

Review by George W. Evans of “Ethics, Economy and Entrepreneurship”
by C. Johnson, R. Lusch and D. Schmitz

October 29, 2018

I have been asked to provide a review of the above book for possible use as a high-school textbook. The version I have available is dated September 2016. Although the textbook aims to be wider-ranging in the sense that it also covers ethics and entrepreneurship, its central focus, as is evident from the topics covered in Parts 1 through 5, which occupy 238 of the 309 pages of text, is economics. Since I am a professor of economics, that will also be my focus. My main areas of teaching and research are in macroeconomics and econometrics. While my expertise is in economics, not secondary education, I do have a great deal of teaching experience in several universities at a wide range of levels.

Let me state up front my overall assessment, which is negative. The book contains numerous deficiencies that concern me as an economist and which, in my view, render it unacceptable as a textbook.

My first major concern is the book’s thoroughly inadequate treatment of macroeconomics. Macroeconomics studies the performance of the national economy as a whole, focusing on the level and rate of growth of the aggregate production of goods, the level of unemployment, the rate of inflation, the role of financial institutions, the determinants of interest rates, government deficits and debt, and related “open economy” topics including foreign exchange rates and the balance of trade. Microeconomics focuses on a range of topics including household and firm decision-making, the determinants of prices and quantities in individual markets, market structure, imperfect competition, labor markets, and market failures. Most introductory textbooks give equal space to macroeconomics and microeconomics, but this textbook is woefully inadequate in the attention given to macroeconomics. As a macroeconomist I am appalled by the very brief and poorly developed sections on macroeconomics.

The discussion of macroeconomics has essentially been reduced to one or two chapters: Part 4, a 34 page discussion of the issues most central to macroeconomics, labeled “Economic Institutions,” and Part 5, a nine page chapter titled “Innovation.” In Part 4, 11 of the 34 pages are taken up by measurement, certainly a worthwhile topic, but not meriting this amount of space given the shortness of the chapter. And the descriptions given are sometimes confusing or inaccurate. For example, in the GDP section, the

paragraph on pp. 224-5 jumbles together the three approaches in a way students will find confusing. This is then followed by the breakdown of GDP into categories, which is based on the expenditure approach, not, as stated, the production approach. Students will also wonder how “net exports” can be a category – in my experience students invariably find this confusing unless it is explained carefully. The section pp. 222-232 on measuring economies notes the limitations of measures of GDP and the unemployment rate, but the critique of the unemployment rate is overstated, concluding that “a little investigation” reveals “how easily they can be misinterpreted and therefore potentially misused.” One might think from the discussion of the discouraged-worker effect that the Bureau of Labor Statistics ignores this point. However the BLS measures this effect in their survey question and also asks whether employed workers working part-time would prefer more hours or full-time work. Their higher U6 measure takes into account both of these effects. If one plots together a time series of the U6 and the “headline” U3 measure, one sees that these two measures largely move in parallel. Thus, the relevant information is publicly available and, importantly, both U3 and U6 provide consistent information about the underutilization of labor in recessions.

But the big problem with Part 4 is what is not discussed. A major part of macroeconomics is providing an explanation of the business cycle, which consists of periodic but irregular stretches of economic expansion punctuated by recessions. Why do recessions occur? Why are they sometimes deep and sometimes mild? What can economic policy do to avoid or moderate recessions? These issues are usually viewed as the central “short-run” economic questions in macroeconomics and should receive a prominent place in any textbook. The inadequacy of the textbook under review can be seen quickly by noting that the word “recession” appears on only one page of the entire manuscript: p. 235.

