The New York Times

September 18, 2011

# Darwin, the Market Whiz

By ROBERT H. FRANK

WHO was the greater economist — Adam Smith or Charles Darwin?

Since Darwin, the pioneering naturalist, never thought of himself as an economist, the question seems absurd. Yet his understanding of competition describes economic reality far more accurately than Smith's. Within the next century, I predict, Darwin will be seen by most economists as the intellectual founder of their discipline.

Smith is renowned for his "invisible hand" theory. According to his modern disciples, it holds that unbridled market forces harness self-interest to serve the common good. Darwin understood that individual and group interests sometimes coincide, as in Smith's framework. But Darwin also saw that interests at the two levels often conflict sharply. In those cases, he said, individual interests trump.

A spectacular example from nature illustrates his point. The massive antlers of bull elk are often four feet across and weigh more than 40 pounds. Why so big? Darwin's explanation began with the observation that bull elk, like males in most vertebrate species, take more than one mate if they can. If some succeed, others end up with no mate at all, making them the ultimate losers in the contest to pass along their genes. So bulls fight bitterly for females, and mutations coded for larger antler size help them win. That arms race has produced the gigantic antlers we see today.

As a group, bulls could better escape from wolves in densely wooded areas if their antlers were smaller, yet any individual bull with relatively small antlers would never win a mate. So bull elk are stuck with unwieldy antlers.

Many 19th-century social Darwinists mistook Darwin's message to be that whatever emerges from the struggle to survive is morally praiseworthy. But Darwin believed no such thing. He understood that competition often favored traits that brought misery to all, and he knew animals like elk could do nothing about it. But human beings, who face similar conflicts, have better options.

Darwin's insight can help us resolve a host of seemingly intractable economic problems in the United States, and in nations that have followed our lead. Applied properly, it would lead to simple steps that could liberate trillions of dollars in resources each year — enough to end perennial battles over budget deficits, restore our crumbling infrastructure and pay for the investments needed for a sustainable future. No painful sacrifices would be required. No cherished freedoms would be threatened. Just a few changes in the tax code would suffice.

These bold claims evoke an alchemist's promise to transform lead into gold. But they rest on sound logic and compelling evidence.

POLITICAL gridlock in Washington has many causes. A seldom-discussed one is that the current rhetoric often rests on basic misunderstandings of how markets work.

On one side, advocates of minimal government invoke Smith's invisible hand to argue that we could make the economy more efficient by pushing government aside and letting markets work their magic. Liberals counter that markets aren't truly competitive. We need extensive government regulation, they say, because powerful elites would otherwise exploit workers and consumers.

Close reading of Smith's work shows that his position was very similar to the modern liberal's. He thought it remarkable that self-interest often promoted the common good, but he never claimed it always did. Like modern liberals, he saw market failure as rooted in insufficient competition. In “The Wealth of Nations,” he wrote, “People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.”

Today, though, markets are far more competitive than ever, just as conservatives maintain, but they’re also hugely more wasteful. The apparent paradox is resolved once we recognize that market failure stems from the very logic of competition itself. As Darwin knew, when individual and group interests diverge, competition not only fails to promote the common good, it also actively undermines it.

The modern marketplace is rife with individual-versus-group conflicts like the one that spawned outsized antlers in bull elk. If you’re one of several qualified applicants seeking an investment banking job, for example, it’s in your interest to look good during your interview. But looking good is a relative concept. If other applicants wear $600 suits, you’ll make a more favorable impression if you wear one costing $1,200.

Trading up is wasteful for the group, however, because the applicants are no more likely to get the positions if they all spend more on suits. But from each individual’s perspective, that’s no reason to regret buying the pricier suit.

When the ability to achieve important goals depends on relative consumption, all bets on the efficacy of Smith’s invisible hand are off. As Darwin saw, many important aspects of life are graded on the curve, and in such cases, individual incentives often lead to mutually offsetting efforts.

MOST parents want to give appropriate gifts, just as they want their children to attend good schools. But “appropriate” and “good” depend on context. When the rich spend more on mansions and gifts, the frames of reference for the near-rich shift, too, causing them to spend more as well, and so on, all the way down.

