CHAPTER TEN

THE PERFECT PRICE

> The frugal man has the advantage over the man of pleasure in facilities for self-improvement, for doing his duty to his country, and for securing general happiness.
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> | PLATO, *SOCRATIC DISCOURSES*

If you hang around economists long enough, you hear a good deal about their intellectual heroes: John Stuart Mill, Adam Smith, John Maynard Keynes. Among the more controversial of these heroes is Joseph A. Schumpeter, the Harvard economist who in 1943 published the iconic *Capitalism, Socialism, and Democracy*. The seventh chapter of that work, entitled "The Process of Creative Destruction," is for many academics a sacred text. "The process of creative destruction," Schumpeter writes, "is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in." Creative destruction is an elegantly simple idea describing the industrial mutation of old structures into new ones. The department store evolves from and "creatively destructs" the country store; the auto industry evolves from and replaces the horse and buggy business, automation makes many factory and farm jobs obsolete but creates new jobs in information technology, engineering, healthcare, and biotech.

Creative destruction is a critical and necessary driver of progress. In the stampede toward ever greater efficiencies we have come to expect that institutions will get torn down, factories closed, stores shuttered, workers made redundant, and lives detoured. And that is as it should be: Nostalgia aside, we know deep down that the good old days were

not always so good. Few of us would want our own children operating a dangerous machine in a hot, dirty factory or spending blistering summers under the sun behind a plow. But in the Age of Cheap we have lost our balance: Creative destruction is as destructive as ever. It's the creative part that is in doubt.

"One of the great insights of twentieth-century economics is that you need excessive profits to create innovation," Harvard trade economist Robert Lawrence told me. "When prices are kept too low, innovation is nearly impossible." Underlying this is what economists call "perfect competition," a state characterized by a multitude of buyers and sellers, many products that are essentially interchangeable, and few if any barriers to entry in a given market. Under this condition, prices are determined by supply and demand, which sounds like a good thing. But when price is the only distinguishing characteristic among products, competition does not necessarily lead to the innovation of better products or to stronger, more highly evolved industries. Often it leads where we wish it would not go: to a price war that discourages the very creativity, entrepreneurship, and invention that we revere.

Low price was made possible by massive innovation in distribution and information exchange, computer-driven supply chain wizardry, and streamlined transportation systems. These new efficiencies brought many things within reach of consumers around the world and powered titanic progress. But in today's global market, producers have far less leverage than they once did to bargain: If a company increases its selling price, consumers can turn to the nearest competitor for a better deal. Hair-trigger price sensitivity shrinks profit margins, and when margins get too thin, producers don't have the means or the will to be creative.

University of California historian Nelson Lichtenstein said that in the last decade, discount retailing had replaced General Motors as the "template industry of our era." Given the difficulties faced by GM, this may sound like a good thing, but looking closer, the challenges become clear. Thanks to their enormous power, discounters have set de facto wage and benefit standards, subordinating the manufacturing sector. Discounters have generated, Lichtenstein said, the "most profound transformation in the spatial and demographic landscape since the emergence of suburbia

in the immediate post–World War II years." In this new environment, many manufacturers are essentially penalized for innovation.

Innovation is by definition risky, and it is made all the more so when stockholders overlook the long view and demand a jump in profits every quarter. When competition is mostly about price, innovation too often takes a backseat to cost cutting. Laying off workers and hiring cheaper ones is one sure way to enhance the bottom line. Another is to scour the world for low-wage workers, especially those in countries with lackluster enforcement of environmental and workers' rights regulations. Neither of these tactics is innovative, and neither in the long run contributes to growth. And both contribute to an erosion of income that leads to debt and a decrease in spending.

Technology-powered globalization is often touted as a boon for business and citizens alike. There is no question that this has been true for the consumer side of us, the bargain-hunting side. Without steady access to the fruits of low-cost labor from abroad, Wal-Mart, dollar stores, and other discounters couldn't exist. Globalism has served our consumer side well, but for the citizen side of us—and the worker side—globalism has been a decidedly mixed bag. Lawrence Summers, one of President Obama's top economic advisors and a vocal booster of free trade, acknowledges that globalism has a troubling aspect. "As the great corporate engines of efficiency succeed by using cutting-edge technology with low-cost labour, ordinary, middle-class workers and their employers—whether they live in the American midwest, the Ruhr valley, Latin America or eastern Europe—are left out. This is the essential reason why median family incomes lag far behind productivity growth in the U.S."

Summers and most economists agree that on the most basic level, trade should make everyone richer by enabling us to buy goods at the best possible price. Bolstering this claim is the principle of comparative advantage, first proposed in 1817 by influential British political economist David Ricardo, in his landmark *Principles of Political Economy and Taxation*. By Ricardo's calculations, individual nations in a global economy are most efficient—and most prosperous—when they both produce and trade. To illustrate the point, Ricardo outlined a hypothetical case. Suppose in Portugal it takes fifty workers to make a certain value of cloth

and twenty-five workers to make an equivalent value of wine. Suppose that in England it takes fifty workers to make a similar value of cloth and one hundred to make the wine. From this it would seem that Portugal, with its competitive advantage in both arenas, should export both cloth and wine, while England should import both. But in a brilliant stroke, Ricardo showed why it would be better for Portugal to make only wine and England only cloth, and for the two countries to trade their wine and cloth.

