consequence, the increase in the price of fuel would hurt the poor much more than it would the wealthy. Again, S&N show no sympathy whatsoever to the plight of the poor. As a matter of fact, there are no poor people at all in their models although there are no less than 45 million poor in this country, hardly a slight oversight.

²The minimum wage in San Francisco is \$10.55 and in Seattle it is \$15.00.

S&N continue by suggesting smugly that politicians would “fret” about the high prices of gasoline. Yet, these are legitimate concerns, because at a time of national calamity it is not fair to have the rich more advantaged at obtaining gasoline than the poor for whom a rise in gasoline prices can be a painful development. Hence, the concerns of the politicians are legitimate. Letting queuing up for gasoline do the rationing is much more democratic in such an emergency, because time is the only resource that is distributed equally. In contrast, money is extremely unevenly distributed.

Obviously, letting market processes do the distribution in such an emergency favors the wealthy unduly unveiling the imbedded hidden biases of mainstream thinking. Hence, depicting government’s helping the poor as “interference” (p. 79) in the free market is a distorted interpretation of the problem. Price controls on necessities such as gasoline are legitimate in a market in which there is a skewed distribution of income, particularly if other policies to redress the inequalities are not open to the policy makers.

In other words, even if S&N deny it, market processes are by no means above ethical consideration. Besides, the repeated use of the pejorative term “interference” is demeaning to what governments legitimately do to redress imbalances created by markets and to modify the unacceptable outcomes. The government is not some booby man. Actually, we are the government. It is an institution that represents our common interests. These include protecting us from those market forces that are morally unacceptable. In this instance, the government instituted price controls in order to protect the poor.

In stark contrast, S&N suggest that “Waste, inefficiency, and aggravation are likely companions of such interferences.” This is disingenuous as they disregard the frustration and aggravation of the working poor if they were unable to get to work, because they could not afford to buy gasoline. Waste and inefficiency would arise with the free market solution as well. So aggravation is unavoidable. The question is how the aggravation is going to be distributed in the society and it is clear that with a price ceiling the aggravation would be more evenly distributed among the social classes. But as mentioned above there are no poor people in S&N’s analysis. How can they overlook 45 million people?

“We also will learn how to measure the benefits that each of us receives from participating in a market economy” (S&N p. 84). Misleading again, because everyone does not receive benefits from the market economy. Instead, for a substantial share of the population it erects many impediments and affords only disadvantages especially for those who are born on the wrong side of the tracks, or the wrong skin color, or without an inheritance and are subsequently disadvantaged or even excluded from the labor market for lack of adequate education and because they have little to nothing to offer the markets. In other words, the market confers benefits to those who have something to offer to the markets: education, good looks, skills, talent, or money. The disadvantaged do not have any of these attributes and are therefore treated by the market as outcasts.

In addition, there are many uncertainties associated with the free market economy that create anxiety in its participants. For instance, the threat of volatility of

recessions and unemployment is a major source of psychological instability. Furthermore, participants in the free market have to bear many risks as far as their education, employment, health, and retirement are concerned and this induces a feeling of insecurity that often borders on hopelessness and is responsible for many of the stresses that impinge on our life satisfaction. College students have a great deal of anxiety because they typically graduate with a debt of \$25,000 and are insecure about their job prospects and about their future. So the free market economy induces many anxieties that are completely overlooked in standard treatments of the discipline such as that of S&N's.

“...utility is a scientific construct that economists use to understand how rational consumers make decision” (S&N p. 84). There goes the “scientific” hype again. However, the statement has nothing to do with being scientific; it is merely a disingenuous way to disguise an assumption. In addition, it is biased, because it overlooks the inconvenient *truth* that psychologists have proved with innumerable experiments that we humans are not rational at all. Conceited perhaps, but not rational. No less than two Nobel Prizes in economics were awarded in economics to scholars for showing definitively that consumers were incapable of being rational—not even close: Herbert Simon and Daniel Kahneman. By ignoring Simon completely and mentioning Kahneman only in passing, S&N reveal their biases clearly.

Decades ago Daniel Kahneman and Amos Tversky proved that human beings are incapable of being rational for a number of reasons including the role intuition plays in decision making. In addition, Pavlovian conditioning, cognitive limitations (IQ), and numerous biases obstruct our thinking. Our unconscious mind, discovered by Sigmund Freud, also has an important impact on our actions; yet we do not have access to the content of our unconscious mind. That means that our prefrontal cortex controls only lightly the commands that our unconscious mind imposes upon us. Furthermore, many of our choices are merely a conditioned response to a stimulus the origin of which is unknown to us. We may not know that we like McDonald's hamburgers on account of the fact that we associate them with the toys we received there when we were toddlers. Our current choice is a conditioned response to the stimulus of years ago.

Furthermore, most of us are incapable of analyzing complex problems particularly when uncertainty is involved and when time constraint is pressing. And almost all economic decisions involve some degree of complexity and uncertainty which are completely left out of consideration in S&N's trivial examples. Hence, when people were speculating that the interest rate on their mortgages would not increase, they were not even close to being capable of estimating the probabilities necessary to make such a decision on a rational basis. Instead, they followed rumors, hunches, rules of thumb, or the advice of a banker or a real estate agent who appeared reliable; some acted impulsively, intuitively, or merely copied what their neighbors were doing with dire consequences.

Kahneman has shown convincingly that in complex situations we rely on heuristics such as rules of thumb or use intuition to make decisions. In other words, our prefrontal cortex is not always in command of our decisions. Moreover, we tend to make biased assessments of uncertainty; we become confused when stressed for

time, have limited self-control, and are biased toward the present. Which 20-year-old thinks that she will need a retirement income someday? In other words, rationality was not the outcome of our evolution. Our brain just needed to be good enough to ensure our survival and reproduction but we did not need to be rational for that.³

Human thinking is biased in numerous ways. We do not always react to the same facts the same way. Our choices depend on how the facts are presented. Such “framing” effects are important. Context matters. When an attractive model is standing by a new car, it makes a difference in our desire for the car because of the unconscious association with reproduction and we are generally not even aware of the association. There is no logical reason to associate a new car with attractive women but marketers know of the advantages of doing so. In short, context can provide stimulus to affect our mood and turn the decision from a rational to an emotional one. The inescapable implication is that preferences and our decisions are affected by irrelevant features of the product such as who is advertising it which is not rational at all.

Notice, however, that S&N’s convoluted formulation does not really say that people are rational even if that is how most students would read the sentence. Instead, they state merely that that is the way economists “use” the construct; hence, their endorsement of rationality is not direct but implied. This is their way of skirting the issue of rationality but would mislead all but the most astute students and is therefore deceiving their readers. They can always claim that they are only reporting what economists think about this issue and they can report that without actually endorsing the strategy. Furthermore, they state that that economists use the concept of utility in order to “understand how rational consumers make decisions.” Reading literally the statement makes one wonder what concepts do economists use in order to understand the decisions of those consumers who are not rational.

