



Fallacies in Micro and Production Economics

By [Dr. Mason Gaffney]

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Fallacies in micro and production economics

MIC-1. Fallacy that Pricing is Counterproductive

a. Fallacy that the high price of an input keeps it from use. (This is equating pricing with overpricing. There is such a thing as overpricing: sometimes it makes serious problems, e.g. in speculative land markets. Usually, though, in most markets, prices play a constructive rationing role.)

Sub-Fallacy that the high price of an input removes the advantage of using it, so it is used only marginally if at all. [Rather, it drives people to use it sparingly by using it intensively, i.e. combining it with other inputs. A good example is land on The Ginza, 5th Avenue, State Street, and other famous central city hot spots.]

Sub-Fallacy that a high tax-price for holding valuable land will drive it from use (Murray Rothbard). Some compartment-minded, double-thinking folks will see privately-taken rent driving land to its highest and best use, but reverse their story when the rent is taken in the form of a property tax on holding land. Passionate anti-statism (like any other single-valued ideology) leads one into contradictions.

b. Fallacy that the high price of an input is routinely and necessarily passed on to consumers. Rather, it depends on elasticities of supply and demand. Ditto for tax costs, q.v.

MIC-2. Fallacy of Melding (Consolidating Accounts, Averaging Costs) to determine regulated prices, power rates, etc.

a. Average-cost pricing, even in simple case.

This fallacy entails:

i. Presuming that $AC = MC$.

ii. Conceiving "cost" narrowly only as something like burning up or rusting out a material, overlooking that "cost," in the true sense, may mean preempting scarce space or capacity of fixed land and capital (cf. #5).

b. Melding decreasing costs with increasing costs, to hide the former:

Example: Milliman on cost of water supply. Milliman wanted to show that you could price utility services at marginal cost, and still make profits, because (he said) they were in the stage of increasing costs ($MC > AC$). He said this because to serve more customers you must extend the lines further, ignoring that you can serve more customers inside each perimeter by widening

each line.

c. Melding over space

i. Postage-stamp pricing (cf. #6).

ii. Letting rentable resources carry subeconomic operations: cross-subsidy. Example: British Columbia Ferry service to small islands, costing \$10 per \$1 of revenue, is carried by profits made on the main runs between Vancouver Island and Vancouver City.

d. Melding over time

i. Melding historical with current costs, during inflation. "Historical-cost pricing."

ii. Allocating capital costs, and interest thereon, arbitrarily to specific years, almost always by rote formula not based on actual depreciation paths. This is a kind of melding over time.

e. Regulated pricing by industry average costs (cf. #3)

MIC-3. Fallacy of The Representative Firm.

a. Fallacy that the mean or median firm in any sense reacts the way other firms do. This masks vital differences among firms, notably differences between marginal vs. rent-taking firms. There are also differences among divisions and enterprises within firms. It is another error by Alfred Marshall (who is generally a good and useful analyst).

i. Natural gas price control in the U.S.

ii. British Columbia Gas Corpn. field pricing.

Foolish plea of FPC economist David Schwartz, "let's just cut the price so low that we eliminate rent."

b. Fallacy of representing all sellers as marginal.

No one wants tax-hungry legislators to perceive slack or fat in their part of the private sector, so it is their interest to present a public image of marginality -- the opposite of their image for bankers and stock buyers. Their rhetoric is understandable by putting yourself in their shoes to understand their motives. Remember, though, people who are grinding their own axes often come to believe their own lies, used originally to exploit others. Understand them, yes; but don't make bad judgments and lose your shirt or waste your vote by actually believing it.

MIC-4. Fallacy that "productivity determines wages."

a. In its most primitive (and therefore most common) form, the fallacy is one of equating MP and AP. Economic writers, who should know better, do it often, sometimes because they are on someone's payroll, or hope to be if they work the right side of the street.

b. Actually, the AP of labor is MP/EP (where EP = Elasticity of Production).

c. From an employer's viewpoint, with wage rates given, it is actually wage rates that determine marginal productivity. From a total system view they are mutually determined by the interaction of supply (labor) and demand (marginal product).

d. Subbing K for workers raises their AP but lowers their MP (lowers elasticity of production). If subbing is widespread this drives down wage rate.