Ricardo's argument went roughly like this: If Portugal transferred twenty-five workers out of the cloth business and put them to work making wine, it would produce one more unit of wine and one-half unit less of cloth, for a total one-half unit increase in overall productivity. If England took one hundred workers out of the wine industry and put them to work making cloth, it would have one unit less of wine and two additional units of cloth, for a total of one unit improvement in productivity. By focusing on what each does best, the two nations in aggregate produce more of both wine and cloth, thereby improving efficiencies and lowering costs. Ricardo concluded that Portugal is far better off trading wine for cloth, and England cloth for wine, than continuing to produce both on their own—showing how trade between nations can increase efficiencies even when one country has a natural advantage over the other.

The law of competitive advantage applies not only to trade but to everyday life. Consider a small law practice comprised of one lawyer and one secretary. Let's say filing papers each day takes the lawyer one hour and the secretary two hours. Now let's say the lawyer makes $200 an hour and the secretary $25 an hour. Clearly, the business is better off having the lawyer stick to legal work and the secretary to filing even though the lawyer is more efficient at both tasks.

Applying this reasoning to the twenty-first century, free trade evangelicals have argued that it is more efficient for America to outsource many functions to low-wage countries such as India and China. Harvard economist Gregory Mankiw, chairman of the White House Council of Economic Advisors in the Bush administration, could not have been more clear on this point. "When a good or service is produced more cheaply abroad, it makes more sense to import it than to make or provide

it domestically. This can be difficult for workers who are displaced and need to find jobs in new growing industries. But the economy overall benefits." Mankiw's comments echoed those made by former Federal Reserve Chairman Alan Greenspan, by which he reassured workers hurt by outsourcing by saying they "can be confident that new jobs will displace old ones as they always have."

This brand of "creative destruction," Mankiw, Greenspan, and others have argued, will allow Americans to focus on what we do best: invention and entrepreneurship. On the surface this seems to make sense. The United States is an innovative powerhouse, a place where ideas are born, raised, and coaxed into profitable ventures. Indian and Chinese workers indeed do good work, and they do it cheaply. But what held true for the trade of wine and cloth in the eighteenth century does not necessarily hold true in the post-Internet age.

The assumption that America is the land of endless innovation begs a critical question: Can the majority of us be—or do we want to be—constantly creative and inventive? Even if this unlikely prospect were the case, Americans hold no monopoly on entrepreneurial zeal, creativity, or intellectual firepower. Jared Bernstein, the chief economic advisor for Vice President Joseph Biden, is an expert on international labor markets. "It's pure hubris to say that we have the market cornered on talent and brains," he told me. Hubris is probably understating it. India, China, and other low-wage economies are ramping up scientific and engineering research with a vengeance. They are also educating their workforces. It is estimated that only 15 percent of the world's PhD's in 2010 will be conferred on Americans, down from 50 percent in 1975. Nearly one-third of those in graduate programs in science and engineering in the United States are foreign students, many of whom return to their home countries, set up businesses, and surpass their American rivals. Other foreign-born graduates stay here, competing for jobs. This, in turn, has made science and engineering less attractive to American students.

New York Times columnist Thomas L. Friedman wrote in his best-selling *The World Is Flat*, "The Indians and Chinese are not racing us to the bottom. They are racing us to the top—and that is a good thing." Well, yes and no. It is a very good thing that globalization has to some degree

redistributed the spoils of innovation and that India and China are supporting educational and technological advance and building human capital. It is a very good thing that millions of people in the developing world are being lifted out of poverty, some into positions of responsibility and influence. But it is not such a good thing that skilled jobs and opportunities are being commodified with little thought and almost no regard for the consequences. For despite the hopeful projections of globalists, the demand for even the most skilled workers is not endless, and the idea that more and more Americans can reinvent themselves into ever more challenging work is a pipe dream. Harvard trade economist Richard Freeman made this case persuasively in a speech delivered to the Boston Federal Reserve conference in 2006: "By giving firms a new supply of low-wage labor, the doubling of the global workforce has weakened the bargaining position of workers in the advanced countries and in many developing countries as well. Firms threaten to move facilities to lower-wage settings or to import products made by low-wage workers if their current workforce does not accept lower wages or working conditions, to which there is no strong labor response."

While Freeman does not believe that U.S. wages will be ratcheted down to the China price anytime soon, he points out that how workers fare in China and India and other rapidly developing countries will determine to a great degree the wages and working conditions for the rest of us. Technological advance, combined with the threat of outsourcing and downsizing, has neutered unions and given employers unbeatable leverage in almost every job sector. Caterpillar, the quintessentially American maker of tractors and earthmoving equipment, offers a stark illustration. Based in Peoria, Illinois, the company once set a gold standard for wages and benefits. Its machines helped build the Hoover Dam and topple the Berlin Wall. In 1982, Caterpillar was featured among the "excellent" companies, in business guru Tom Peters's best-selling *In Search of Excellence*. But after losing more than $1 billion thanks to competition from Japan in the 1980s, the company decided to change course. First it farmed out work to nonunion shops. Then it adopted a "southern strategy," moving some of its manufacturing to "right-to-work states" where labor