“...we assume that people maximize their utility, which means that they choose the bundle of consumption goods that they most prefer” (S&N p. 84). More than a half a century ago, Herbert Simon showed convincingly that people do not maximize a phantom utility function and received a Nobel Prize for it. Rather, he demonstrated that people seek to find a satisfactory solution to whatever problem they need to solve. In other words, we do not seek the best possible outcome—because that is too difficult and therefore unattainable for mortal souls. Rather, we seek an acceptable outcome. The two methods are very different. The best is satisfactory but that which is satisfactory may not be the best and usually is not and may be even far away from being the best. Given the limitations of our brain to process information, the limits of time available to us, extensive search costs and other transaction costs, and the myriad other impediments to acquiring information, we are content when we attain a solution that is at least acceptable to us. Trying to

³See his Nobel Prize Lecture, December 8, 2002. Daniel Kahneman, Maps of Bounded Rationality: A Perspective on intuitive Judgment and choice. <http://nobelprize.org/mediaplayer/index.php?id=531> accessed October 8, 2014.

maximize would get us bogged down in everyday life, would be frustrating, and ultimately would lead to paralysis because we would become catatonic. Survival in evolutionary time required that we can make decisions quickly with little information and lot of uncertainty. There was no time to contemplate for long whether the approaching band was friend or foe; one had to make a quick judgment and act quickly. Rationality would not have helped much in such situations.

Simon called this method “satisficing” or seeking a satisfactory solution. His model is much more realistic than the maximization approach S&N assume. It is a pity that his ideas are not even mentioned even though a survey article suggests that “Psychology and economics provide wide-ranging *evidence* that bounded rationality is important.”⁴ It is not scientific to perpetuate ideas that have been disproven.

There is yet another serious problem: We need to distinguish between expected and realized utility. Conventional theory assumes that when consumers purchase a product, say, a hamburger for \$4.30, they receive at least \$4.30 worth of utility from them. This is not the “utter truth,” because the item was paid for before it was consumed. In other words, at the time of the transaction the consumers do not yet know the utility they will receive from them. That utility has to be forecast. To be sure, they expect to receive at least \$4.30 worth of satisfaction from them, but it may not be realized. Upon consumption, the satisfaction can turn out to be different from that which was anticipated. Hence, the amount one spends need not be equal to the amount of utility received from an item and this is another reason why income ought not to be equated with welfare. The gap between expected and realized utility may have increased over time and this may well be one of the reasons why happiness has not increased in unison with the increase in income.

One of Kahneman and Tversky’s main discoveries is that absolute levels of utility are much more difficult for individuals to ascertain than changes in utility. Conventional theory claims that a smart phone will yield one a given amount of utility, i.e., that there is a one-to-one relationship between the level of consumption and the level of utility. Kahneman and Tversky have refuted this, however. Our judgment on how we value an iphone depends crucially on a reference value such as whether our peers possess one and whether we had become adapted to the use of a smart phone. In other words, the utility obtained from an iphone is not immutable. Rather, the utility derived from it is relative to a reference value or a social norm. In a sense, Kahneman and Tversky did for economics what Einstein’s theory of relativity did for physics. Before Einstein people thought that time was absolute but Einstein proved that it was relative. Similarly, Kahneman and Tversky demonstrated that utility is not a constant and levels of consumption are not the conveyors of utility; the conveyors of utility are the changes in those levels.⁵ So if consumers have adapted to having a smart phone the possession of an iphone would not yield

⁴John Conlisk, 1996. “Why Bounded Rationality?” *Journal of Economic Literature*, 34, 2:669–700.

⁵YouTube video, “NBR Interview with Daniel Kahneman: Your Mind and Your Money,” from an interview televised by PBS on October 19, 2009, posted by “PBS,” November 6, 2009. <http://www.youtube.com/watch?v=rZUyIXXJbHE> accessed October 8, 2014.

as much utility as if they were not accustomed to having one and no one else in the society had one. In sum, the level of consumption people are adapted to plays a major role in determining the amount of satisfaction obtained from a product. This does not refer to goods that satisfy a basic need, which are essentially different. The utility derived from their consumption is absolute inasmuch as hunger and thirst has its own gauge and does not depend on external social or cultural factors. My hunger is not mitigated by the hunger of others the same way as the utility derived from the possession of iphones is.

“We know that people make mistakes. People sometimes buy useless gadgets or are bilked by unscrupulous sales pitches” (S&N p. 88). In that case, why assume that people are able to maximize utility? S&N allude to Kahneman’s and Akerlof’s work in this short aside, but do not weave their findings into the rest of the text: Asymmetric information and bounded rationality are disregarded. But those are extremely important factors in the real existing economy. In the presence of imperfect information—which is to say practically always—markets are not generally efficient. And if people are hurt by predatory business practices, then it behooves us to try our best to mitigate them through consumer protection.

“a consumer will achieve maximum satisfaction or utility when the marginal utility of the last dollar spent on a good is exactly the same as the marginal utility of the last dollar spent on any other good” (S&N p. 87). Again they obfuscate the distinction between expected and realized utility. At the time people buy something they expect a certain amount of utility from that product. But forecasted and realized utility are often not the same, as the purchasers of the toxic mortgage backed securities found out. Moreover, their formulation is ambiguous. The consumer would reach maximum satisfaction at the point as described but they leave open the question whether they are capable of finding such a point.

Even more importantly, however, S&N completely overlook the fact that Kahneman and Tversky have shown that this principle is false for several reasons. Marginal utility is too difficult to ascertain, and as a consequence, people compromise and substitute a heuristic, or a rule of thumb, for this rule, because otherwise they would become catatonic. Thus, making consumption decisions in the real world is much more complicated than they want to make us believe. This holds for other marginal concepts in the remaining text. Marginal product and marginal cost are also too difficult to calculate in the real world given the limitations of our brain and data available to us. In order not to become catatonic we satiate and aim for a satisfactory solution as Simon argued a couple of generations ago.

Indifference curves (S&N p. 101). Their description of the indifference curve is incorrect, because they assume that when deciding between two goods, say, food and clothing, it is as though we have never consumed them before. Thus, we are assumed to come to the problem of choosing in a pristine state, without indicating the amount of the goods in question we consumed in the prior period or are adapted to. However, this is inconsistent, because if we have not consumed these items before how are we supposed to know how much utility we should expect from them.

Their analysis overlooks the empirical evidence that current consumption (or current endowment) matters to subsequent consumption decisions as it becomes a

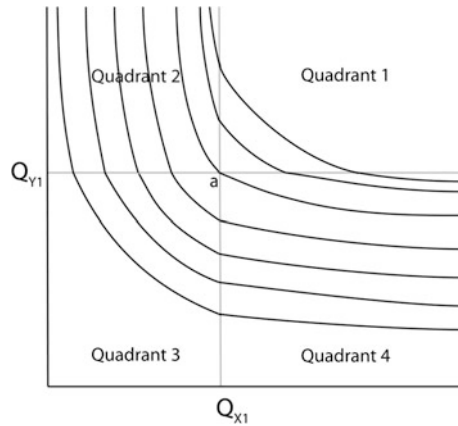


Fig. 2.1 Behavioral indifference curves showing initial endowment

reference point to which other states of the world are compared.⁶ The endowment effect implies that there is an excess discomfort associated with giving something up, i.e., in excess of the pleasure associated with acquiring it. Let us suppose that the current level of consumption is (Q_{x1}, Q_{y1}) (Fig. 2.1). Then point “a” becomes the origin of the coordinate system and the relevant reference point for the current period.

