

10 Secrets about Economics

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When studying economics at a university today you undoubtedly learn a lot of things. For example, you learn that central banks stabilize the currency and help us avoid booms and busts. You learn that leaving people alone in the market place, they will set the wrong prices of most things, and that we need to regulate this. You learn that the road to wealth and growth of nations comes through more labor, i.e. more man hours, and technology. And you can prove all this through advanced mathematical modeling, so advanced that only very few understand it and can question it.

In other words, you become very good at things like downplaying individual freedom, a pleasant lifestyle and at justifying the elites robbing the rest of the people. Yes, it's indeed a dismal science, when put into this perspective.

Fortunately, the stuff you learn at school has very little to do with economics. And if you read on, I will give you the top 10 things I think you need to know about economics that the average professor likely won't tell you about. They are fundamental insights, new and old. They are so well hidden from students today, that you might well call them secrets. If you have encountered even one of these 10 secrets in class, I'd be surprised.

Secret #1 – The Division-of-laborⁱ

While I think most people have a general understanding about what the division-of-labor is, I reckon very few have any idea about its absolutely fundamental importance for the creation and sustenance of any advanced society. And unless you take a class in economic history, you might get a full degree in economics without even hearing about it.

Back in 1776, Adam Smith published his *Wealth of Nations*, and here are the opening lines:

“The greatest improvement in the productive powers of labour, and the greater part of the skill, dexterity, and judgment with which it is any where directed, or applied, seem to have been the effects of the division of labour.”

In fact, it's the division-of-labor that explains how we nowadays can be so many times more productive than only say 200 years ago. It's the basis of capital accumulation, the division-of-knowledge and all the insights that follow from it, like new technological inventions. More man-hours have very little to do with explaining the rising living standards, and technological advances doesn't fall from the sky, like the modern growth models assumes.

Secret #2 – The law of comparative advantagesⁱⁱ

Similarly, I think many people have a general understanding about what the law of comparative advantages is, although they might be gravely mistaken about what it really tells us. Most people likely think that this law says that a country should specialize in an area that they are best at.

In his book *Principles of Political Economy and Taxation* from 1817, David Ricardo outlined the principle of comparative advantages by means of an example involving two countries, England and Portugal. In Portugal they could produce a certain amount of both wine and clothes faster than in England and, hence, the Portuguese had absolute advantages in both these areas of production. In other words, one might conclude that international division-of-labor should be arranged according to what you're best at. This idea implies that a country that is best at nothing will be run over by the more productive, a very common notion today.

However, Ricardo showed that it was in the interest of both countries, i.e. also the more productive Portuguese, to specialize in one area and trade their goods with the other party. In this case the countries specialize in the production where they have a comparative advantage. Hence, even if a country had no absolute advantages, there would still be room for this less productive country. Most people that have studied some economics likely remember this law when asked about it. But few academics seem to have read the sources of the idea, including the famous [Paul Krugman](#) (look, no reference to Ricardo in his reading list).

However, what is perhaps less well known is that this is also true for the division of labor at all other levels of society, as Ludwig von Mises emphasized. In fact, all trade, international as well as domestic, stems from the same source – the comparative advantage of the individual. The comparative advantage of the individual then lends itself to groups of people, companies, regions and countries. It is these that make it worthwhile for people to cooperate and divide labor at all on any larger scale. The law guarantees that there will be room for everybody. The comparative advantages could thus be seen as the glue of society.

Hence, when people are left free to specialize in the things they seem to be best at relative others, the division-of-labor flourishes and there's room for everyone. As Mises pointed out, "it makes friends out of enemies, peace out of war, society out of individuals." Absent this knowledge, it should come as no surprise that people sees potential friends as enemies, makes war out of peace and sees freely cooperating individuals as threats to society.

Secret #3 – Marxian exploitationⁱⁱⁱ

Well, even if people did appreciate the division-of-labor and the comparative advantage, people would still be alienated and, worse, exploited. You see, some people would soon come and take the wages of the laboring people, or in the common lingo, the capitalist would exploit the workers, profiteering on the backs of the ordinary citizens. Or so we are led to believe.

There have been many attempts at falsifying this Marxian exploitation theory, and the perhaps best known is Eugen von Böhm-Bawerks attempt, in his *Karl Marx and the Close of His System*.

