

Straight Talk about Economic Illiteracy

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A few centuries ago, people who could read and write were rare. But now, at least in the capitalist democracies, practically every adult is literate. In the absence of widespread literacy, it is hard to imagine how modern societies could function at all.

There are other forms of illiteracy, though, that are harder to correct.

Democracies ultimately let voters decide what government policy should be. Citizens can vote on these important matters, even if they have no idea what they're doing. If enough voters fit that description, democratic governments are bound to make foolish decisions.

Political scientists have documented that roughly half of all U.S. citizens do not know that each state has two senators, and that only a quarter realize that senators serve six-year terms. It is hard to see how voters can hold politicians accountable for their performance if they do not even know who did what for how long.

Valuable as studies of political illiteracy are, they hit only the tip of the iceberg of public ignorance. The primary activity of modern governments is to determine economic policies: which services the government supplies and which it leaves to private markets; how open the economy is to foreign trade; what environmental, consumer, labor, and business regulations to impose. Even if voters knew our constitutional structure and their representatives' voting records by heart, intelligent policies are unlikely to emerge if the voters are economically illiterate.

Economic illiteracy does not necessarily translate into foolish policies. We could imagine that the errors of half the electorate balance out the errors of the other half. In the real world, though, such happy coincidences are rare. The unfortunate reality is that more than half of the electorate does suffer from economic illiteracy. Indeed, it is fair to say that an ample majority does not understand the basics of how economies work.

The problem is not that voters lack doctoral-level expertise in economics, or that they make an occasional error. We call someone "literate" even if they misspell a word every now and then. But most voters lack even an elementary

understanding of economics. They are especially confused about labor markets, international trade, and the profit motive; and they tend to cluster around the same errors—like blaming foreigners and greedy corporations for all their woes, real and imagined.

One way that the damage of economic illiteracy might be contained is if voters based their decisions on the concrete results of economic policies, even if they didn't understand how the policies achieved those outcomes. But that isn't what seems to happen. Politicians spend a lot of energy trying to find out what policies voters want, but comparatively little investigating whether what voters expect from these policies are accurate. Indeed, when the media analyze the "results" politicians have achieved, they usually mean that their proposals have been enacted, and sidestep the difficult issue of whether their proposals, once enacted, have worked as advertised. So how can voters know which policies actually work?

In sum, while foolish beliefs do not necessarily lead to foolish policies, there is every reason to think they actually do.

THE INTUITIVENESS OF ECONOMIC ILLITERACY

Before turning to statistical evidence on economic literacy, let me confess that 15 years ago, I was economically illiterate myself. Before I began to study economics, I already had a set of emotionally appealing beliefs about it. To a large extent, learning about economics consisted in unlearning what I thought I knew. My easiest heuristic for understanding economic illiteracy, nowadays, is simply to recall my unschooled intuitions on economic issues.

Suppose, for example, that you asked me what I used to think about "technological unemployment"—the fear that machines are gradually eliminating the economy's demand for human beings. Fifteen years ago, I would have taken this possibility seriously, just as most Americans do today. But I do not take it seriously any more.

I will discuss the causes of technological unemployment in a minute. But the "obvious" remedy—restricting new technology—was fresh in my mind when I read Frederic Bastiat's *Economic Sophisms* for the first time, and suddenly realized how misguided I had been about such matters. Ten years before I picked up Bastiat, at the age of 8, I had become engrossed in Greek mythology and learned the legend of Sisyphus, the evildoer forever condemned to roll a boulder up a hill, only to have it slip from his grasp every time he neared the pinnacle. This myth made a light go on in my head when Bastiat suggested that

those who favored restricting new technology so as to prevent technological unemployment are Sisyphists:

The avowed object and acknowledged effect of restrictive measures is to increase the amount of labor necessary for a given result. Another of its avowed objects and acknowledged effects is to raise prices, which means nothing more nor less than a scarcity of goods. Thus, carried to its extreme, the policy of restriction is pure Sisyphism...: infinite labor, without any result.

Reading Bastiat inspired me to delve deeper into economics. While I was disappointed to find out that few economists rivaled Bastiat's flair and wit, they had plenty of solid arguments—few of which had seemed to me the least bit obvious. Economics takes mental work. This isn't because, as so many critics like to think, economics requires cramming a recalcitrant reality into straitjacket models. There's some of that in economics (see "Theory Gets a Reality Check" in this issue—Ed.), but not enough to invalidate the main teachings of economics. These teachings, however, aren't intuitively evident; far from it. Indeed, they require that you make a deliberate effort to see beyond the immediate consequences of an action to its long-term and indirect effects. Bastiat called this "seeing the unseen."