MIC-5. Fallacy of not recognizing preemption as consumption.

a. Fallacy that people should not be charged for using streets because they do not "really" consume them. Here, to "consume" is seen as breaking things into little pieces. This fallacy would make streets a kind of "public good," a commons of infinite capacity. This makes them like telecasting, with no marginal cost of use. (See also under Taxation, marginal cost pricing.)

Actually, occupying valuable space during a time-slot is how the space is mainly consumed. Paving depreciates with time more than with use; and the r.o.w. does not depreciate at all. Its social cost is purely the cost of preempting its time-slots.

b. Fallacy that holding land is not consuming anything, because the land is not used up or impaired. This attitude would make land be a kind of public good: use by A does not preclude use by B. Rather, preempting land for occupier A keeps its use from all others. Like the lawyer, its time is its stock in trade.

c. Fallacy of Not Recognizing "The Second Law"

The Second Law of Thermodynamics says that adding entropy (chaos, disorganization, adulteration) to a resource is consuming it.

Example: fallacy that only diversions of flowing water (less return flows) are true "consumptive" uses of water (it's the law!). Rather, loss of elevation and purity both lower value of residual water, consuming its value.

d. Fallacy of Ignoring value of low-cost resources

Example: when oil production is prorated, deeper wells should be allowed to produce more days per month than shallow wells, be cover the costs of the deeper wells.

Example: oil and base prices should be controlled at the cost-of-production at the individual wells. High-cost sources should be allowed higher prices than low-cost sources.

MIC-6. Fallacy of Abstracting from space.

a. Rate regulation with postage-stamp pricing.

b. Overstating economies of scale when this involves "spreading the overhead" of indivisible capital items over more land. The fallacy is to overlook transportation cost of linking the lands. This fallacy is widely committed by farm economists, explaining, for example, the advantages of larger farm buildings and machinery. It is committed by urban economists analyzing the scale economies in a city as a whole, overlooking or trivializing the costs of urban sprawl.

Frequently, too, analysts make it worse yet by overlooking the opportunity cost of the land itself, especially where the alternative use is untenured, e.g. the service of sheltering wild waterfowl. The environmental movement is a reaction against this kind of fallacy. The reaction generates its own fallacies. Economists are inclined to sneer at these, but it is really our fault, for failing to accommodate the environmental values in economic thinking to begin with.

c. Example: measuring the cost of highway usage in ton-miles. In fact, the empty truck uses as much space as the loaded truck.

MIC-7. Fallacy of fixed proportions

The Fallacy: Inputs are always combined in fixed proportions, like chemical valences, for technological or natural reasons. This belief arises from the same mindset that makes demand and supply curves inelastic, and the price mechanism generally irrelevant and delusive. Examples follow.

The universal rule is that "*Scarcity breeds substitution.*" A good manager works with the cheapest suitable inputs suitable to meet demands. History and practice show economic man is flexible and imaginative in adapting over wide ranges. Dimwits say things like "It takes \$60,000 of capital to make one job," but assets/worker range from \$5,000 (Singer, Mattel) up to \$700,000 (Chevron).

a. People who adapt to current prices and costs are accused of abandoning proper "standards," "requirements," "duties," etc. Professional associations (doctors, engineers, labor unions, building inspectors, etc.) are notorious for insisting on rigid standards regardless of cost or demonstrated need.

b. The Charls Walker Fallacy (one of several): national income bears a fixed relation to energy consumption. (Walker is a highly skilled lobbyist and "rainmaker" for foundations engaged in "deep lobbying," tax-exempt. His very job is to promulgate fallacies for his clients, so we find his tracks on several of them.) During the energy crisis, Walker's job was to stampede people into exempting oil firms from taxation. Time has disproven this Walker Fallacy, but he just keeps rolling along, spinning out more.

c. The Fallacy that Farming Requires a Fixed Input of Water.