We divide the plane into four quadrants (numbered counter clockwise) with the axis going through the origin at point *a*. In quadrant 1, the endowment effect is irrelevant as both *x* and *y* are increasing. In this quadrant, the standard convex-to-the-origin indifference curve is unchanged. However, *x* decreases in quadrant 2 while *y* increases; in quadrant 3, both *x* and *y* decrease, and in quadrant 4, *x* increases while *y* decreases. (All changes are relative to the axis that goes through the initial reference point *a*) (Fig. 2.1).

Thus, lowering consumption of (*x*) below the initial level, Q_{x1} , requires a larger amount of a compensating good (*y*) in order to maintain the same level of utility than the amount of *y* required to be given up if there were an identical increase in *x* beyond Q_{x1} . In other words, at point *a*, the loss in marginal utility of giving up a unit of *x* is larger (in absolute value) than the marginal utility of obtaining a unit of *x*; i.e., decreasing one’s consumption from the current level is more painful than increasing consumption from the current level is beneficial. This is critical, because it implies that the indifference curves are kinked at the axis which go through point *a*, with slopes steeper in quadrant 2 than in quadrant 4, a factor overlooked in conventional treatments of indifference curves.

⁶Kahneman, D., Knetsch, J.L., and Thaler, R.H., 1991. Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias. *Journal of Economic Perspectives*, 5(1):193–206; Knetsch, J.L., 1989. The Endowment Effect and Evidence of Nonreversible Indifference Curves. *American Economic Review* 79, 1277–84; Knetsch, J.L., Sinden, J.A., 1984. Willingness to pay and compensation demanded: Experimental evidence of an unexpected disparity in measures of value, *Quarterly Journal of Economics* 99, 507–521.

The budget line (S&N p. 103). The budget line is not constrained as firmly as S&N suggest, given the availability of credit cards. Most of us face a fuzzy budget constraint and that makes budgeting so difficult. That is why the USA has become an indebted nation with a median credit card debt per household of \$7000 totaling about \$1 trillion in total.⁷ The burden of servicing such debt with an interest rate of about 15 % is obviously substantial.

“New and improved products” (S&N p. 103). They fail to note that not all new products are improvements. For instance, in the financial sector, the innovations that were hailed as making the economy more efficient ended up costing the taxpayers trillions of dollars. So they were not improvements at all. S&N discussed Pareto improvements earlier, but one important aspect of technological change that they fail to mention is that technological change is never a Pareto improvement as it always hurts some people.⁸ One of the more blatant inconsistencies of economic theory is that we celebrate such a process of technological change even though it is not Pareto efficient while at the same time economists generally argue against the government redistributing income for exactly the same reason, i.e., that the redistribution is not Pareto efficient. From what derives these privileges of the entrepreneur that do not accrue to the state? In other words, according to S&N redistribution is bad because it is not Pareto optimal but innovation is good even though it is not Pareto optimal.

A major problem with our economic system is that the people who are hurt are not compensated for the losses they suffer in the wake of technological change, whereas it is not fair to have people benefit at the expense of others. Until we can create institutions which compensate the losers adequately, the economic system will not create well-being for the whole population.

“Such complex production processes can be found in every sector, from pharmaceuticals that change our mood or help our blood flow more smoothly to financial instruments that take apart, repackage, and sell the streams of mortgage payments. And most of the time, we don’t even know what exotic substances lie inside the simple (recycled) paper that wraps our \$2 hamburger” (S&N p. 113). The “brutal truth” is that exotic products can turn out to be toxic ones. Because of asymmetric information, i.e., the person who packages the exotic securities knows more about the product than the person who buys it. As a consequence, there is a terrific temptation that can push the person toward opportunism and ultimately deception can play a substantial role in the transaction. For instance, Goldman Sachs had to pay \$650 million fine for just one such deceitful transaction. S&N fail utterly to consider this important element in exchange.

⁷Tim Chen, “American Household Credit Card Debt Statistics: 2014,” <http://www.nerdwallet.com/blog/credit-card-data/average-credit-card-debt-household/> accessed April 15, 2015.

⁸John Komlos, “Has Creative Destruction Become More Destructive? NBER Working Paper No. 20379, August 2014.

“Inferior technologies are unprofitable and tend to be discarded in a market economy...” (S&N p. 114). The quality of a product is not easily discernable. There are hidden qualities which do not become apparent until one has some experience with the product. For instance, the new financial instruments, i.e., mortgaged backed securities and credit default swaps, appeared to be innovations that diversified risk and Alan Greenspan and Ben Bernanke gave numerous speeches saying that they made the financial sector safer. Yet they misunderstood the risks involved and the innovations morphed into toxic assets in due course. They were very profitable until their true nature came to light. Another example is the Windows operating system. It is not and was never the best. It won the competition because of chance and an early mover advantage. Network externalities imply that early adoption of a technology can favor even an inferior one.

Again they rely on the insightful and novel example of a mousetrap. Obviously, the quality of a mousetrap is easy to discern but what about a product such as a credit default swap whose attributes are much more difficult to ascertain? Ask Dick Fuld, the last CEO of Lehmann Brothers. Actually, the business model of the whole financial system was inferior—borrowing short and lending long term—yet it is repeatedly propped up by taxpayers through the government because the failed banks were deemed too big to fail.

The development of technology is not a single event. Rather, it is a series of events following one another in space and time. The problem with the conventional view of competition leading to an optimum is that consumers as well as producers do not have perfect foresight to know how technologies will develop in the future. They are basing their current choices on current knowledge and these initial choices may lock them into a developmental path such that in the future the optimal technology can no longer be reached. According to this theory of path-dependence, the initial steps confer first-mover advantages, network externalities, such that the technology that would have been optimal but was not yet known at the beginning of the process may not be attainable. This is particularly true in case of increasing returns to scale, which means that as the quantity produced increases the average cost decreases. Most modern technologies do experience decreasing costs as the scale of operation increases. This means that first mover advantage can lock-in a technology that was not as efficient as an alternative technology that started later. It can also be that a small random event such as IBM ordering an operating system from Bill Gates can provide such initial advantages that even better technologies are going to be priced out of the market.⁹ Consequently, competition does by no means guarantee that the best technology will emerge the winner in the competition if consumers and producers do not have perfect foresight or if increasing returns are in effect. Hence, Pareto inferior outcomes, i.e., socially inefficient equilibriums occur

⁹W. Brian Arthur, 1994. *Increasing Returns and Path Dependence in the Economy*. Ann Arbor, University of Michigan Press.

