



False Performance Standards

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False Performance Standards

False PS-1. Fallacy of Partial Maximization.

This is the Fallacy of Maximizing Average Product (AP) of just one input, (usually labor), ignoring cost of others. You have been warned against this in Micro-economics, but probably not often enough. Economists who should know better are frequent violators: they haven't even listened to themselves.

"Productivity" has become a buzzword leading to error, and often to ruin. The AP of a Variable Factor (VF) is a max where the Marginal Product (MP) of the Fixed Factor (FF) is zero, and v.v. That is, You (the boss) max the partial AP of one input only by wasting all others. Not smart.

Don't judge the salesman without looking at his territory; don't judge the professor without looking at his labs, experimental plots, and budgets; don't judge the farmer without valuing his land; don't judge the nation without looking at its territory.

a. Fallacy of single-factor efficiency. Every input has its zealous champion who would economize only on it, or produce only one output, and measure performance accordingly. Some value only labor, others energy, foreign exchange, food, fine arts, ATVs, endangered species, habitat, fishing, sex in its various forms, abstinence from sex, minority rights, majority rights, women's rights, men's rights, motherhood, birth control, surfing, skiing, endangered species, property rights, water conservation, wild rivers, the environment, speed, highways ... you name it, there's a freak for everything.

A good manager (or a good statesperson) recognizes single-valued fanaticism, and holds these fundamentalists in check. He must reconcile their demands: not with simple-minded personal compromises, but with good economic analysis. Sometimes, with ingenuity, he can compose them into a synthesis that is better than a trade-off, achieving much of both or many goals. Marriage, for example, has been known to satisfy the needs and overcome the loneliness and insecurity of both parties. Now that is good managing (when it works out); it takes good thinking, self-analysis, motivation, judgement of character, time spent searching, timely decision-making, and a bit of luck.

b. Fallacy and Folly of Setting Naive Records ... like max sales, gross output, budgets, height of building, speed of travel, size of desk, area of spread, cost of a party, fullest

use of damsite (e.g., highest possible dam), most perfect flood control, max output of forests and mines regardless of cost (aka "low-grading"), greatest assets of firm or bureau, etc.

All those fallacies involve ignoring Marginal Costs (MC) in Stage II,B of the production function. Stage II,B is that part of Stage II wherein $0 < \text{VMP} < \text{MC}$. Some of them can even carry you into Stage III, where the VMP of the VF is < 0 ; and Stage I, where the VMP of the FF < 0 .

The costs most often overlooked are imputed interest and rent on owned assets. They often result from overacquisition or overretention of land caused by Malthusian apprehensions, guarding against anticipated monopoly, storing up for possible future needs, holding for the rise, securing boundaries, avoiding sales to hide market values from tax assessor, sharecropping, inflating rate base of utilities, etc.

Here are some more examples.

c. Maximizing yields per unit of land (the most corn; the tallest building).

d. Maximizing sales

e. Maximizing "return on sales." This is the same as max AP of variable inputs, ignoring value of fixed inputs.

f. Minimizing costs/output. Same as max AP of sum of variable inputs. (This is a Fallacy unless "costs" include all fixed costs, **marked to market**.) It is better than max AP of just one input, e.g. labor, but what is just "better," while still wrong, is often more dangerous than what is blatantly wrong, because harder to detect.

g. Beware of something called "benefit/cost ratio" (used in project analysis). It is the AP of everything included in "cost," but often owned inputs are omitted, leading to wasting them when you max this ratio.

In fine, AP is a dull tool for dimwits. Don't be one. Its main use is for blurring issues and supporting fallacies.