Adequately discussing business-cycle fluctuations requires a model of goods market and financial markets equilibrium. The standard treatment is the IS-LM model or its extension, the AD-AS (aggregate demand - aggregate supply) model. The model plays a central role in macroeconomics, comparable to supply and demand in microeconomics. As with supply and demand in microeconomics, elementary versions of the standard macro model can be presented in introductory courses, and the model can then be used to discuss causes of different recessions. For example, in the “tech bust” recession of 2001 a major role was played by reduced business investment, particularly in telecommunications and the tech sector, whereas the Great Recession starting

in December 2007 was initiated by falling house prices and a financial crisis. Besides understanding how recessions are precipitated and propagated, the model can be used to discuss how monetary and fiscal policy have played a role in moderating recessions and to facilitate expansions.

The treatment of policy in the book is much too brief, and it is poorly written. Fiscal policy is reduced to two pages and monetary policy is reduced to two pages. The discussion of fiscal policy near the top of p. 234 is hindered by its brief description of the aggregate demand curve; this relationship has an explanation quite different from the demand curve in a single market; it needs the macro model to understand the mechanism. The second full paragraph fails to make the critical distinction between government transfers and government purchases of goods and services. It then ends with a statement that is at best misleading; instead, theory and empirical estimates agree that, *ceteris paribus*, an increase in government purchases of goods and services financed by tax increases is net expansionary.

The next paragraph on p. 234, which considers an increase in government spending financed by bond issue (deficit spending) is also misleading. This cannot be coherently discussed without considering both the state of the economy and the way monetary policy is set. However, in almost all contexts, the increase in government spending will be net expansionary in the short run (over several years). Furthermore, if the economy is below capacity, e.g. in a recession, and if monetary policy is implemented by setting a target for the federal funds interest rate, as it has been in the US the last 25 years, then increases in government spending will be effective, increasing GDP by substantially more than the increase in government spending (the multiplier effect). The discussion on p. 235 is better, though it suffers from a disconnect with the poorly presented and misleading arguments on the previous page.

I should also mention that the discussion at the bottom of p. 234, concerning the exchange rate effects of fiscal policy in an open economy, depends critically on the stance of monetary policy. This is the only reference in the book that I can find to foreign exchange rates. Consequently, students coming upon this paragraph will have no idea what is being discussed. I also note that, near the bottom of p. 235, the criticism of discretionary fiscal policy that it takes too long to implement did not apply to the fiscal stimulus of 2009-2011.

Finally, the discussion of fiscal policy does include a useful graph, Figure 4.1, of the deficit to GDP ratio from 1962 to 2002 and the increases in the deficit ratio in the late 1960s connected to the Vietnam War, and in the

1980s and 1990s resulting from tax cuts. Looking at the graph, students may wonder what the “cyclically adjusted budget surplus” is; this should be explained. Looking at Figure 4.1, students may well also wonder what turned the deficits that remained in 1992 into a surplus in 1999 and 2000. This was due to a mixture of fiscal and monetary policy known as the Clinton-Greenspan policy mix: President Clinton and the Congress tightened fiscal policy while Fed Chair Greenspan reduced interest rates. The result was a reduction of the deficit combined with a long economic boom. The details of this are important and can be clarified using the standard economic model, which this textbook fails to provide. Why does the graph end in 2002? This gives the impression that in this chapter the authors have just slapped together what they had readily available.

The discussion of monetary policy on pp. 236-7 is similarly abbreviated and poorly presented. Prior to this, pp. 213-221 is a description of the Financial Institutions. The creation of the Fed (Federal Reserve System) in 1913 is described on p. 213-4. I really think it should have been said here that the reason the Fed was set up was because of the recurrent banking panics in the 19th century that frequently roiled the economy. The Fed’s remit was to stabilize the banking system and the economy as a whole.

There then follows 5 pages discussing saving, borrowing and financial investments that are available to the reader as “an individual or head of household.” In my experience this extent of detail for equity and bond investing (pp. 216-8) is too much for many college students and thus will not find a receptive audience with most high-school students. Discussion of household finance for students is important – especially comments on credit-card debt along the lines given – but in general it needs to be taken slowly and kept very relevant to their current experience. The pp. 219-221 idealized account of the origin of money, with its pocketfuls and piles of IOUs, is an overly fanciful account, and the p. 221 discussion of fractional reserve banking, while compact, will likely raise many questions with students that are not answered.