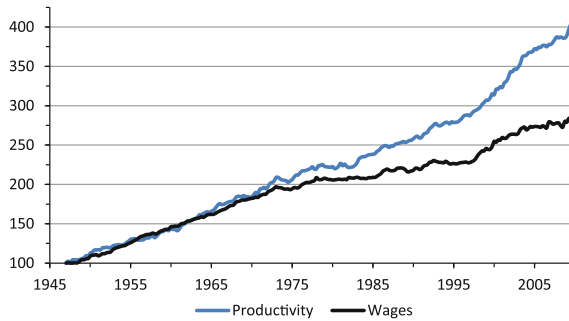


Fig. 2.2 Productivity and wages in the USA

frequently. In short, technological change is a path-dependent process that does not guarantee that the best mouse trap will be declared the winner in the end by the market.¹⁰ S&N present a biased view that economic processes invariably and incessantly improve toward the ideal current free market economy. They fail to see the disadvantages and challenges of many developments. Otherwise, we would not have so many people in jail, so many relying on antidepressants, so many killed and wounded by gun violence, and so many struggling to make ends meet.

“...wages have tended to rise even faster than the 1.5 % percent per year attributable to total factor productivity” (S&N p. 117). This is utter nonsense. This was true in the post-World War II era while the unions were strong enough to fight for workers’ wages and globalization had not yet destroyed the manufacturing sector, but has not been true since 1975 (Fig. 2.2). The fact is that real wages of men have actually stagnated since 1968 and real median household income has declined since 1999 by some \$5000 (Figs. 2.3 and 2.4)!¹¹ The only wages that have been increasing is that of women but they have still not caught up with that of men. In other words, all this praise of productivity growth fails to recognize that salaries have not kept up with productivity. That is one of the reasons why income has become so unequally distributed as profits have increased substantially (Fig. 2.5). Hence, productivity has benefited only a tiny minority people.

“The rising tide of executive compensation raises important questions about public policy.... Most economists are reluctant to have the government set any kind of pay standards” (S&N p. 122). Economists are reluctant to set pay limits

¹⁰Paul David, “Clio and the Economics of QWERTY,” *American Economic Review* 75, 2 (May 1985):332–337.

¹¹Wikipedia contributors, “Household Income in the United States,” http://en.wikipedia.org/wiki/Household_income_in_the_United_States accessed October 8, 2014. Erik Eckholm, “Recession Raises Poverty Rate to a 15-Year High,” *The New York Times*, September 16, 2010. <http://www.nytimes.com/2010/09/17/us/17poverty.html?emc=eta1> accessed October 8, 2014. See also: James K. Galbraith, *Created Unequal. The crisis in American pay*. The University of Chicago Press, 2000.

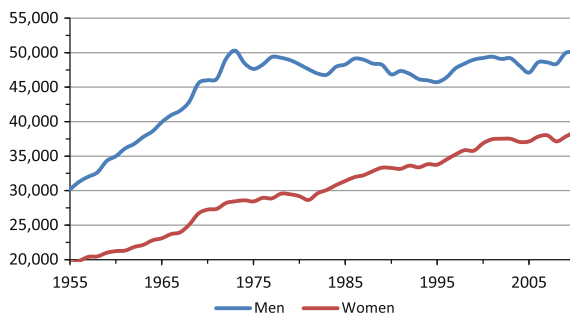


Fig. 2.3 Median income of full-time year-round workers by gender 2010 dollars

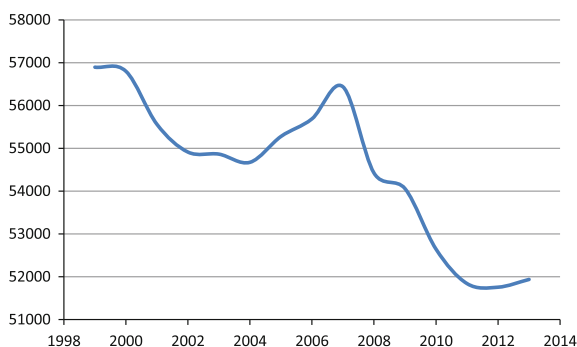


Fig. 2.4 Real Median Household income in the USA in 2013 prices

because they have a Panglossian view of the free market. They do not present an iota of empirical evidence to support the notion that capped CEO salaries would bring forth less managerial skills. Lower managerial salaries have not hurt European or Japanese firms. So capping CEO salaries at European levels would be a reasonable policy. Of course, this would not work unless it was a general policy throughout the USA. Individual firms cannot accomplish it successfully by themselves.

Those who are ambivalent about government involvement in markets might consider that the extraordinary profits and hence salaries of the Lords of Finance are possible only because they were bailed out at taxpayers' expense. The incomes earned by the likes of Lloyd Blankfein and Jamie Dimon whose annual compensation was in the \$10 million range even during the bad year of in 2009 would not be as high if the market for CEOs were perfectly competitive. They are not paid their opportunity cost. After all, even those CEOs who ran their companies into the ground received astronomical figures. For instance, John Thain received \$83 million before Merrill Lynch became insolvent. This evidence defies the theory that wages equal the value of marginal product.

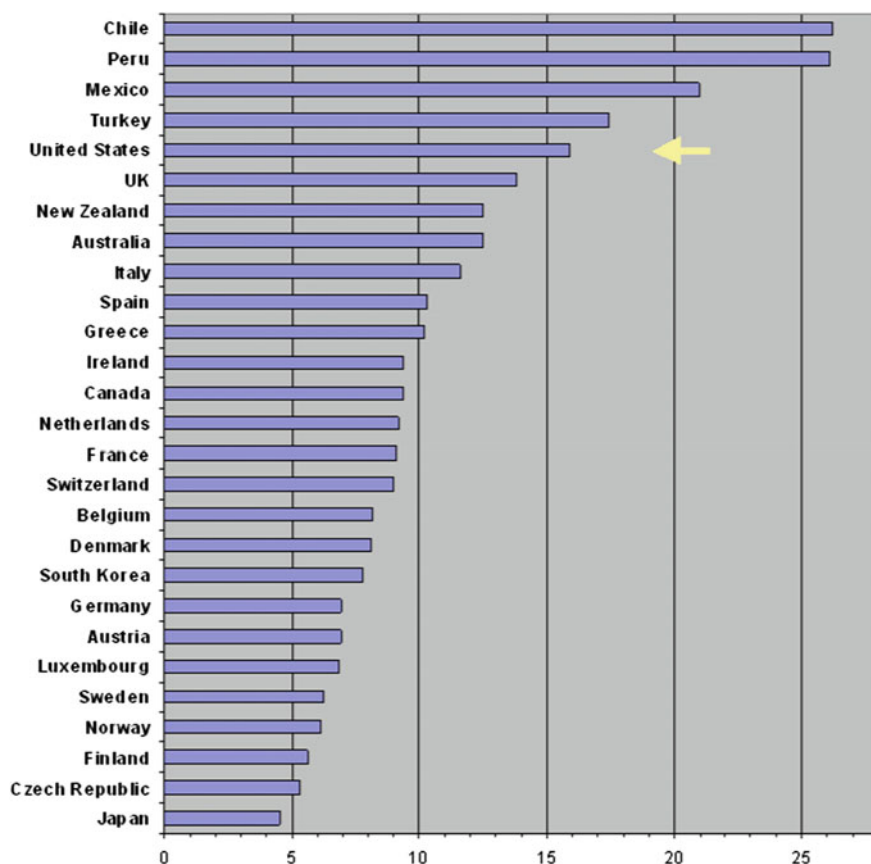


Fig. 2.5 Ratio of expenditure of top 10 % of income recipients to bottom 10 %

The reason for the high salaries is that the market for CEOs is not perfectly competitive. The positions are not advertised openly and there is no transparency on how the chief executives are chosen. Once chosen, they can essentially pack the board of directors and eventually write their own salaries. They can “hold-up” the board. If the market were competitive salaries would decline markedly, because the current salaries are way above opportunity costs. Just ask yourself if one could have found someone to run Bank of America for less than \$4 million in 2009 (that is almost \$2000/hour) at a time when the bank was propped up by the US treasury.¹² I bet that it could have been run as efficiently for under half a million, i.e., for one-eighth of the salary that was actually granted. The usual argument that to cap salaries would be inefficient is not supported by any evidence whatsoever, because