Actually, water in California yields high returns or low, depending on the crop to which applied: high for tomatoes, low for rice. There is no fixed output per unit.

d. Fallacy that factor proportions remain fixed over the life of curable capital.

Actually, factor proportions change automatically over the life of durable capital. Measuring capital in value terms, a new auto provides capital-intensive transportation; as it ages and requires more maintenance and upkeep and operating care it provides labor-intensive transportation. Ditto for houses and shelter; and if the location rises in value, and the building ages, it becomes land-intensive shelter. All this from the same sticks and stones, over time.

e. Fallacy of Transplanting Technology to regions with different cost patterns.

i. Example: the "Ugly American" syndrome in foreign aid programs.

ii. Related example: the "Edifice Complex" of distant lenders, e.g. The World Bank. This is a virulent complex, not easy to wipe out, because it has been exposed and lampooned and admitted to over many decades. Various Presidents of the World Bank have acknowledged it, and vowed to change - but the World Bank does not change.

If the Bank won't reform, why don't we just stop subsidizing The Bank, then, and let it die? One is drawn to conclude the Bank has another function (promoting private rent-taking, and derivative political conservatism), for which transferring capital is just a cover, and a tool of political persuasion.

iii. Example from earlier times: Americans should adapt the best conserving practices from crowded older countries like Germany, The Netherlands, Belgium, and Japan.

e. "Appropriate Technology" and "Intermediate Technology" and "Soft Path" technology as solutions. Ridicule, marginalization, etc. as counterploys.

MIC-8. Fallacy of 2-factor substitution

In this Fallacy, the marginal productivity of labor always rises when a firm or economy adds more capital, whether in fixed form like plant/equipment, or working form like energy and raw materials. The Fallacy ignores the substitution of capital for labor; its preachers tell labor it is better off, even though out on the street lining up for soup.

Rather, substituting A for B implies the presence of C: A occupies C and displaces B from its former attachment to C. It's *The Eternal Triangle of Economics*. This is not a case where "Three's Company."

Most texts are faulty and misleading on this point. They give examples of "substitutability" between K and L. K would truly substitute for L only if it lowered the MP of L, but in most examples in most texts, adding K raises the MP of L. That would in fact cause more L to be hired, and the firm to expand.

Here are some examples of true substitution. Farm machinery displaces labor by bumping it off the land; so does capital in other forms like sheep, cattle, timber, bar-code machines, automated controls, etc. So may other natural resources used in fuel, fertilizer, pesticides and water supplies.

Many of these substitutes, in practice, actually lower yields/acre. Such an input is "preemptive." It is nice for landholders who want to cut down their management input: labor is hard to manage. By the same token, they are hard on displaced workers. The modern fallacy of 2-factor substitution could only develop, thrive, and survive in a profession dominated by a wish to keep people from seeing and understanding phenomena like the enclosure movements of the 19th Century, that triggered off the radicalism of both Marx and Henry George.

The productivity of a substituting input is measured in the cost of what it displaces/replaces, less any decline of the Product (and plus any rise of it).

Cobb-Douglas production function is faulty because it contains built-in, unspoken presumption of complementarity between capital and labor: more K always raises MP of labor.

Actually, capital is "Protean" (takes many forms), and

changes form each time it turns over and readapts. Some capital substitutes for land and uses labor: e.g. tall buildings, fork-lifts, tomato vines, land-fills, fertilizer, narrow-band broadcasting equipment, theatres, etc. Good land generally complements (makes opportunities for) labor, and substitutes for (obviates) capital. Developing marginal land is capital-using.

MIC-9. Fallacy of exaggerated compensatory effect

Sometimes an analyst will note that a major effect is tempered (muted, or damped) by some compensatory reaction; then take the compensatory reaction for the major effect, forgetting the prime reaction that causes it.

a. The Laffer Fallacy that raising a tax rate lowers the tax base so much it lowers tax take. (This is possible, hence makes a good debating point, but it is rare: Laffer's forecast turned out to be wrong.)

b. A new source of supply (e.g., letting imports into a country) lowers price, which then lowers old sources of supply so much that price rises (Paul Ehrlich, a pessimist who will not be comforted).

c. Higher interest rates lower land rents; the lower land rents make it cheaper to hold standing timber on land, lowering the pressure to cut and liquidate (this fallacy is rare).