The median size of a new single-family house in 2007 was over 2,300 square feet, more than 50 percent larger than its counterpart from 1970. That creates a problem for concerned parents, because good schools are usually found in affluent neighborhoods. To send your children to one, you must outbid others for a house in a good school district. Yet when all families increase their bidding for such houses, they succeed only in driving up their prices. No matter how much parents pay, only half of all children can attend schools in the top half.

Much of this waste could be eliminated by a few relatively simple changes in the tax code. Scrapping the current progressive income tax in favor of a more steeply progressive tax on consumption is probably the single most productive change we could make.

What's a progressive consumption tax? First of all, it's not a sales or value-added tax, neither of which takes individual income into account. Those taxes are imposed on the spot when someone buys a good or a service.

Under a progressive consumption tax, taxpayers would report their incomes, much as they do now. They'd also report their annual savings, much as they do for tax-exempt retirement accounts. The tax would be based on "taxable consumption" — the difference between their income and annual savings, less a standard deduction of, say, $30,000 for a family of four. Rates on additional expenditures would start low and rise gradually with taxable consumption.

Because savings would be tax-exempt, the biggest spenders would save more and spend less on luxury goods, leading to greater investment and economic growth, without any need for government to micromanage anyone's behavior. Consumers in the tier just below, influenced by those at the top, would also spend less, and so on, all the way down the income ladder. In short, such a tax would attenuate the expenditure cascade that has made life for middle-income families so expensive.

Adopting a progressive consumption tax would be like creating wealth out of thin air. Its magical quality stems from the fact that luxury spending is strongly context-dependent, just as antlers are. If everyone spends less, you can still have the biggest mansion — or antlers — on the block, but you'll also be able to do many other useful things. The money saved could help resolve the current fiscal impasse. And it could also be used to fix roads and bridges and support a host of other genuine improvements.

Changing the tax code in a fundamental way won't be easy. But as the late Herb Stein, Richard M. Nixon's chief economist, once remarked, "if something can't go on forever, it won't." The dysfunctional system now in place threatens to destroy our economic future. If we don't change it now, we'll have to change it later.

Can anyone imagine anti-government conservatives embracing a progressive consumption tax? Actually, yes. It's perhaps the only important policy option that could win support from both ends of the political spectrum. A version of it, for example, was proposed in 1995 by Senators Pete V. Domenici, a Republican, and Sam Nunn, a Democrat.

Many conservatives advocate a flat tax — essentially, a national sales tax — but most realize that its adoption is unlikely because it would fall disproportionately on people with lower incomes. If the alternative is to stick with the current income tax, however, a progressive consumption tax begins to look pretty good to many conservatives. And once they understand how it would reshape spending patterns, they often become openly enthusiastic about it.

In 1997, shortly after publishing an article advocating this kind of tax, I received a warm letter from Milton Friedman, widely hailed as the patron saint of small-government conservatism.

He questioned my claim that additional tax revenue could be put to productive uses in the public sphere. But he added that if the government did need additional revenue, the progressive consumption tax would be by far the best way to raise it. Attached to his letter was a reprint of his article published in the 1943 American Economic Review in which he advocated the progressive consumption tax as the best way to pay for the World War II effort.

IN the current climate, it's not likely that this tax will become law soon. That's actually a good thing, since we wouldn't want to discourage consumption during a deep economic downturn. But if the tax were passed now and phased in once the economy returned to full employment, it would kill two birds with one stone. It would reassure deficit hawks that we're committed to putting our fiscal house in order, and it would encourage an immediate burst of private spending by people eager to avoid the tax.

In a nutshell, Darwin's simple insight reveals that the modern economy is not only far less efficient than Adam Smith's modern disciples think it is, but also that it would be relatively easy to improve matters. That simple truth will someday be self-evident. But until then, the wasteful aspects of the competitive process will continue to impose enormous costs on everyone.

*Robert H. Frank is an economics professor at the Johnson Graduate School of Management at Cornell University. This essay is adapted from his new book, "The Darwin Economy: Liberty, Competition and the Common Good." (Princeton University Press).*