However, there's a much more powerful rebuttal of the Marxian exploitation theory, as suggested by George Reisman. He points out, that in a world without the capitalist, the income people earn aren't wages, but profits. If I grow flowers in my garden and then sell them at the

local fair, my income is 100% sales revenue, and since my money outlays are likely zero, the revenue turns into 100% profits. Hence, profits are the primary form of income, not wages. It is only when capitalists enter the scene that people are able to work for wages.

In other words, if I hire somebody to take care of my flowers, I pay them out of past sales revenue and profits, i.e. out of my savings (often referred to as the wage fund). Thus, the interests of the capitalists and the wage earners are complimentary rather than exploitative. My employee might be happy I offer them a chance to work for wages, believe it or not.

I take it this completely explodes the Marxian exploitation theory, and the labor theory of value as well. My Marxist economics professor didn't speak to me for months after I told him about this, and I take that as a kind of confirmation as well.

Secret #4 – Economic calculation^{iv}

I suppose most people think economic calculation is a necessary evil imposed by the tax-collectors. But we don't do calculation solely or not even originally because we want to declare our taxes. Calculation is nothing new and is of far greater importance. We do the calculation also because we need to be able to calculate profit and loss (p/l) and have such calculations guide us on how to act. People that have studied business administration, accounting or are running a business might know that economic calculation is a central part of running a business.

And as it happens, profit and loss (p/l) calculations are of extreme importance to the existence of any advanced society at all. You cannot aggregate and compare costs of various inputs if you don't have the cost amounts. 'Price x quantity = cost' and such cost amounts are comparable even if the prices and quantities refer to such different things as nails, labor or whatever. But you cannot simply set the prices arbitrarily; this requires prices that are allowed to change according to both the circumstances and the needs of the individuals involved.

Through such a decentralized system of freely adjustable prices and p/l calculations, the society as a whole coordinates all the plans of all participating individuals. Without freely adjustable prices and p/l calculations, planning and coordination is hampered.

Without any pricing at all, p/l calculations and planning becomes almost impossible, as experienced in every place and field where freely adjustable prices have been abolished. Any attempts at central planning are totally dependent on the planning of individuals and their decentralized coordination.

This is why the Chinese government can make such massive central planning nowadays but not 30 years ago. Today a billion Chinese are making their own p/l calculations and bargain as much as they can, thereby making everyone far better off (most also pay little or no taxes), while that was a clear no-no 30 years ago.

Central planning means chaos and in practice no advanced planning is possible at all if freely adjustable prices are abolished and hence the individual p/l calculations are made impossible. Thus, the importance of good economic calculation goes far beyond simple tax declarations and business accounting.

There's however one unit-of-account that serves especially well because of its stability. Let me show this by another simple example; 2,000 years ago, in 1st century AD Rome, a secretary earned 15 denarii, a lecturer 12 and a messenger 9 denarii per month. Translating this into current USD, we end up with yearly incomes of about USD33,000, USD26,000 and USD20,000. This is astonishingly similar to what the wages for these kinds of jobs are today in the US (I found typical numbers of USD32,000, USD28,000 and USD20,000 when googling secretary, teacher and mail delivery).

Secret #5 – Proper Accounting^v

After realizing the importance of economic calculation, the next step is to see what unit-of-account to use and what accounting principles that is suitable for maintaining the books.

When it comes to the unit-of-account, it's something that's definitely not discussed in the standard economics text books. The closest thing area topics like currency unions and inflation, but also in relation to this, the discussion is completely bogus; what fiat currency monopolies could be united into greater monopolies or how much price inflation is optimal, i.e. the topics are all about the scope of wrongfulness and the speed of it.

Selecting a unit-of-account is extremely important. The characteristics of your choice, good or bad, will directly and to 100% transfer straight into your accounting. The standard choice is the local national fiat currency, and while people can see that it fluctuates in relation to other fiat currencies, most people reason that as long as they don't deal with foreign currencies, it's not a big deal. They might go on overseas holiday once a year, and that's about as important it is, they reckon.

Wrong! Even if we had a global monopoly fiat currency, so we didn't have to bother about exchanges rates at all – the wet dream of the elites – such money wouldn't be a very good unit-of-account. Apart from currency swings, there's also continuous inflation and occasional deflation. Even a small target of say 2% consumer goods price inflation translates into 64% inflation in a generation and 442% in a lifetime (75 years). And yes, that's the lower end of the monopolists' targets. Normally, they can't keep their hands off the goodies for long, so normally the price inflation is much higher.