False PS-2. Fallacy of Arrogation

The Fallacy of Arrogation is imputing to B the product of A's effort or saving. Its committers include most of those who oppose marginal analysis. A theory may be understood better by understanding its opposition. Whom does it threaten? Marginal analysis threatens all who gain by Arrogation. These groups jointly form "The Omelette School," so-called because their slogan is "you can't unscramble an omelette." They resist even scraping the omelette off the skillet, so they can avoid analysis. Arrogators include the following.

a. On the extreme left, those who believe that "labor produces all value." This now includes workers in fat industries, where ϵ of production is low, who would like to claim their AP. In syndicalist economies (worker control of plants, one by one), such as recently found in Yugoslavia and parts of China, some workers got good plants on good sites, others got marginal ones. Those in the better plants claimed they produced all the value.

On the moderate left (Bertrand Russell), those who believe that production is cooperative and it is impossible to impute specific amounts of production to specific inputs. (Note how people often call something "impossible," when they really mean they think it undesirable on other grounds. Russell, for example, thought imputation to specific inputs is destructive of cooperative spirit, so he called it impossible.)

Russell was a socialist, but that doesn't automatically mean he was crazy: any football player talks the same way to the press after the game. It is indeed hard to unscramble teamwork among people, and we should temper our enthusiasm for marginal imputation with that in mind. On the other hand, it is easier, and more important, to separate the contributions of labor from those of land and capital. That will be our major endeavor in this course.

b. On the extreme right, Tory rent-takers (drones and predators) who seek to blend in with productive management, and/or with savers who create capital, and take credit as managers or savers for the high AP of labor.

c. Anti-rationalists who find it hard to follow analysis. The world is full of these, seeking some easy rule to follow, so they needn't think. They are easily stampeded by those who are perfectly able to follow the analysis, but do not like its findings.

d. Managers seeking to overstate their performance.
Fallacy of understating value of fixed inputs.

Let G =Ground Value (annual), P =Product Value, and W =Work input. Consider the ratio, $P/(G+W)$. As G approaches zero, the ratio approaches P/W . Then max P/W looks like max efficiency. Managers do that routinely, to make themselves look better -- a Fallacy of Arrogation, meaning they are arrogating to their credit the output properly imputable to the fixed input.

They do this by carrying land on the books at historical cost, and by ignoring associated costs, complementary costs, allocated overhead, etc. They fight like tigers against marking to market, reserve recognition accounting, and such obvious devices for entering owned inputs at their true values.

Socialists like Bertrand Russell play into the hands of capitalist managers of this kind. That seems ironic, but it is more consistent that socialist managers in Russia became worse than capitalist managers about understating values of resources in their control. Indeed, in the Russian version of Marxist economics, natural resources have no value at all. Thus, Comrade Chernomyrdin gained his great power by running the natural gas industry, arrogating personal credit for all the natural gas that nature has stored up in Russia over billions of years.

False PS-3. Fallacy of Maximizing Usable Life of Capital (ignoring re-use value of site it preempts).

a. In commercial forestry (where trees are valued for lumber content only), that might mean maximizing growth per tree, an extreme error (except to "tree-huggers," but that is another issue not addressed here). Or, it might mean letting trees stand and grow so long as current growth covers interest on the liquidation value of the tree (thus, in effect, earning no return on the land). This is the fallacy that financial maturity arrives when value of current growth just covers interest in harvest value of tree, leaving nothing to cover rent of the site. Most economists fall into it - they are trained to overlook land values.

b. Building extra durability into dwellings, cracking towers, boilers, vehicles, etc., to "spread the overhead" of capital outlay over more years. This position is advanced with great self-righteousness about the alleged "myopia" of those who act otherwise. It overlooks at least three things:

i. The extra cost of the capital tied up over many years to provide the durability;

ii. The fall in the present value of the reuse value of the space occupied;

iii. The waste of capital resulting from obsolescence in its many forms.