¹²The salaries can be found at AFL CIO, “Executive Pay Watch,” <http://www.aflcio.org/corporatewatch/paywatch/ceou/database.cfm> accessed October 8, 2914.

most of the salaries are rents. They would work as well at 10 % of the current salaries. What else would they do? It would still be the most they could earn. Would they emigrate? Where would they go? I do not think that any inefficiency would arise. Note that the US President earns \$400,000 per year. I think that should be the top pay in the country. Angelo Mozilo of Countrywide Financial, a major culprit in the sub-prime mortgage crisis earned some \$450 million between 2000 and 2008. He was fined \$67 million for fraud, a mere 13 % of his pay but most of that was paid by the successor to the company he bankrupted.¹³

CEOs who earn such exorbitant rents should be taxed at a much higher rate. The second richest man in America agrees: billionaire Warren Buffett says, "I think that people at the high end, people like myself, should be paying a lot more in taxes. We have it better than we've ever had it..." When the interviewer pointed to critics' claims that the very wealthy need tax cuts to spur business and capitalism, Buffett replied, "The rich are always going to say... 'Just give us more money, and we'll go out and spend more, and then it will all trickle down to the rest of you.' But that has not worked the last 10 years, and I hope the American public is catching on."¹⁴

Moreover, S&N are again reluctant to reveal their own opinion on the matter. Rather, they merely state what most economists prefer. Being "reluctant" is not scientific without adequate empirical evidence which they neglect to present.

"a system of progressive taxation is the most evenhanded way to deal with income inequalities" (S&N p. 149). Then why is Warren Buffet, who is the second richest person in the USA paying a lower marginal tax rate than his employees?

"First, we will assume that our competitive firm maximizes profits" (S&N p. 149). They can assume anything, but how relevant is it to the real economy? Insofar as firms typically consist of tens of thousands of individuals how can they coordinate all the employees in such a way as to maximize profits? Rather, the more likely scenario is that managers maximize their own salaries, as was demonstrated during the Great Meltdown of 2008, even if it is to the detriment of the firms. Another major problem is to align the interest of the managers and that of the

¹³Gretchen Morgenson, "Lending Magnate Settles Fraud Case," *The New York Times*, October 15, 2010. <http://www.nytimes.com/2010/10/16/business/16countrywide.html?th&emc=th> accessed October 8, 2014.

¹⁴"Buffett isn't the only billionaire who has argued for higher taxes. Both Microsoft co-founder Bill Gates and his father, Bill Gates, Sr., came out in support of a Washington state measure to 'create a 5 percent tax rate on annual income exceeding \$200,000 for individuals and \$400,000 for couples, and a 9 percent tax rate on income that tops \$500,000 for individuals and \$1 million for couples.'" Amanda Terkel, "Warren Buffet: I 'Should Be Paying A Lot More in Taxes,'" *Huffington Post*, November 21, 2010. http://www.huffingtonpost.com/2010/11/21/warren-buffett-paying-more-taxes_n_786516.html accessed October 8, 2014. "Executives Who Support Tax Increases to Fix the Deficit," *The Wall Street Journal*, October 25, 2012. Ryan Grim and Sabrina Siddiqui, "Top Two Percent to GOP: Tax Us," *Huffington Post*, December 5, 2012. Andrew Garber, "Like Father, like son: Bill Gates supports income-tax initiative 1098," *The Seattle Times*, September 21, 2010. http://seattletimes.com/html/politicsnorthwest/2012959755_microsoft_co-founder_bill_gate.html accessed October 8, 2014.

stockholders insofar as the owners of the firm are far away from the day-to-day operations of the executives and are not able to oversee it or control it. Take Dick Fuld again, for instance. He walked away from the bankrupt Lehman Brothers with some \$450 million.¹⁵ The shareowners walked away with next to nothing. Maurice Greenberg walked away from AIG with 4.5 billion in his pocket before the corporation went bankrupt.¹⁶

The problem is known as the principal–agent problem, a variant of “Moral hazard.” People maximize their own utility to the detriment of others, when they do not bear the full consequences of their actions due to uncertainty or incomplete contracts or information asymmetries. The agent of the shareholders cannot always be held responsible for his or her actions because contracts cannot be completely specified. There are too many contingencies. In other words, there is a fundamental conflict between the manager’s utility and that of the shareholders.

Adam Smith was well aware of this moral hazard: “The directors of such companies,... being the managers ... of other peoples’ money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own... Negligence and profusion, therefore, must always prevail more or less, in the management of the affairs of such a company.”¹⁷ In other words, S&N’s assumption has little relevance in the real economy.

“An economy is clearly inefficient if it is inside the Production Possibility Frontier” (S&N p. 160). Economies are practically always inside their PPF, because of unemployment, underemployment, and the underutilization of capital equipment. In 2014, for instance, 12 % of the labor force was underemployed and 22 % of plant and equipment was idle. The last time the US economy was on its production possibilities frontier was in 1944 when demand for war-related production brought unemployment down to 1.2 %.

Moreover, it is well nigh impossible to structure the culture and laws in such a way as to minimize the cost of production. For instance, German pharmacies are more efficient than American ones. Why? Their task is relatively straightforward: to dispense prescription drugs. The difference is that US legal system is such that pharmacists have to register the name of the patient and have to type up a label before dispensing the drug, whereas their German counterparts are not constrained by laws to perform such tasks and therefore can provide the drugs quicker. In this case, the laws render the US system less efficient than the German one.

“One of the most important results in all economics is that the allocation of resources by perfectly competitive markets is efficient” (S&N p. 160). This is

¹⁵Wikipedia contributors, “Richard S. Fuld, Jr.,” http://en.wikipedia.org/wiki/Richard_S._Fuld,_Jr accessed October 8, 2014.

¹⁶Mary Williams Walsh, “Insurance Giant A.I.G. Takes Ex-Chief to Court,” *The New York Times*, June 14, 2009. <http://www.nytimes.com/2009/06/15/business/15aig.html> accessed October 8, 2014.

¹⁷Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, ed. Edwin Cannan (London: Methuen & Co., 1904), available online at Library of Economics and Liberty, p. 700.

also the most misleading result, because the result is almost always applied to markets that are not perfectly competitive. Moreover, perfectly competitive markets are a negligible share of the economy and consequently irrelevant for all intents and purposes. Therefore, the perfectly competitive market should not be the default model.