I turn now to the two-page discussion of monetary policy on pp. 236-7. This discussion is ridiculously brief, and is longer on institutional details than on the central mechanisms. Monetary policy primarily affects the economy via a change in the policy interest rate, and hence interest rates more generally, achieved via open market operations. In practice, for the last 25 years, the Fed policy instrument is setting the federal funds rate itself, rather than setting targets for money growth. More should be said concerning the

channels through which interest rates affect aggregate demand.

As with fiscal policy, the impact of monetary policy cannot be sensibly discussed without considering both the state of the economy and the broader policy context. The one sentence paragraph, middle of p. 237, states: “If the supply of money and credit increases too rapidly over time, the result could be inflation.” Enquiring minds would want to know when this would happen and when it would not. Instead we move on to the next paragraph, which states that “slowing the growth of the money supply can slow economic growth, increase unemployment and depress borrowing and spending.” With that possibility noted, and students now wondering whether the key danger may instead be money growth that is too slow, we loop back in the next paragraph yet again to the concern that expanding the “money supply too rapidly can increase the growth of the money supply to the point that it runs the risk of creating inflation higher than 2-3%.” This discussion of monetary policy creates intellectual whiplash. What is needed is to combine the standard macro model with the Phillips curve relating changes in inflation to aggregate output and the unemployment rate. These relationships can be used to discuss the appropriate combination of monetary and fiscal policy, given the state of the economy, and taking into account the trade-offs of objectives usually found in economics.

The other astounding omission, particularly from the viewpoint of a macroeconomist, is the complete lack of any discussion whatsoever of the financial crisis of 2007-8 and the resulting Great Recession. This omission is really quite incredible. The Great Recession of Dec. 2007 - June 2009 included a failure of major banks and required a vast infusion of funds from the Treasury and the Fed to keep the financial system from imploding. Many households lost their house or found it valued less than their mortgage. From October 2007 to March 2009 the Standard & Poors stock market index fell over 50%. The headline U3 unemployment rate rose to 10% during 2009. The Great Recession was followed by a long slump in GDP per capita, which did not recover its previous October 2007 peak until over $6\frac{1}{2}$ years later. The Fed, mindful to avoid another Great Depression, reduced the policy rate to near zero by late 2008, and then embarked on a series of unconventional expansionary monetary policies, given the zero-lower bound to interest rates and the risk of deflation.

How can it be that there is no discussion in this book of arguably the worst US and global economic crisis of the last 75 years? The title page gives a publication date of September 2016. Even assuming there is a planned

revision of the textbook, the fact that there is not even a mention of these events in the 2016 version gives one no confidence that an adequate discussion or analysis would be provided in a revision, particularly given the overall weakness of the book's macroeconomic analysis. Indeed, there is an equally stunning lack of discussion by the authors of the Great Depression of the 1930s, in which the US unemployment rate rose to 25%. This textbook has no discussion or even reference to either the Great Depression or the Great Recession. Not a word. Nothing at all.

I have focussed my discussion on macroeconomics, because that is my field of study, but there are other aspects of the textbook that I also find troubling as an economist. I will restrict my discussion to several issues triggered by reading the section of the Introduction labeled "Why Economy?"

In the Introduction, as well as throughout the book, there is a framing issue, that reveals some implicit biases. On p. 4 we are asked: "What is the Economic Question?" We are told that the question is: Why is there such a thing as material progress? This is, of course, an important economic question. (Clearly there are other key economic questions as well.) "The answer" we are told, "is that there has been an explosion of trade. Trade is not only positive-sum, but also win-win." As an economist I am hard-wired to appreciate the benefits of trade, and in a market economy in which people are free to choose whether or not to make a specific trade, then both parties benefit (or, at least, neither party is made worse off, assuming they understand the consequences of the trade). And indeed the benefits of specialization (or "division of labor") are central to economics. But it is a fallacy of composition to say that therefore trade necessarily benefits everyone. For example, does reducing the barriers to international free trade benefit everyone? In principle it may or it may not. Opening markets will change wage levels, and in particular sectors wages may fall as a result, making workers in those sectors worse off. And the empirical evidence for this effect is now clear. While there are many gainers there can also be losers, and there is strong empirical evidence, for example, that manufacturing workers in much of the US suffered significantly in the 2000-7 period due to import competition.