False PS-4. Fallacy that Optimum is max MP, or TP

False PS-5. Fallacy of Overvaluing Foreign Exchange (relative to earnings of domestic currency).

a. In international trade and lending, this leads to maximizing exports, without regard to cost of imports. It is treating foreign exchange as though it were inherently worth more than domestic currency (at the market rate of exchange). Foreign lenders have always pushed this one hard; they still are, through IMF and World Bank. These agencies with this attitude are doing a good job of giving free trade a bad name. (Through a confusion of terms, their views are now labelled "monetarism.")

b. A variation on this idea, in local affairs, is the Fallacy that Import-competing Firms are Nonbasic and Parasitic, so a city should court and subsidize firms that export, "bringing money into the community." The Riverside Chamber of Commerce has long been in the fell clutch of this fallacy, treating little local import-competing businesses like poor relations. Bringing money in is presumed to be more worthy than keeping money from flowing out.

False PS-6. Sometimes the reverse fallacy is in style, Undervaluing Foreign Exchange or Trade relative to domestic currency or trade.

This is the way of "Autarky" (self-sufficiency). It was long practiced by Canada and its various Provinces, which would supply the local market with cheap oil and gas, rather than export it at much higher prices (even after NAFTA, I doubt if this practice has been rooted out). Russia still does this, so everyone can stay warm at 20 below zero, and you have to open the windows to avoid overheating your room. In one phase, Henry Ford

tried it for his motor company ("The Rouge" steel plant remains). Hitler sought it as a goal for the 3rd Reich.

False PS-7. Fallacy of Minimizing Costs

The way to minimize costs, literally, is just to go out of business. Something is obviously missing from this standard.

In practice, this false standard means minimizing just selected costs. These days it means downsizing labor force while keeping land and capital idle. (If firms downsized their property holdings in proportion as they downsize their work forces, the laid-off workers and the spun-off properties could combine in new business firms, compete with the old, and keep everyone employed. Obvious: but no one thinks of that. Why not? That is the power of Fallacies, they twist and stunt people's minds.)

False PS-8. Arbitrary assumptions about scale:

Bigger is better, or the reverse, small is beautiful

False PS-9. Selective and exclusive emphasis on one side of a tricky optimizing question.

Example: consider how "comprehensively" you should build the parts that fit into a massive, integrated plan (e.g., the California Water Plan).

a. Build total project all at once: achieve economies of synchronizing, integrating, and coordinating the building process, but getting way ahead of demand. (Monument builders and empire-builders fall into this one, usually naming the monuments for themselves and their friends, leaving the costs to the rest of us.)

b. Build capital only as needed: gain economies of synchronizing supply and demand, but ignoring the cost side. Example: to avoid borrowing money, people in Utah used to build a basement with a tempo roof, and live there until they saved enough to finish the house, and had enough children to need the extra rooms.

c. The optimizing solution is "phasing." It is tricky, important, and badly neglected by micro theorists.

False PS-10. Fallacy that Maximizing GNP (or local or state, or any gross product) is a normative objective of economic policy.

This belief led Alaska to lease its state-owned oil lands prematurely, turning them over to private people on the cheap, just as they began to rise steeply in value. The oil lobbyists worked hard to nurture the correct viewpoint - for them.

Subfallacy: any resource should be used the moment prices rise, or costs fall, to the point that it becomes supramarginal.

False PS-11. Fallacy of Engineering Efficiency, where:

a. Output is measured only in units engineers can observe, excluding other aspects that consumers may value. Example: engineering "needs," as determined by engineers. "Standards," without regard to diminishing returns, or personal tastes or budgets. Engineers are not trained to be modest about imposing their values on others.

b. Input, the same story, e.g. maximizing output/energy. The energy crisis produced a flood of advice along these lines. Much of it added the fallacy of defining energy strictly in physical terms, regardless of quality of fuel, tendency to pollute, cost of use and shipment, etc.

False PS-12. Fallacy of Prorating.

a. Managers on economy drives may cut back every enterprise, division or dept. by x% of some input, or total budget, or capital.

b. Cartels that restrict output routinely cut back all members by x% of some basis; or to operate their fixed input just y days/mo.

c. In Utah, in a dry year, all water users are cut back the same % of their base entitlement (the California system is even worse, based on different fallacies).