MIC-10. Fallacies of historical cost

a. Shrinking the meaning of land rent to mean only returns in excess of normal returns on historical purchase price of land. (Coupled with redefining most labor income as a form of rent, this fallacy completely reverses the classical idea of land rent is peculiarly eligible for heavy taxation.)

b. Arrogating current rent to the credit of current management, by carrying appreciated land at historical cost, instead of marking to market.

MIC-11. Fallacy of automatic, routine pass-through of higher costs and taxes.

In fact, where prices are determined in world or national markets, large local supply changes hardly affect prices at all. Sellers are price-takers, not price-makers. Prices are determined by supply and demand. Costs are only passed through if they cut supply, and demand is inelastic.

How is supply affected? Look at effects on marginal production (intensive and extensive). Low *EP* probably means

there is little marginal production (the MP curve falls steeply).

A rise of fixed costs, in fact, may spare marginal production completely, but force better use of fixed inputs. Thus it will actually raise production, and lower price.

Higher variable costs abort only marginal production, and where *EP* is low there is little of that. *EP* is low where rent/worker is high, and here "royalties" based on units of production, and "share-cropping" contracts are common, because their convenience and risk-sharing advantages outweigh their incentive-killing effects.

Here is also where unions can raise wage rates. Low *EP* means a steep MP curve; MP is the demand curve for workers; a steep curve means inelastic demand. Employers with low *EP* may actually favor unions, which hurt their marginal competitors much more than themselves.

Here also is where consumers can capture some rent, by getting legislatures to impose max price controls. Examples: oil and gas; rents in Sta. Monica and N.Y. City.

MIC-12. Sacrificing allocative efficiency to achieve distributive equity, when:

- a. Distributive equity is badly defined, e.g. parity for agriculture, helping poor "regions" (with a few rich owners);
- b. The policy does not serve the alleged end, e.g. shifting to state sales tax to help poor people; shift to payroll tax to help workers; etc.
- c. There are means to attain equity and efficiency jointly.

MIC-13. "First come, first served."

This is how most western water is distributed, resulting in cross-hauling, through a "law of comparative disadvantage": San Francisco goes south for its water, because L.A. might get there first; so L.A. goes north of S.F. for water.

MIC-14. Fallacy of Extending Scale Economies in Production Functions Indefinitely.

Example: the "Six-tenths Rule" of engineering says that Long-run Marginal Cost (LRMC) = $.6 \times \text{LRAC}$, in sizing structures, machines, etc. There must be limits to this, but they are not found in The Rule.

MIC-15. Fallacy that Price Controls Always Distort the Allocation of Resources (a Libertarian Fallacy).

If the sellers are already monopolized or cartelized, a price cap might improve things

Where AC-pricing prevails, a cap = MC will improve things (with necessary adjustments, like a flat-rate standby charge, to balance the books)

MIC-16. Fallacy that a monopoly or cartel gains nothing from holding actions, because they must pay the paper tomorrow.

False, because money today is worth more than money tomorrow.

MIC-17. Another Libertarian Fallacy: Street congestion cures itself optimally because drivers avoid congested streets and times.

Likewise, overdraft of aquifers cures itself optimally because as well-water levels sink, pumping costs more.

MIC-18. Fallacy that Uniform Prices are Non-discriminatory

Example: belief that peak-load pricing is an example of price discrimination. In fact, the absence of peak-load pricing discriminates against non-peak customers.

Example: belief that zonal pricing is discriminatory. In fact, uniform pricing is discriminatory, where costs of service are non-uniform.

MIC-19. In a competitive market, surplus profits are all competed away.

MIC-20. High rents drive people away from central cities.

Fallacy is failing to distinguish between demand-driven high rents, and overpriced land. Overpricing keeps land from use, but high rents in a properly functioning market force owners to economize on land, i.e. use it intensively, hiring workers and serving customers.

MIC-21.