The Introduction, p. 4, shifts to an argument against those who argue as if it were a "law of nature" to "assume society is a zero sum" game. But this is a straw man. While trade is usually "positive sum," and while at the level of a specific trade between individuals, it is usually "win-win," this does not imply that expanding trade will make everyone better off. Quite often there are those who become worse off. This rhetorical slight of hand is deeply

concerning in a textbook, which presumably aims to develop critical thinking. While there is a statement on pp. 3-4 that “there is no guarantee that every member of society will be involved in mutually beneficial trade,” the possible reasons are left vague, and the implicit message of these final two pages of the Introduction seems to be that because trade is positive sum, everyone will benefit. If not – if, for example, in another rhetorical pivot made on p. 5, life expectancy of poor people in some “places” fell while for rich people it rose – then “we would want to know why.” The implicit message of this section, despite the slippery caveats, is that if you think trade can make some people worse off then most likely you are a foolish person who believes that trade is always zero-sum.

A closely related issue arises in the Section titled “Creative Destruction” (pp. 256-258). The passage correctly points out that major innovations, which eliminate jobs, typically create as many jobs as are lost. We are told, concerning the mechanization of farming, that “Particular jobs in farming were undoubtedly lost. However other jobs were created. Journalists and social commentators do not talk about the new jobs being created.” I think this process is pretty well understood by most people. What surprises me about this passage is that it glosses over the adverse effects at the individual level. The tone is that since in aggregate there is (or usually is) net job creation, then there is no need for concern. This neglects the fact that, because those who lose their jobs may well have skills that have become obsolete, for those individuals this can be a life-changing experience for the worse. Surely this merits comment, and indeed it merits serious analysis: what social policies should be in place to assist those who suffer economic dislocation arising from expanded international trade or creative destruction?

Here are two other major Economic Questions that would be appropriate for the Introduction:

1. Why, in a market economy, do markets usually work well but sometimes work poorly?
2. In a capitalist economy, what determines the distribution of income and wealth. Is the degree of inequality fair? If not, what measures should be taken to reduce inequality?

Part 3 does contain some useful material on when markets can fail or work poorly. There is discussion there of how this might be corrected in the case of negative and positive externalities, though the textbook insists on emphasizing concerns about the practical difficulties of implementing what are usually called “Pigovian” taxes or subsidies. However, from the point

of view of a textbook, especially a high-school textbook, there are two big missed opportunities here. Arguably, the biggest environmental issue of our time is climate change (or “global warming”). If the growing and now almost overwhelming scientific evidence on this is correct, then we should urgently be considering policies to reduce the negative externalities, due to carbon and methane emission, using Pigovian taxes and other public policies to foster renewable and green energy. What could be better for a high-school textbook than a treatment of the economics of climate change? Yes, bizarrely, the phrases “climate change” and “global warming” are nowhere to be found in the book. It is worth noting that one of the recipients of the 2018 Nobel Prize in Economics, William Nordhaus, received the award for his pioneering work in this area.

For an example of a positive externality, return to the issue of the reasons for material progress. Expansion of trade is only part of the story. The question of why in capitalist market economies there have been vast increases in the standard of living over the last several centuries is the focus of “growth theory,” a branch of economics centering on the long-run questions connected with growth and development. The consensus view is that the rising average standard of living is not just due to division of labor and trade, nor greater exploitation of natural resources, nor the increasing capital stock due to saving and investment. While these are important, the central factor is technological progress: the development of new products and new methods of production that yield more output without using new inputs. Technological progress can take the form of major innovations or be the result of numerous incremental improvements. The advance of scientific knowledge obviously has frequently played an important role in numerous major innovations. The accumulation of human capital – education – also plays a key role as this is often necessary for exploiting technological progress.