Results are not "equimarginal"; and usually have strong bias toward substituting land and capital for labor. Cartels force all sellers to carry excess capacity, which screens out lean firms w/o regard to their true efficiency. Water law induces all users to install excess diversion capacity, to build up their claims. Fishing quotas based on size and value of boats have led to there being far more boats than fisheries can support. Etc.

False PS-13. Fallacy of Single-valued Priorities.

Example: "I read that oatmeal lowers your blood pressure, so the only crop of real value is oats." Ergo, never let good oat land be used for corn, or vines, or cities, or wildlife habitat, or anything but oats. There is only so much Class I soil for growing oats. There is no market for oats, you say? Then save up the land for future oat production.

You think I'm making this up? Try attending a few meetings on land-use planning.

False PS-14. Is efficiency uneconomical? Is economizing inefficient? (Recap)

A fallacy of partial economizing is to focus narrowly on Physical Efficiency (e.g. energy-efficiency). Energy conservation is wonderful, but it is not an economic performance standard. It is totally at odds with maximizing labor productivity, for example: you can't have them both. Neither, standing alone, is economical, because it totally overlooks the other. Also, investing more capital to conserve energy is not always the most productive use of the capital, nor the cheapest way to save energy.

a. In False PS-1, and False PS-2,d, we stressed the folly and fallacy of maximizing AP of VF. True optimizing is maximizing the AP of the sum of VF and FF, for total efficiency.

b. The AP of labor is often loosely called "productivity" and equated with "efficiency." Interfirm, international, and interdivisional comparisons by these measures are common, and fallacious, and harmfully misleading. AP is partial efficiency of one input alone, and is maximized only by wasting other inputs.

c. A most common bias in American thinking and management and regulation is to make a fetish (i.e., a False Performance Standard) of minimizing short-run VC, **regardless of the rise in capital costs**. Two examples are combatting pollution, and responding to the energy crises.

Pollution control has worked this way now for 40 years. The idea has been to install expensive clean-up or control equipment, ignoring the cheaper alternatives of modifying processes and products.

Responding to the energy crunches of a few years' back, all kinds of subsidies were offered you to install new capital equipment to conserve energy. Demand management, which is labor-intensive, was neglected. There were no subsidies to the extra labor involved in cleaning your furnace or tuning your car, for example.

Congress' reflexive response to any perceived need is the low-interest loan, i.e. subsidizing the capital input. Tax credits and fast tax-depreciation are also given to capital - not to labor. Indeed, payroll taxes are raised to pay for the subsidies to capital. Result: a capital-intensive bias.

False PS-15. Fallacy of Petty Incrementalism.

This Fallacy bids us consider only minor nibbling at fringes of existing uses, overlooks major changes in uses, quantum leaps of all kinds. It can easily lead us to a low local max on the shoulder of a peak: a "molehill on a mountainside." It is one of the few errors by the estimable Alfred Marshall, whose motto was *Natura non facit saltum* (nature makes no leap). In fact, nature does leap (mutations, eruptions, extinctions, ice ages), and so do mankind, society, and the economy. It was, rather, Marshall who made no leaps - he was a cautious fellow.

We have seen that high-volume land uses (intensive, with high elasticity of production) compete for land with low-volume land uses (extensive, with low elasticity of production) where the low-volume uses yield high rents/worker. The high-volume uses are marginal in those areas, so a small drop in prices relative to variable costs wipes out their rents. Here, adjustments to price changes are not minor marginal changes, but quantum changes in use.

Again, in urban growth there often comes a need to replace a collection of individual systems with one large system, e.g. a mass of septic tanks with a sewer system, or a gaggle of private cars by mass transit. Just prior to the last, improving traffic control is rearranging deck chairs on the Titanic.

