



# IOWA ECONOMIC SCORECARD

Volume 24, Number 1

March 2016

## College Students Flunk Economics

By Allan H. Meltzer

The enthusiastic response of college students to Senator Bernie Sanders’ “democratic socialism” is one of the most surprising and dispiriting events of the current presidential campaign. Apparently students have not learned that, historically, all socialist systems — democratic and authoritarian alike — failed to satisfy public demands and were abandoned after much suffering. Capitalism is the only economic system that offers freedom, opportunity, and increased living standards to the greatest number of people.

These students must be unfamiliar with Friedrich Hayek’s *The Road to Serfdom*, a brilliant critique of the 1945 British decision to adopt democratic socialism. Hayek insisted that socialism could not work. If voters chose to elect a non-socialist government, the socialist economic plan would be discarded. The alternative was an authoritarian government that prevented voters from rejecting the plan.

In the 70 years since the British decision, we have seen both outcomes. Britain kept its democracy. Voters eventually elected Margaret Thatcher in 1979. She transformed the economy, sold the socialized industries, strengthened the market system, and enhanced freedom. Growth of per capita income and productivity rose. Socialists never forgave her for successfully achieving what they failed to achieve. Subsequently, labor governments returned to office, but they did not restore socialism. Socialism failed.

Starting in the middle of the 20th century, Argentina tried its own version of socialism called Peronism. Despite its rich supply of raw materials and productive agricultural sector, Argentina under Peronism suffered from sluggish growth, high inflation, and the loss of freedom. The November 2015 election ended Peronism. Unhappy voters elected a president who promised to restore the market system, private property, and personal freedom. Socialism failed.

Venezuela is an oil-rich country. The socialist government there has expropriated most industry and replaced professional managers with political friends that lacked both skills and knowledge. Inflation soared and recently rose to above a rate of 100 percent a year. Food became scarce. Poverty increased so much that the government stopped publishing the data. A privately produced estimate shows that the poverty rate is higher today than it was when the United Socialist Party came to power 17 years ago. Policies designed to help the poor by redistributing income hurt both rich and poor alike. After two decades of socialism, voters [in December 2015] elected a large anti-socialist majority to their Congress. Socialism failed.

Socialism failed also in Cuba, in the former Soviet Union and its satellites, and every other place it has been tried. Although Cubans are surrounded by ocean, they were not allowed to fish. When the Soviet

## IOWA ECONOMIC SCORECARD

March 2016

Volume 24, Number 1

Dr. Don Racheter, President

John R. Hendrickson, Editor

IOWA ECONOMIC SCORECARD is our semiannual economic forecast, arriving in March and September. It consists of statistics about and analysis of the Iowa economy.

IOWA ECONOMIC SCORECARD is published by Public Interest Institute at Iowa Wesleyan University, a nonpartisan, nonprofit, research and educational institute, whose activities are supported by contributions from private individuals, corporations, companies, and foundations. The Institute does not accept government grants.

Permission to reprint or copy in whole or part is granted, provided a version of this credit line is used: "Reprinted by permission from IOWA ECONOMIC SCORECARD, a semiannual newsletter of Public Interest Institute." The views expressed in this publication are those of the authors and not necessarily those of Public Interest Institute.

The articles in this publication are brought to you in the interest of a better-informed citizenry, because IDEAS DO MATTER.

A Publication of: Public Interest Institute at Iowa Wesleyan University, 600 North Jackson Street, Mount Pleasant, Iowa 52641-1328.

If you wish to support our efforts, please donate by sending a check to us at the above address. If you wish to donate by credit card, please go to our website: [www.LimitedGovernment.org](http://www.LimitedGovernment.org). PII is a 501 (c) (3) non-profit organization and all contributions are tax deductible. E-Mail: [Public.Interest.Institute@LimitedGovernment.org](mailto:Public.Interest.Institute@LimitedGovernment.org) Phone: 319-385-3462 Fax: 319-385-3799

Copyright 2016

Union collapsed in 1989, its satellites promptly abandoned socialism and joined the market system. They understood from experience what U.S. college students, who today cheer socialism, have not learned. And they could see that the two systems gave people different incentives. Capitalism encouraged effort and innovation. Socialism did not.

It is easy to add other examples of socialist failure. Examples of success cannot be found because no socialist country has brought both growth and freedom. Two of the major reasons for failure are the absence of the rule of law and constructive incentives. Instead of firmly held legal rules, socialism brings government authorities who impose arbitrary political decisions. People adapt by learning to please politicians.

Take the case of China. China's economy stagnated after the Communist takeover. So Deng Xiaoping looked around: Hong Kong, Singapore, Taiwan, South Korea, and Japan had grown by allowing capitalist firms to compete in world markets. Living standards rose in these capitalist countries. Deng changed direction, inviting foreign capitalists to come to China if they brought their best technologies. Growth soared, not by a miracle but by the workings of market capitalism. Vietnam later followed the path away from socialism. The countryside has many new factories owned by capitalists from Europe and the United States.