And then someone is surely destined to be the first to get the hands on all the new monopolist money that's created (through QE's, bailouts, etc), like manna from heaven. And it's surely not the average Joe that gets it first.

All such crappy characteristics of the unit-of-account hits your accounting to 100%.

And on top of this, the accounting principles you choose will also affect your accounting and decision-making to 100%. So you would like to have some principles that help you to avoid over-estimating your assets and under-estimating your liabilities. Unfortunately, in this age where cooking the books is standard procedure of all governments, they are forcing us to do our tax reporting according to principles that basically will make you over-estimate your assets and under-estimate your liabilities. And this makes your accounting suck.

So selecting a unit-of-account and accounting principles definitely requires some serious thinking.

Secret #6 – National Accounting^{vi}

One of the major flaws of our time is the reliance on GDP as a measure of gross output or income. One basic reason for this is the fact that the term labeled 'gross investment' that's included in GDP consists of two terms, 'gross investments in fixed assets' and 'net investments in inventories'. Yes, believe it or not, the measure almost everyone uses includes such an obvious fallacy as a mix of net and gross terms.

So what would it look like if both investment terms were on a gross basis, i.e. if we would have gross investments in fixed assets and gross investments in inventories? George Reisman has termed the sum of gross investments in fixed assets and gross investments in inventories 'Productive Expenditure' (B), and his measure Gross Domestic Revenue would then simply be $GDR = C + B + G$, instead of the ordinary $GDP = C + I + G$.

I covered all of this in a piece called The Grossly Problematic Gross Domestic Product, so I won't go into more detail here. But it's so important, you better check it out.

Secret #7 – Sources of overall profits^{vii}

One of the greater questions of all times in economics is where overall profits come from. We have already noted that they aren't deducted from wages, but precede wages. But what then are the sources of overall profits? How come revenues tend to exceed costs on aggregate?

There have been many, many attempts at explaining this, and the best answer is again provided by George Reisman. He calls the two main sources 'Net Consumption' and 'Net Investment' and to explain them is basically an accounting exercise.

We start with Net Consumption. Let's assume that this holds for any particular year:

| Business revenue: | | Source: |
|--|---|---|
| 1. sales of capital goods to businesses | = | 1. the money spent on capital goods by businesses |
| 2. sales of consumer goods to wage earners | = | 2. the money spent on wages by businesses |
| 3. sales of goods to the government | = | 3. tax payments to the government |
| <hr/> | | |
| Sales revenue 1-3 | = | Costs 1-3 |

We then have no profits, since sales revenue equals costs. But we also have to take into account that people also earn non-wage income, like dividends, and also spend this. However, while this brings in sales revenue to the businesses, dividends aren't a cost to them at the other end. Hence, this amount forms one source of overall profits and is what Reisman calls Net Consumption.

We then have Net Investment. So far we have treated the business income to be equal to business costs, except for the addition of the Net Consumption, in a given year. This means that there is no periodization at all. But businesses do invest and they do divest in fixed assets and inventories, also on aggregate. This means that such amounts of investment also adds or

subtracts to the overall profits. Reisman calls this amount Net Investment, and it tends to be positive over time as the money supply and money spent expands.

There's no room here to dig deeper into the Net Consumption and Net Investment theory of George Reisman, but it's one of the freshest theories I've encountered, and by far the one best rooted in reality. And it's definitely still one of the greatest secrets of economics.

Secret #8 – Interest rate vs discount rate^{viii}

One of the major confusions in modern economics is to equate the interest rate with the discount rate. It seems very few economists today make this distinction, although the terms both still remain.

Interest is the sum of money you pay in order to borrow money. The relation between the amount of interest and the amount borrowed is called the interest rate.

Discount is the sum of money that you don't pay for something. For example, if I pay \$95 for something that normally is \$100, the discount is \$5. The relation between the amount of discount and the usual amount is called the discount rate.

Clearly, the interest rate and the discount rate aren't the same thing. Furthermore, the origins of these two rates are completely different. The origin of the interest rate is the propensity to save and it varies inversely with this propensity. By contrast, the origin of the discount rate is the propensity to consume and it varies inversely with this propensity. Hence, the saver is the important character when it comes to the interest rate, while the consumer is the important character when it comes to the discount rate.