The more I read about the counterintuitive teachings of economists, the more I thought these people were on to something.

How very differently one understands the world after making an effort to "see the unseen" comes out in bold relief in the Survey of Americans and Economists on the Economy. The premise of this fascinating research, undertaken by the Washington Post, the Henry J. Kaiser Family Foundation, and the Harvard University Survey Project, is to ask average Americans (1,510 of them) and professional economists (250 of them) the same questions about economic matters, and see how their answers compare.

The viewpoints of the two groups could hardly be more different, as a quick glance at the [table](#) on the next page reveals. (If you want more details, the survey's write-up at <http://www2.kff.org/content/archive/1199/econgen.html> is rather engrossing.)

At least to me, the natural inference of the divergence of laymen's and economists' opinions is that economic illiteracy is rampant in the general public. If the public's beliefs about math or history sharply diverged from those of professional mathematicians and historians, I know which side I would bet on. Is it likely that people's untutored intuitions about economics are any more

accurate than their “common sense” about history or math? The public (consisting of human beings, after all) is ignorant about many things. For my part, I suggest that one of them is economics.

IRRATIONAL NATIONALISM

One of the first things that stands out in the survey is the public’s anti-foreign bias. When they contemplate economic interaction with foreigners, most people are unreasonably negative. Thus, the public is very worried about companies sending jobs overseas, while few economists take this alleged danger seriously. I hardly find this surprising, since before I studied economics, the threat of foreign competition driving us to penury seemed like a real problem to me, too.

However, the (counterintuitive) principle of comparative advantage shows that specializing and trading make sense for all countries involved. If you make clothes, and then have to face cheaper Chinese imports, your profits from making clothes will go down; but at the same time, everyone (even you) can buy cheaper clothes; plus you can switch to making something more valuable, like cars, for which you will be paid more—by car-buyers whose lives were improved by the cars you helped make—than they paid you for clothes. And meanwhile, millions of formerly impoverished people in China hoist themselves out of poverty.

The public also worries a great deal about the economic harm of immigration (“foreigners” taking away “our” jobs), while economists see little cause for concern. Once again, I have been on both sides of the issue: until I studied economics, immigration seemed to me at best a necessary evil. But after you digest the implications of comparative advantage for the international exchange of goods, it is only a small step to notice that comparative advantage applies to the international exchange of labor, too. A fixed amount of labor can accomplish more if workers specialize and then trade their services, and this can often best be accomplished if workers move to where their specialty is needed.

In the United States, for example, millions of highly skilled women leave the workforce for years due to the high cost of child care, even though there are millions of women in Latin America who would be delighted to move here to offer child-care services at an affordable price. If these Latin American women had been born in the United States, the benefits of letting them become nannies would be plain to all; but when they are “foreigners,” the U.S. public’s warning bells go off.

The public's anti-foreign bias is also at work in more subtle ways. Many economists, pre-eminently Peter Bauer, have shown that foreign aid often hurts recipient countries, because (again, counterintuitively) its main effect is to allow bad policies to linger by enriching incompetent (and corrupt) recipient governments. And virtually no economist thinks that foreign aid is a serious drain on donor nations, because it is such a tiny percentage of the budget—in the neighborhood of 1 percent of the U.S. government's spending, for example. In stark contrast, the general public sees foreign aid as a grave danger for the domestic economy. Whenever foreigners are part of the equation, the public assumes the worst.

VISIBLE UNEMPLOYMENT; INVISIBLE PROSPERITY

A second major pattern in the public's economic illiteracy is that people tend to see job loss as an unmitigated evil. This is because they focus only on the immediately perceived, very real misfortune of someone losing a job. But "see the unseen": when technological progress or increased specialization causes job losses in one line of work, labor is freed up for more productive uses. There is always something else to do. And the more goods an economy produces, the more a worker can buy with his wages. The problem is that it's harder to "see" the more productive work that, in the future, a newly unemployed worker might do than it is to empathize with his current, more visible predicament.

Similarly with the fear of technological unemployment that I used to share with most people. Economists point out that if technology posed the threat of making people economically superfluous, then surely we would all be unemployed by now. After all, 300 years ago almost everyone was a farmer, but agricultural technology now enables one farmer to feed 100 people. Does that mean that the 99 people fed by the farmer (apart from himself) are unemployed? Obviously not. They are employed in other occupations, which have been made possible by freeing their labor from producing food.