Often, proponents of socialism point to the Scandinavian countries, especially Sweden, as successful examples of socialism. Sweden developed an extensive welfare state, but it retained two central capitalist principles — private ownership of industry and property, and a strong commitment to the rule of law. The welfare state and income redistribution appealed to a homogenous population that shared a common culture. Recently, the population has become more diverse, and the welfare system, though still extensive, has shrunk.

The facts about socialist failure and long-term capitalist success are not secret. Argentina and Venezuela are in the current news cycle. The United States did not become wealthy by redistributing income. It took hard work, innovation, on-the-job training, personal incentives, and private investment.

The mystery is why U.S. college students ignore socialist failures to cheer for socialism and Senator Sanders. The most likely reason is a reaction to two well-known weaknesses of capitalism: occasional recessions and income inequality. Growth following the 2008-09 recession is relatively slow and, for earners not in the top income groups, incomes are stagnant.

Senator Sanders does not call for old-time socialism — that is, government ownership of the means of production. His main proposals demand higher taxes on the highest incomes, free college education, increased social security payments, and a higher minimum wage. These are not new ideas, so we know what their consequences are: Minimum wages reduce employment; increased social security payments go to people who do not work and encourage older workers to retire, so those payments reduce growth. They also widen the income distribution gap because they often go to the relatively well-off older citizens.

Sanders' promises will cost trillions of dollars. His tax proposal will not cover the costs and will lower growth. Higher tax rates for those who earn high incomes reduce savings and the return to investments, so investment will decline. Reducing investment especially harms the middle class because new investment is a principal source of productivity growth, the principal way that middle class incomes rise. The persistent success of capitalist economies over the last two centuries in raising incomes and distributing the gains widely over all income classes mainly resulted from investment that increased workers' skills and productivity.

It works like this: When a company invests in new machines or new computer programs, it must train its workers to use the new tools and systems. Learning on the job increases workers' skill sets. They are able to produce more, often at a lower unit cost. Productivity and profits rise. Workers earn more. Further, capitalism provides the incentive to develop new ideas that raise living standards and improve lives. It is not an accident that the computer, the social network, the increased reliability of automobiles, and much more originated in capitalist countries. Socialism failed at innovation also. Freedom and property rights encourage innovation and progress.

To pay higher wages, producers must increase productivity and therefore investment must rise. The socialist program that raises tax rates on savers and businesses is counter-productive because it reduces investment. Productivity growth benefits all classes. Owners of firms have more profit; workers have higher wages; consumers have lower prices. Capitalism produces a cooperative outcome from which everyone gains. Socialism and higher tax rates impose the non-cooperative arrangement of taking from some to give to others. As the many examples show, everyone eventually loses.

Past administrations and Congresses have promised much more spending than the revenue the economy will generate. At all levels of government, spending has greatly exceeded revenues. Many estimates put the unfunded promises for future social security and healthcare at about \$90 trillion. Adding free college tuition and other promised benefits pushes the unfunded promises well above \$100 trillion. Unless reformed and reduced, the promises cannot be met.

Voters should demand that candidates offer a program for managing past promises. Reform of healthcare programs should begin by turning Medicare over to the states and lowering federal tax rates. Competition across state lines could lead to cost savings. Competition brings new ways to improve outcomes and reduce waste. We should use the federal system to find policies for health, education, and welfare.

To get better policies, we require informed voters and productive incentives. Understanding the benefits and flaws of capitalism is a first step toward political reform. Many of today's college students show the need to start. Our future depends on getting the right policies and the right incentives.

**Public Interest Institute  
at Iowa Wesleyan University  
600 North Jackson Street  
Mount Pleasant, IA 52641-1328**

NONPROFIT ORGANIZATION  
U.S. POSTAGE PAID  
MAILED FROM ZIP CODE 52761  
PERMIT NO. 338

*Allan Meltzer is a distinguished visiting fellow at the Hoover Institution and the Allan H. Meltzer University Professor of Political Economy at the Tepper School of Business at Carnegie Mellon University. Professor Meltzer's writings have appeared in numerous journals; his most recent publication is Why Capitalism? (Oxford University Press, 2012). He has authored several other books, including A History of the Federal Reserve (University of Chicago Press, 2 volumes, 2003 and 2009) and numerous papers on economic theory and policy. His career includes experience as a self-employed businessman, management adviser, and consultant to banks and financial institutions.*

*This article originally appeared on January 14, 2016 on the Hoover Institution's Defining Ideas: A Hoover Institution Journal and is reprinted with permission from the Hoover Institution. This article can be found online at <http://www.hoover.org/research/college-students-flunk-economics>.*

Visit  
[www.LimitedGovernment.org](http://www.LimitedGovernment.org)  
to learn more  
about conservative and  
free-market ideas.

**Thank you** for your  
continued support of  
Public Interest Institute.

Your support helps us  
provide public policy  
research on the issues  
facing both Iowa and the nation as  
well as the importance of  
free-market and constitutional ideas.