Clearly, treating the interest and discount rates as equal must have consequences. After all, discounting is an important thing also today, but just equating the discount rate with the interest rate is hazardous. Are you aware of the hazards?

Secret #9 – Price determination^{ix}

Another big issue in economics is how prices are determined. Is it cost of production or utility, marginal cost or marginal utility? The by far best writings on this topic have originally been provided by Carl Menger and Eugen von Böhm-Bawerk. Menger was the founder of the so-called Austrian School of Economics and also of the theory of marginal utility, a theory he published independently the same year 1871 as Walras and Jevons.

The basic idea is two or more buyers on the one side, and two or more sellers on the other side. The buyers tend to bid up prices towards their individual perceived utilities (objective or subjective) as they compete at getting the good or service at hand, while the sellers tends to bid down the price towards their cost for the good or service. Since it's not the average seller or buyer that finally determines the price, but rather the people acting on the margin, we can refer to these buyer and sellers as marginal pairs and note that it's the marginal utility and marginal cost that's involved, not the averages.

Now, if there is only one buyer there might be very little of bidding up the price, and if there's only one seller, there might be very little of bidding down the price. In most real-life situations there often is an element of buyer or seller power influencing the price determination.

One thing that I think few people can answer is how the (marginal) cost itself is determined. This is where Eugen von Böhm-Bawerk enters the picture. He wrote extensively on this, and it's very clear and easy to follow. In his essay *Value, Cost, and Marginal Utility*, he has a chapter called 'Which Is "More Ultimate," Costs or Marginal Utility?' that deals with this. The basic idea is that the marginal utility of a good or service to the seller also affects whether the price is bid down by sellers. The raw materials etc involved often have an alternative use that also plays a role in this. For example, we cannot drive a car without a steering wheel, so the utility of the steering wheel must make the price of it very high, right? Not really, since the marginal utility of the seller of steering wheels of this particular marginal steering wheel is very low. The seller likely has thousands of it, and perhaps even wouldn't miss it if it was stolen or lost from inventories. However, the seller isn't prepared to sell it at the price of zero, since he has bought inputs like plastics to make it. So how much is this plastic worth? Well, it depends on all the other potential uses of such plastics and the marginal pairs involved in determining the price of the marginal potential other uses. In practice, the seller of steering wheels often just takes the price of plastics for granted and puts the price at the marginal cost plus a mark-up to earn something. Nevertheless, there's more to it than meets the eye, as Böhm-Bawerk explains to us so well.

It should be noted, that there's very little about this in standard text books about economics. But understanding marginal pairs is important for many reasons, like for example bid-ask-spreads when trading stocks.

Secret #10 – Real bills & clearing^x

The last major secret (of this list) hidden from modern day students is Adam Smith's real bills doctrine and the importance of bills clearing. The easiest way to understand the importance of the bill market is to "merely assume that EVERYTHING IS FIRST PAID FOR WITH BILLS," as German economist Heinrich Rittershausen put it. When a business pays for its supplies, it accepts a bill from the supplier. This bill is an IOU and it's an asset to the supplier and a liability to the buyer.

Thus, the buyer doesn't pay with cash but by an IOU. When the IOU is due for payment, the standard is that cash is handed over to the supplier. But there are other things that can happen as well. For example, the bill could be paid through clearing, something not that common nowadays, but still a procedure as old as money. Nowadays, EVER since the international bill market was officially ruined hundred years ago, it's mostly major banks and such that can benefit from clearing. The rest of us have to rely on cash to pay our IOU's.

We should also note that the supplier can sell his bills to others. For example, if the supplier has an IOU of \$1,000 that's due for payment in say 30 days from now, it might be possible that others might be willing to buy this asset. But since the payment is 30 days away and not 100% certain, the buyer of such a bill likely wouldn't pay \$1,000 for it, but something less. This means the bill is discounted.

The general rate at which bills like this are discounted was called the discount rate. The bills market was a highly liquid market and a chance for businesses with a need for cash to sell

assets (the IOU's) or for businesses with too much cash at hand to buy IOU's and instead earn something (since 30 days later they would get paid a slightly higher amount).