In the same paragraph S&N state: “we... illustrate the general principles underlying the efficiency of competitive markets.” In other words, they fall into their own trap as the “perfectly” of the original statement was already dropped from the generalization and the result is applied to all competitive markets and that is how the concept seeped incorrectly into the popular mindset. Students think that competition is sufficient to establish efficiency. But that is not the case insofar as competitive markets include oligopolies and monopolies which are not efficient. Hence, they obfuscate an extremely important point in economics.

“We have seen that markets have remarkable efficiency properties” (S&N p. 164). We have seen claims to that effect but we have not seen actual evidence to support that assertion. Note that S&N now stealthily generalize the outcome of the perfectly competitive model to all markets without qualification and that is precisely one of the main reasons why such mainstream textbooks mislead millions of students. This is a pernicious oversight, because there is a world of a difference between “markets” and “perfectly competitive markets” insofar as students will be misled into thinking that all markets are efficient without exception. However, on p. 169 they themselves admit that such firms are “hard to find,” and on p. 187 they do say that such firms are rare. While those qualifications do contradict the above-unqualified assertion, they do not mitigate the pernicious effect of this misleading sentence on students. Many students will retain the false impression that markets are efficient, whereas markets are rarely efficient and are more likely to be inefficient.

Furthermore, it is not only students who are misled. Such misconceptions led eventually to the deregulation of financial markets. Alan Greenspan was also misled inasmuch as he basically applied the perfectly competitive model to the financial sector that was everything but perfectly competitive. So such misleading assertions as the above are by no means benign. They have real-world consequences. Thus, the default model should be that markets are inefficient without effective government oversight and proper institutional structure, without perfect information about the product being exchanged, and if the market structure is oligopolistic or monopolistic, that is to say, practically always. In other words, efficient markets are rather the exception rather than the rule.

“People are not equally endowed with purchasing power.... So the weighing of dollar votes, which lie behind the individual demand curves, may be unfair” (S&N p. 164). Why don’t we try to make it fair then? Markets are men-made institutions. Their legitimacy does not have divine origins. We can structure them so as to make them fair or at least fairer.

“Positive economics cannot say how much governments should intervene to correct the inequalities and inefficiencies of the marketplace” (S&N p. 165). If positive economics cannot say that then perhaps the theory of justice can. Or

common sense, like we should all have our basic needs met before a select few indulges in conspicuous consumption. Why cannot we say, for instance, that the government, which represents our interests, should make markets more efficient? Why cannot we say that democracy trumps positive economics? That it should protect the consumer from powerful business interests as it did, for example, against the cigarette lobby so that the number of smokers has been halved? The government is not a foreign entity. It is not the enemy of the people. The government is we, and in a democratic society we, the people, have the ultimate legitimate power, and not positive economics or the marketplace.

“Sometimes it is possible for companies to create barriers to entry for potential rivals by using advertising...” (S&N p. 176). Advertising does more than create barriers to entry and not only sometimes. It always has psychological effects which create artificial demand for products we would not want otherwise. It manipulates us from the very beginning of our lives and destroys our will power. It creates a culture of instant gratification. It forms our utility function and subconscious in significant ways. Advertisements frequently use authority figures to create trust in their products. They also devalue products that you already have. For instance, by creating and promoting new fashion that has the effect of devaluing our current inventory of clothing. That means that one does not obtain as much utility from the clothing one owns as was anticipated at the time of purchase. So the new clothing destroys the value of the old.

“Branding and Differentiated Products” (S&N p. 176). Note that such brands exist only because of government intervenes in the free market and grants such monopoly powers. Without such interference enacting laws and sanctions, these brands would not exist at all and the market would be much closer to perfect competition. Perfect competition does not exist with branded products. They fail to mention that.

“Why are economists concerned about industries characterized by imperfect competition? The answer is that such industries behave in certain ways that are inimical to the public interest” (S&N p. 189). These statements contradict the assertion on p. 164 that “markets have remarkable efficiency properties.” Insofar as most markets are imperfectly competitive, it is fair to say that markets are generally inefficient. Once we come to this realization then we can work on how we can improve upon them. That is the task ahead.

Consider the California electricity crisis of 2000 and 2001 in which energy wholesalers were able to “game the market” in order to create artificial electricity shortages and blackouts.¹⁸ Enron was one of the firms which reaped huge speculative profits from manipulating the market. S&N have already forgotten what they wrote about Enron on p. 138.

“In reality many obstacles hinder effective collusion” (S&N p. 191). Moody’s did not find it that difficult to collude with the investment banks to fix the ratings of

¹⁸Wikipedia contributors, “California Electricity Crisis,” http://en.wikipedia.org/wiki/California_electricity_crisis#Involvement_of_Enron accessed October 8, 2914.

their bonds.¹⁹ Arthur Anderson did not find it that difficult to collude with Enron to fix the books and hide liabilities. OPEC is an important cartel that colluded and dominated the oil markets for decades. But even at the local level there is a lot of tacit collusion. Consider real estate agents. There are millions of real estate agents, yet practically all of them charge a fee of exactly 6 %. One cannot find someone who would be willing to sell a house for 5.9 %. When I asked a number of realtors if they would lower their price they were all adamant about not competing with price and seemed rather insulted because such queries questioned their professionalism. In short, their collusion may not be tacit, but it is nonetheless real and is kept afloat as a social norm. It is not supposed to happen according to theory but it does. In theory, theory and reality should be the same, but in reality they are not. Economic theory does not take into consideration the sociological and psychological factors associated with competition. If they lowered their commission, realtors would be ostracized by their peers in the association of realtors and the social pressure is such that the members conform to an unwritten rule not to use price competition. It is collusion by other means. The realtors also realize that by lowering the price they would unleash a price war and others would follow suit and also lower their commission to 5.9 % and in the end they would have few advantages at a lower price.

In a market characterized by monopolistic competition firms **“will continue to enter the market until all economic profits ... have been beaten down to zero”** (S&N p. 192). That outcome would be the exception rather than the rule. It would obtain only if there are no barriers to entry and only if the expected future profits are sufficiently high to warrant entry of a new firm. Those conditions do not obtain as a rule particularly because firms do their utmost to erect barriers to entry such as advertising campaigns that imply that potential competitors have to make large investments before they can become viable competitors. Hence, in reality such firms as McDonalds, Home Depot, and Walgreens all make extraordinary amount of profits which S&N neglect to mention. They also fail to mention that even if it were true that profits were zero, the market would be inefficient nonetheless, because marginal cost would still not equal price. In other words, such firms are not operating at the minimum cost possible.