The Fallacy of Petty Incrementalism vastly understates supply responses to price and cost changes. A current petty incrementalist in California is Prof. Robert Hagan, UC Davis, who studies the economy of water use and declares that farmers cannot lower their water use by more than 2% without basic changes (which are presumed to be unthinkable). He will consider only incremental changes in current systems, overlooking possibilities of shifting from alfalfa (high water use, low value) to berries, vines, and orchards (low water use, high value); from primitive flood and furrow irrigation to drip irrigation; etc.

False PS-16. Fallacy of Free Rent. Examples follow.

a. Timber is financially mature when its growth rate is equal to the interest rate ($F'/F = i$).

b. Dams should be sized so as to max the "benefit/cost ratio." (In practice, the value of the damsite, reservoir site, and the water source, however scarce, are omitted from "cost"). This has resulted in some "pygmy dams" on certain key sites - dams apparently calculated more to seize and hold the sites and power drops than to use them fully.

c. Parking meter fees must be limited to the cost of paying for the meters and meter-maids.

d. Tolls on the Golden Gate Bridge must be set no higher than enough to pay debt service on outstanding bonds.

e. Exxon is more efficient than mom and pop farmers in the hills because Exxon has more sales per worker.

f. It is a senseless waste to tear down a sound structure when it could provide more years of service.

False PS-17. Fallacy of Subsidizing what is Largest

Example: "Farming is California's largest industry; therefore we must supply it with cheap water." I am not putting

you on: this argument is seriously advanced, and carries weight with many people.

False PS-18. Maximizing Mean Annual Increment of Forest Growth

In managing timberland, rotation ages should be chosen so as to maximize mean growth per year, regardless of cost.

False PS-19. Fallacies of Static Equilibrium

Example: the flow of timber from U.S. forests, and from each particular forest, should be constant in perpetuity (sustained yield). The inventory of timber should never fall below its present level. Timberland should never be used for any other purpose. Etc.

False PS-20. Fallacy of Lowering AFC by Increasing Scale

The falling AFC curve, spreading overhead and all that, is a matter of proportions: FC are assumed fixed. Firms that raise scale, however, generally do so by raising FC more than in proportion to VC, substituting K for W. Data from *Fortune*, e.g., show this clearly.

Thus, a graph with sales on abscissa, showing relation of LAFC and LAVC looks like a squat, wide X: LAFC has the positive slope; LAVC the negative.

You can break down LAFC into Land and K: Land rises faster.

Break down LAVC into Work, Materials, and Energy: only Work falls with Sales, for sure; Materials and Energy may rise some.

False PS-21. Fallacy of Spreading Overhead of K by Buying more Land.

This is common among farm economists. Its problem is that the land costs a lot more than the capital on which they are economizing. Machinery, equipment, and livestock are about 10% of the wealth of American farmers; land is much more.

False PS-22. Fallacy of AC pricing

This is common in the management and regulation of public utilities, and has led to the ruin of many (e.g. mass transit in the U.S.). Prices should be set equal to MC, not AC. If $MC < AC$ this results in a deficit. Then, flat charges (not varying with usage) should make up the difference. These flat charges often take the form of taxes on the properties that are served, and whose value is created or enhanced by the service.

Flat charges may also take the form of "demand charges," billed to each customer just for hooking up. In Riverside's Gage Canal, a mutual water company, they take the form of annual flat "assessments" levied on the shareholders, per share. Shares are 2 per acre, so they are at root flat assessments per acre.

False PS-23. Fallacy of basing price on obsolete MC

Continuing from False PS-22, another fallacy is to base current prices on what MC used to be. This is common in California water cities and farm districts that supply water at prices based on 19th Century abundance of water, ignoring today's high scarcity value of water.

False PS-24 to ∞ More Fallacies?

One could go on: error is infinite. Enough of fallacies. It is useful to survey some of the more common ones, as we have done: they keep popping up, and you should be prepared. Every Presidential campaign produces its new crop. Otherwise, it is more economical to study truth, which is less varied, and which automatically screens out fallacies.