If the unemployment of hand-loom weavers caused by advances in weaving technology had been stopped in nineteenth-century England, the Industrial Revolution, to which most of the world's billions of people owe their lives, would never have happened. If the unemployment of horse breeders caused by the advent of the car had been prevented in early twentieth-century America, we would not be able to drive farther than our carriages could take us, and the streets of our cities would be piled high with horse manure.

What's seen is the suffering of those whose jobs are rendered superfluous by technological change. What's unseen are (1) how those workers adapt; (2) how

they require less income to meet the same needs, because technological improvement raises everyone's standard of living; and, most of all, (3) the suffering that never occurs because of the higher wages technology enables.

CORPORATE GREED

Those who don't understand economics often ridicule the economists' belief in an "invisible hand" as a matter of ideology or faith; what could be more superstitious?

But economists don't take the invisible hand literally; it's a metaphor explaining that even though most people in markets may be motivated by greed, under capitalism, the only way they can pursue their self-interest is by offering each other things they want to buy from each other. So in markets, self-serving motives are transformed into other-serving actions, as if by magic.

However, there really is a matter of faith involved in the public's division of opinion with economists over greedy corporations. But the faith is on the non-economists' side of the divide. It is the unshakeable conviction that greed is (always) bad.

This faith is understandable if one forgets—or doesn't understand in the first place (as I didn't)—that markets give people choices: you can go elsewhere if a greedy corporation fails to satisfy you, so the best way for the corporation to pursue self-interest is to be attentive to your needs. Is it any wonder that greedy corporations are constantly conducting market research to figure out what people will buy, while the things government provides (consider public schools or post offices) are notoriously customer-unfriendly? KFC wants you to come back, so it tries to minimize lines and give you good service. But why should the DMV care if you have to wait for hours to get a driver's license? You can't go to a competing DMV if you're dissatisfied.

One survey question from the 1996 study that captures the public's misunderstanding of this point asks why the price of gasoline rose back then. An overwhelming majority of economists—89 percent—pointed to the normal operation of supply and demand. An almost equally lopsided fraction of the public—74 percent—blamed "oil companies trying to increase profits." Apparently most people think that prices go up when businesses suddenly start to feel greedier. Economists, in contrast, expect businesses to be greedy year-in, year-out; but only if supplies have gone down (or demand has gone up) can they greedily increase prices without losing business to competitors. An oil company that raised prices in the absence of a supply shortage would lose

customers to an equally greedy oil company that took advantage of plentiful supplies to charge less—and thereby get more customers, and more profit.

But what if the companies collude to raise prices together? Such cartels are rare because of the constant pressure each member of the cartel feels to undercut the others to gain profit for itself. And look at the “unseen” past conditions that must have occurred for a cartel even to be conceivable. A group of companies that are in a position to form a cartel must already have conferred considerable advantages (low prices, high quality) on their customers to have rung up so much in sales that they have a commanding market position. Once they start trying to act like a cartel, they have a long way to go before their bad behavior overcompensates for the good (albeit greedy) behavior that made these companies so big.

What I can't understand as I look back on my own anti-corporate-greed days is exactly what I thought corporations do that is so evil. No corporation ever made me buy something I didn't want, nor do corporations employ anyone who doesn't want a job.

The survey questions about excessive profits and executive pay help flesh out the general public's resentment of corporate “greed.”

Very few economists see executive compensation as a drag on economic performance. Quite the opposite: incentives for corporate executives to make wise management decisions help markets serve consumers (thereby making the corporations managed by the executives profitable). Many non-economists fail to connect performance and reward. It is hard for them to see what executives “really contribute.” If they were thinking about professional athletes or movie stars, they might see matters differently. But the performance of a corporate manager isn't nearly as visible as the exertions of a point guard.

THE TROUBLE WITH DEMOCRACY

When experts observe the seemingly endless list of failed economic policies, they often blame an “iron triangle” of special interests. Under a veneer of democratic rule, these experts assume, politicians actually tune out public opinion in favor of helping whichever special interests give most generously to their campaigns.

But research on economic literacy raises doubts about the power of interest groups to derail democracy. The policies economists deplore—like protection against globalization (i.e., against foreign trade)—turn out to be immensely

popular with the voters. Why should we think that politicians fail to listen to the voice of the people, when heeding the voice of the people is the usual path to political power in a democracy? I would suggest that politicians listen all too well, and that as a result, they heed a host of economically illiterate demands. Even if a politician is economically literate, the need to get re-elected encourages him to go along with economic illiteracy.

But if bad policies exist because of voters' economic illiteracy, there may be hope. I used to be among the economically illiterate myself. If I could be educated, maybe other voters can be, too. The question is whether they have the imagination to "see the unseen."