“Originally... Apple... made big profits.... Today, there are dozens of firms, each with a small share of the computer market but no economic profits to show for its efforts. The monopolistic competition model provides an important insight into American capitalism: The rate of profit will in the long run be zero

¹⁹Gretchen Morgenson, “Raters Ignored Proof of Unsafe Loans, Panel Is Told,” *The New York Times*, September 26, 2010. <http://www.nytimes.com/2010/09/27/business/27ratings.html?emc=eta1> accessed October 8, 2014.

in this kind of imperfectly competitive industry..." (S&N p. 192). However, this prediction is ridiculous: in 2008, Apple earned \$8.2 billion profits on assets of \$47.5 billion, which makes its profitability 17 % and its net income has risen since then to \$39 billion.²⁰ These profits were not competed away in spite of intense competition.

"Reducing the number of monopolistic competitors might lower consumer welfare because it would reduce the diversity of available products" (S&N p. 164). S&N concoct all sorts of rationalizations in order to sing the praises of markets. They fail to mention that reducing the number of products from which to choose might also increase welfare on account of the fact that choosing between products takes time and effort and is therefore costly. Choice is good up to a point, after which it becomes a nuisance and lowers consumer welfare especially for people who live busy lives. In other words, S&N are consistently telling half-truths. Too much of a good thing can turn into a negative, i.e., having scores of salad dressings on the shelf is excessive choice and actually detracts from our ability to make wise choices and thus decreases welfare.²¹ He suggests that having "more is less," as the conventional thinking does not take into consideration the confusion created by too much choice and the time and effort needed to learn about the products offered. The market fails to provide adequate limits to facilitate our choices.

"What are the economic effects of price discrimination? Surprisingly, they often improve economic welfare" (S&N p. 193). Wow! The market can do no harm in their Panglossian view. Even price discrimination can be good..., but for whom? The owners of firms? the "brutal truth" is that most of the time it is bad for the consumers, because it takes considerable effort to elude the snares of business strategies whose managers want to charge as much as possible. Price discrimination mostly involves deception as firms take advantage of one's lack of information. They also exploit disadvantaged groups who are not in possession of a lot of information and are unable to figure out how to obtain a lower price. There is no

²⁰ Apple Inc.'s annual report to the Securities and Exchange Commission for the fiscal year 2014, October 27, 2014, http://investor.apple.com/secfiling.cfm?filingid=1193125-14-383437&cik=#D783162D10K_HTM_TOC783162_8 accessed April 18, 2015.

²¹ "...we assume that more choice means better options and greater satisfaction. But beware of excessive choice: choice overload can make you question the decisions you make before you even make them, it can set you up for unrealistically high expectations, and it can make you blame yourself for any and all failures. In the long run, this can lead to decision-making paralysis. And in a culture that tells us that there is no excuse for falling short of perfection when your options are limitless, too much choice can lead to clinical depression." Barry Schwartz, *The Paradox of Choice: Why More is Less* (New York: Ecco Publishers, 2003). He also has a number of great lectures on video in the internet: "Barry Schwartz: The Paradox of Choice," YouTube video, 20:23, posted by "TEDtalksDirector," January 16, 2007; "The Paradox of Choice-Why More is Less," YouTube video, 1:04:08, posted by GoogleTalksArchive, April 27, 2006.

discussion about the morality of price discrimination. There is nothing, for instance, about a phone company offering one a lower price once they declined to accept their initial offer. Companies deliberately make their offers so complicated that it becomes exceedingly difficult to understand cell phone contracts or health insurance contract and compare the various plans. Companies also try to outsmart consumers by using so-called decoys which are higher priced products they are not really trying to sell. Instead, the strategy behind the higher priced decoy is to make the lower priced version seem better in comparison with it.²² In other words, companies do not miss a psychological trick to take advantage of their ability to increase their profit at the consumers' expense.

“monopolies produce economic waste” (S&N p. 199). So do oligopolies. In fact, they should have stated that all market structures except perfectly competitive ones create inefficiencies. Hence, almost all of the economy produces waste as perfectly competitive firms are a negligible share of the economy. We could and should set ourselves the goal of squeezing these inefficiencies out of our economic life to the extent possible. All of a sudden markets do not have such great “efficiency properties.”

Antitrust Law (S&N p. 203). Oligopolies should also be included in antitrust legislation in order to improve the efficiency of the economy.

“By evening out supplies and prices, speculation actually increases economic efficiency” (S&N p. 213). Nonsense! This is not the general case. S&N again present the simplest of cases in a market that is well established and people have lots of experience with it. And they fail to mention that in the case of speculation with grain when prices increase in the first period, people might well go hungry and might revolt and destroy the speculator. In other words, they have a wealthy society in mind in which the increase in price in the first period does not cause havoc. That is crucial, but they present their conclusion as though this was the case in general. However, this does not hold for markets which are much more risky, not well regulated, and investors have not had experience with them, such as with credit default swaps. Speculation in housing, in mortgage backed securities, and credit default swaps brought us the meltdown of 2008. S&N's unequivocal praise of the benefits of speculation borders on the bizarre and is distasteful in light of all the damage the financial crisis caused including a GNP which is one trillion dollars lower than what was projected if the crisis had not occurred. This GNP gap has now occurred for the seventh year in a row adding up to an inordinate sum!

²²Alexis Madrigal, “Apple’s Brilliant Decoy Pricing Game,” *The Atlantic*, October 5, 2010. <http://www.theatlantic.com/technology/archive/2010/10/apples-brilliant-decoy-pricing-game/64104/> accessed October 8, 2014.

“Reasons for providing social insurance” (S&N p. 218). There is yet another reason for providing social insurance, namely the inability of people to ascertain and believe probabilities associated with ill health and old age and therefore discount the future excessively. Young people are not generally thinking of retirement income. How many 20-year-olds are going to start saving for their retirement? Government on the other hand, through taxation, can make sure that social insurance will be provided upon retirement. Otherwise, people who lack the foresight to plan for the future can cause problems for the society once it dawns on them that their life is threatened for lack of savings. This is called time inconsistency.

“Health-care spending rose from 4 percent of national output... to 16 percent in 2008” (S&N p. 203). Lot of it is because the system is extremely inefficient. Europeans—Sweden for example—deliver better care at half the price and live two years longer!

“Infant mortality is higher than in many countries with lower incomes” (S&N p. 219). “Many countries” turns out to be about two dozen. Life expectancy in the USA is at the level of Cyprus (Fig. 2.6). Canadians and Australians can expect to live three full years longer. The health care sector provides a good example of the failure of markets to provide efficient services. There is a lot of price gauging on account of the lack of price competition among hospitals and doctors and asymmetric information between doctors and patients (Fig. 2.7). Doctors can take advantage of patients’ lack of information in order to increase their own income. It is not efficient to organize the health care sector as a business enterprise.



