

## *Economic Facts and Fallacies*

By Thomas Sowell. 2008. New York, NY, Basic Books. Pp. 272. \$26.00 hardcover.

In this book, Thomas Sowell, the well-known conservative African-American economist, marshals volumes of facts from statistics, history, and economics and assorted other disciplines to dispel “false beliefs” or fallacies. Most of the fallacies of concern underlie economic policies that have not achieved their objectives and have often led to disastrous unintended consequences. Others are the basis of arguments for policies that, if implemented, would have harmful effects. During this campaign season, many of them will be shamelessly repeated over and over again in hopes that audiences will accept them on faith without evidence or proof. They will be discussed around water coolers and other venues in businesses across the country. Consequently, this is a very timely book for business economists.

Some fallacies have formal names. Policies based on the “zero sum fallacy” assume that economic transactions are a zero sum process in which what is gained by someone is lost by someone else. Rent control attempts to benefit renters at the expense of landlords. But renters are eventually harmed when the supply of apartments falls because of disincentives to maintain property and expand supply. Minimum wage laws harm their intended benefactors by ultimately reducing the supply of jobs. And, when countries have restricted trade to protect their domestic populations from “exploitation” by foreigners, their economies have historically stagnated.

The name of the “chess-pieces fallacy” derives from Adam Smith’s description of the person who “seems to imagine that he can arrange the members of a great society with as much ease as the hand arranges the different pieces on a chess-board.” This fallacy underlies the “smart growth” movement now underway in California and elsewhere, which assumes that central planning can yield results that are somehow superior to those produced by decisions manifesting tastes and preferences of individuals pursuing their own self interest. Blaming the ubiquitous ownership of automobiles for urban sprawl and lack of popular use of public transportation reminds Sowell of the Duke of Wellington blaming nineteenth century railroads for encouraging “the common people to move about needlessly.”

A common fallacy motivating a major portion of the discussion is that of assuming sameness when there is no reason to expect sameness. This fallacy typically underlies conclusions based on gross statistical comparisons of gender earnings differences, and economic differences between racial and ethnic groups. Sowell invokes history, statistics, and economics to show that most such disparities have explanations other than discrimination.

Similarly, certain changes shown by comparison of statistical categories over time are invalid because changes in composition of the categories are not taken into account. For example, the often-made claim that the bottom 20 percent of households has fallen behind those in upper income brackets does not take into account the fact that most of the people in the bottom bracket move into higher brackets over time. Moreover, most of such comparisons are faulty due to bogus statistics that

leave out both taxes on people in upper brackets and transfers to people in lower brackets, exaggerating inequality at any point in time.

The major theme of this book is that fashionable ideas are seldom scrutinized in the light of the facts. When exposed to the facts, most do not withstand scrutiny. Numerous ideas and assertions are pummeled with facts throughout the chapters, which are essentially essays on urban issues, higher education, gender and income comparisons, racial issues, and economic development. The book is not an easy read because of the concentration of the arguments, but it is well worthwhile for business economists.

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## *Predictably Irrational: The Hidden Forces That Shape Our Decisions*

By Dan Ariely. 2008. New York, NY: HarperCollins. Pp. 304. \$25.95 hardcover.

Written in a lively style by a leading behavioral economist, *Predictably Irrational* is perhaps the most enjoyable economics book around. It draws on material from the author’s own life and presents experiments that are conducted in real life situations. It should help readers dealing with some business decisions, but primarily it is oriented toward consumer behavior. Ariely, a management economist at the Massachusetts Institute of Technology, Duke University, and

the Federal Reserve Bank of Boston, also refers readers to his website ([www.predictablyirrational.com](http://www.predictablyirrational.com)) and communication with him reveals that he now seeks to work directly with business people.