The discounting used to be the major business of banks and the main source for the creation of bank notes. Besides real money, like gold and silver, the discounted bills were the safest and most liquid asset banks could have on their balance sheet. In fact, if we look at old banking laws, like the German banking act of 1873, we see the importance of discounted bills:

"The bank is obliged to keep a reserve of at least 33 1/3 per cent of the total amount of its outstanding notes in German currency, imperial treasury notes, gold bullion, or foreign coins, the pound fine calculated at 1,392 marks; and the balance in discounted bills, which mature in three months, and which are indorsed by three, and in exceptional cases by two, persons known to be solvent."

We do still have clearing, and factoring businesses are daily discounting bills, but I believe few economists today have any idea whatsoever about the importance of real bills and clearing. I suppose they haven't read Adam Smith.

Summary

To sum up, these are secrets I suggest you learn more about:

- Secret #1 – The Division-of-labor
- Secret #2 – The law of comparative advantages
- Secret #3 – Marxian exploitation
- Secret #4 – Economic calculation
- Secret #5 – Proper Accounting
- Secret #6 – National Accounting
- Secret #7 – Sources of overall profits and interest
- Secret #8 – Interest rate vs discount rate
- Secret #9 – Price determination
- Secret #10 – Real bills & clearing

I hope this list of secrets has been useful to you. It doesn't take a lot to know more about economics than the average Nobel laureates (see the endnotes below). That's the sad state of modern economics, mostly reduced to an orgy of quasi-advanced mathematics and the complete absence of basic things like cause and effect.

Why not seize this opportunity to become the shining star?

Endnotes & Reading List

ⁱ Secret #1 – The Division-of-labor, suggested readings:

Adam Smith, Wealth of Nations, especially Book 1, chapter 1

George Reisman, Capitalism, especially chapter 4

ⁱⁱ Secret #2 – The law of comparative advantages, suggested readings:

David Ricardo, Principles of Political Economy and Taxation, chapter 7

Ludwig von Mises, Socialism, especially chapter 18

George Reisman, Capitalism, especially chapter 9, section C4

Richard CB Johnsson, Taxation and Domestic Free Trade

ⁱⁱⁱ Secret #3 – Marxian exploitation, suggested readings:

Eugen von Böhm-Bawerk, Karl Marx and the Close of His System

George Reisman, Classical Economics vs. The Exploitation Theory

^{iv} Secret #4 – Economic calculation, suggested readings:

Ludwig von Mises, Human Action, Chapter XXVI. The impossibility of economic calculation under socialism

- Economic Calculation in the Socialist Commonwealth

- The Problem of Economic Calculation

^v Secret #5 – Proper Accounting, suggested readings:

Antal Fekete, Is our accounting system flawed?

Richard CB Johnsson, Monetary Freedom, Monetary Magic, Gold as Unit-of-Account, and The Global Financial Crisis 101

^{vi} Secret #6 – National Accounting, suggested readings:

George Reisman, Capitalism, especially chapter 15

Richard CB Johnsson. The Grossly Problematic Gross Domestic Product

^{vii} Secret #7 – Sources of overall profits and interest, suggested readings:

George Reisman, Capitalism, especially chapter 16

^{viii} Secret #8 – Interest rate vs discount rate, suggested readings:

Antal Fekete, The Invention of Discounting and The Mystery of the Discount Rate and INTEREST AND DISCOUNT and the continental divide between them

^{ix} Secret #9 – Price determination, suggested readings:

Carl Menger, Principles, especially chapter V

Eugen von Böhm-Bawerk, Value, Cost, and Marginal Utility and the essay called The Ultimate Standard of Value in "Shorter Classics of Eugen von Boehm-Bawerk"

George Reisman, Capitalism, especially his note A Little Known Essential Aspect of Austrian Economics: Böhm-Bawerk and Wieser on the Determination of Price by Cost of Production

Antal Fekete, DISEQUILIBRIUM ANALYSIS OF PRICE FORMATION

^x Secret #10 – Real bills & clearing, suggested readings:

Adam Smith, Wealth of Nations, especially book 2, chapter 2

Antal Fekete, Detractors of Adam Smith's Real Bills Doctrine

Heinrich Rittershausen, Unemployment as a problem of turnover credits and the supply of means of payment

Richard CB Johnsson, The Classical Monetary System- According to the German School of Monetary Freedom