Fig. 2.6 Life Expectancy at Birth, 2008

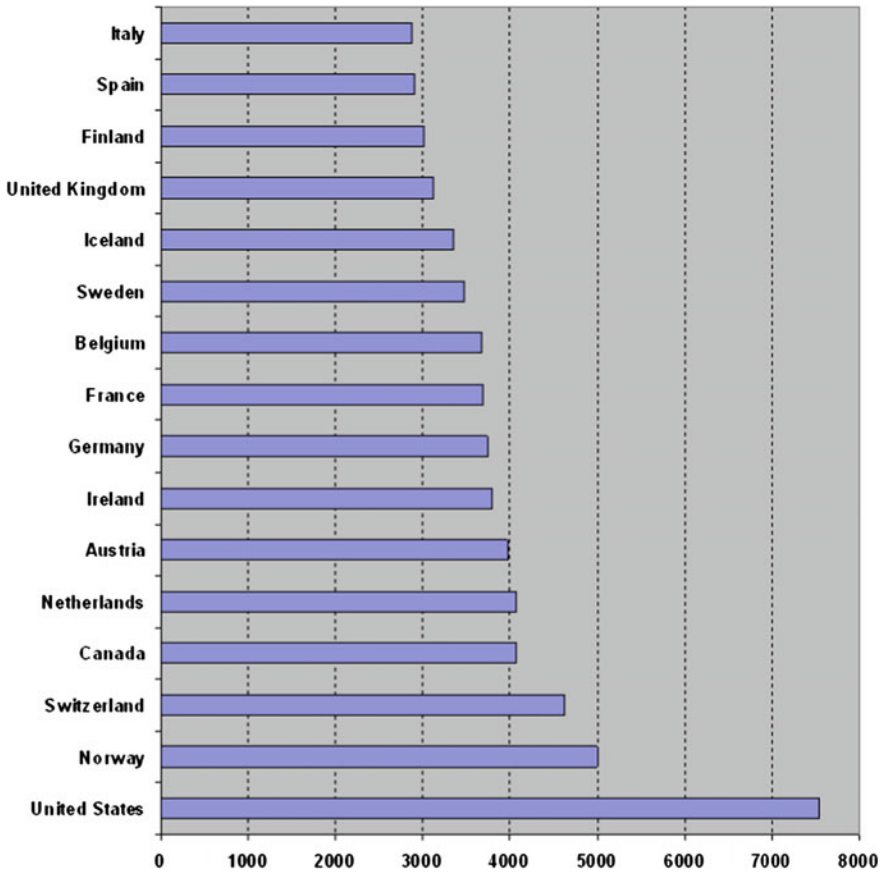


Fig. 2.7 Cost of Health Care per capita 2008

“some countries feel that people should have a safety net under them should they lose their job” (S&N p. 219). Countries do not have feelings. It is the people in all advanced industrial societies who choose in a democratic manner to structure unemployment benefits in such fashion. One has to consider also that unemployment causes financial and psychological distress and, in addition, has a destabilizing effect on society both politically and socially. In other words, the unemployed also produce negative externalities. The anti-social behavior includes break-ins, or robberies, and if unemployment ends in destitution it can lead to foreclosed houses, or homeless people living under viaducts; such a society leads to a sense of insecurity and stress even among the people who do have jobs. And of course, in Europe many people have not forgotten that the Nazis came to power because of the steep rise in unemployment in the early 1930s. Without the Great Depression, the Nazis would not have come to power and there would not have been a Second World War.

“rapid growth of expenditures on medical care” (S&N p. 203). It has also grown because the American Medical Association is a powerful cartel that limits the supply of doctors. It is rather odd that the USA can produce everything else in abundance but is unable to produce as many doctors per capita as other rich societies. The well-kept secret is that the American Medical Association (AMA) has been very successful in quietly restricting medical education in the name of fostering excellence in medical care. But that is a pretext. The real reason is to inflate doctors’ salaries well above competitive levels.

Other countries have been able to cap costs because they have adopted a more efficient health care system. It is much more convenient and efficient to have a single not-for-profit entity organizing the medical system than navigating through the confusing offerings of a free market for-profit system. The former is much less expensive because the administrative costs are much lower and costs are kept down by the bargaining power of government so that medical care does not become a business and no profits are generated. S&N are great supporters of efficiency yet fail to see that the US health care system is among the most inefficient in the world.

“Health care is an economic commodity like shoes and gasoline” (S&N p. 221). This is nonsensical. Health care is a basic need that completely different from the other products. Running out of gas can well be an inconvenience but it is nonetheless on a different level of misery from seeing people suffer from an ailment, particularly if they could have been treated if they had the money for medical care. Theirs is an ideologically loaded perspective, because there are others who think that health care is a human right that does not have to be rationed in a way that shoes have to be rationed. For one thing, medical care it is not subject to fashion changes as are shoes; X-rays are not likely to become trendy. Moreover, it is not an exhaustible resource as is oil from which gasoline is derived and does not pollute as gasoline does. I have not heard of anyone wanting to get a lung X-ray when it was unnecessary. However, I have heard of doctors ordering X-rays when they were unnecessary.

In fact, 3 of the 8 Millennium Development Goals of the United Nations pertain to health: child health, maternal health, and combatting diseases. I guess S&N do not know that Article 23 of the Universal Declaration of Human Rights of the United Nations states that “Everyone,... has the right to social security” and Article 25 states that “Everyone has the right to a standard of living adequate for the health and well-being of himself and of his family, including food, clothing, housing and medical care and necessary social services, and the right to security in the event of unemployment, sickness, disability, widowhood, old age or other lack of livelihood in circumstances beyond his control.” Mothers and children are singled out for being “entitled to special care and assistance.” However, gasoline is not mentioned as a human right while health is one of the more important ones. Thus, attempting to conflate these three very different kinds of goods/services obfuscates their actual importance to real human beings rather than virtual people on the blackboard.

“Physicians’ services, nursing care, hospitalization, and other services are limited in supply” (S&N p. 221). But the supply should and could be the amount required to keep the population healthy. S&N overlook the role of the AMA in

restricting supply and competition in the name of fostering excellence in medical care (see Footnote 15). By restricting the number of students of medicine, the AMA inflates doctors' salaries well above competitive levels. Only half of those applying to medical schools are accepted. In spite of the shortage of doctors, the medical profession is opposing foreign medical schools sending their students to the USA for internships (see Footnote 16). There are only 140 accredited medical schools in the country as compared to 200 law schools. Consequently, US doctors earn five times as much as their Japanese colleagues. I doubt seriously that they are five times more productive.

It is rather odd that the USA can produce all other professions in abundance but is unable to produce as many doctors (per capita) as other advanced industrial societies (see Footnote 17). Compared to Austria's 4.6 and Norway's 4.0, the USA has only 2.6 doctors per 1000 of its population. In order to increase the number of physicians per capita to Norway's level, the number of doctors in the USA would have to be increased by some 480,000. Compared to the 750,000 physicians in the USA currently, this would be a 60 % increase.

Because of the artificial shortage created by the AMA, the income of doctors is well above the competitive level. In other words, the high earnings of US doctors are not brought about by market forces; they are not predicated only on their investment in education, but by the fact that the institutional structure protects doctors from market forces. In short, the AMA has been much more effective than other organizations in maintaining the salaries of its members well above competitive levels by restricting supply (see Footnote 18). Already decades ago Milton Freedman called the AMA the strongest trade union in the country.

Moreover, the demand for health care is not as price sensitive as S&N depict in their Fig. 11-3. In fact, the demand for most services is perfectly inelastic. Who would fill a cavity in their tooth unless there was one, or put a cast on their hand unless it was broken? Hence, all the worry about abuse of the system is unwarranted. The system should not be designed for hypochondriacs.

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