Surprisingly, despite the book’s emphasis on entrepreneurship, there does not seem to be discussion of the fact that the development of scientific and engineering knowledge, and knowledge more generally, is an example of a positive externality that clearly justifies the government subsidizing research. It is worth noting that the other recipient of the Nobel Prize in Economics in 2018, Paul Romer, developed growth theories that focused on the economic mechanisms that determine technological progress, and that he emphasized the ways in which governments should promote technological innovation. A similarly compelling argument applies to government financial support for public health.

The other major question I raised above is income and wealth inequality. A central feature of general equilibrium theory in economics is that the society's distribution of wealth and income is logically separate from achieving an efficient economy. Some high-income market economies have relatively equal distributions of income and wealth, while others are much more unequal. Inequality within many high-income countries is growing, and the evidence is now clear that in the US the distribution of income and the distribution of wealth have become substantially more unequal since 1980. This is true of wage inequality, but becomes particularly acute when capital income is included. Over the last ten years the increased inequality has become an issue of widespread discussion, so it is strange to see that there is no explicit discussion of this trend by the textbook. The structure of the tax system is obviously a major tool that could be used to reduce inequality. Economists in public economics, building on the theory of welfare economics and social welfare functions, have long studied this topic and the extent to which there is a significant trade-off between reducing inequality and economic efficiency. I was not able to locate a discussion of these issues anywhere in the textbook.

This appears to be a case in which the textbook has an implicit bias. In the discussion of Thomas Edison, pp. 194-5, it is hard to read the passage other than as saying that he deserved every dollar he received. Edison was a great inventor and became very rich. The textbook implicitly discusses whether he should have been taxed more in terms of whether he owed something to future generations: "Then the question becomes, did Edison, in fact, pay it forward? Did he help the next kid who comes along? And the answer is this: yes, of course, he gave something to the next kid who comes along. He gave that kid the light bulb." This is a tendentious discussion that does not attempt to address the serious policy issues about the appropriate level and progressiveness of income taxes, including the specific rates on capital income, and the rates of estate or inheritance taxes that would be appropriate for very wealthy individuals.

Finally, I find that the book in many sections has an overly "preachy" tone, with motivational passages that strike me as out of place in a textbook, and that carry with it implicit biases – e.g. the entrepreneurship section reads like a motivational talk encouraging the reader to become an entrepreneur. We are told (p. 18): "In summary, you may spend your whole working career working for someone else, and live a perfectly happy life. There is no shame in avoiding the risk of going into business for yourself." But the overall tone suggests otherwise. If you are up to the challenge, you should become an

entrepreneur, and if you are good enough then (p. 19) “you can make a lot of money, and you can be proud of every dollar.”

To conclude, I strongly recommend against adopting this textbook. The sections on macroeconomics are very poor, well below the threshold for consideration, in terms of the quality of the analysis presented. Other sections of the book that I read carefully are also below the bar. In addition, despite its 2016 copyright, it is stunningly out of date in terms of its treatment of macroeconomic events. The authors may indicate that they can update the book, but based on my reading it is highly unlikely that they would do an adequate job of revising and updating it.

Successful economics textbooks frequently include both a senior author, with a well-established research record and who has achieved eminence in either macroeconomics or microeconomics, and another established economist in the complementary area. In my experience the best textbooks are produced by well-known publishers (like Pearson/Prentice-Hall, Worth, Norton, McGraw-Hill, etc.). I have never heard of the publisher of this textbook, and it does not look like an Editor has read the book – it is riddled with typos and with passages that are poorly written. I understand there are several good high-school economics textbooks available, e.g. in your position I would look closely at Pearson Economics, by Arthur O’Sullivan (Lewis and Clark College) and Steven M Sheffrin (Tulane University).

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