Ariely shows that in terms of the standard economic analysis irrationality is commonplace—and, he maintains, predictable. He acknowledges that some of that irrationality is understandable, given the constraints of time and data, and the fact that we are human after all. However, he insists that we can take steps to increase rational decision-making. *Predictably Irrational* marshals a wide variety of empirical evidence and ad hoc tales to drive home its conclusions about many types of decisions. This book compares to *Nudge, Improving Decisions About Health, Wealth and Happiness*, by Richard Thaler and Cass Sunstein (reviewed in the previous issue of *Business Economics*), also a pleasure to read; but it covers more ground and is more focused on the changes that can be brought about to reduce irrationality. Both books provide a solid appreciation for behavioral economics. Some readers may also want to turn to my forthcoming book, *A Guide to Behavioral Economics*, Higher Education Publications, 2008.

Ariely's introduction maintains that understanding irrationality is important for everyday decisions, how we design our environment, and make the choices that the environment presents. Whereas standard textbook economic theory assumes we are rational or that market forces will push us in that direction, often that does not happen. Chapter 1 deals with the importance of relativity; most people don't know what they want unless they see it in context. The discussion also notes the role of irrational but effective marketing stratagems, such as decoy options. Chapter

2, "The Fallacy of Supply and Demand," deals with ways in which demand can be influenced. It draws on examples that reveal the role played by factors that come to us from cognitive and social psychology. This leads to (or reinforces) the conclusion that anything approaching maximization of utility may require more than market forces.

The role of emotional factors is revealed in chapter on "The Cost of Zero Cost," which deals with goods that are "free"—but whose true (opportunity) costs tend to be ignored. The chapter on "The Cost of Social Norms" shows that there was a good deal behind Tom Sawyer's explanations about whitewashing fences. We are often happy to do things, but not because we are paid to do them. It discusses the blurring of the line in many business situations and maintains that social norms are often sharper and more effective in motivating people, though most of the examples given are more convincing for consumer than business behavior.

"The Influence of Arousal" chapter has some persuasive material on safe sex, safe driving and better life decisions (some of which seems applicable to investment behavior). Its applications to business behavior seem more limited (although psychologists have long maintained that certain business behavior could only be understood by taking emotions into account). In any event, the modern tendency of business to have organizational review committees should limit the influence of the mere arousal of any one individual.

The chapter on "Procrastination and Self-Control" relies primarily on experiments involving student deadlines, but there is also material on health care, consumer debt, savings and automobile servicing. Chapter 7 on "The High Price of Ownership" and how we overvalue what we poss-

es, provides interesting follow-ups to what has been termed the endowment effect, first described by Knetsch, Thaler, and Kahneman.

Chapter 8, "Keeping Doors Open: Why Options Distract Us from Our Main Objective," emphasizes what we may give up in making a decision by having too many options. It thus provides a useful antidote to the assumption of economists that more choices are necessarily better. The following chapter on expectations outlines their role in promoting stereotypes, often useful even if they involve biases. However, it may seem somewhat incomplete for those producing goods and services where expectations are critical in estimating future demand. The chapter on "The Power of Price" and the significance of placebos in disparate fields may be most useful for those in marketing.

Two chapters follow on character, the first of which has the subtitle, "Why We Are Dishonest and What We Can Do About It," and the second of which affirms, "Why Dealing with Cash Makes Us More Honest." The first focuses on the forms of dishonesty of those who generally consider themselves honest. It raises the question of a cost-benefit approach to honesty. It is based on real life experiences to limit dishonesty. The experiments are removed from the real world of business, but a number of business examples are cited. The second of the chapters on character contends that most people rationalize dishonesty more readily when they are at least one step away from cash, and uses several interesting and convincing examples from the world of business to support this view.

The final chapter summarizes more experiments showing that people often make decisions that are not rational, and they do not learn easily. It observes that behavioral economists believe that people are suscep-

tible to irrelevant influences from their environment, irrelevant emotions, shortsightedness, and other forms of irrationality. Ariely maintains that there is a free lunch to be had—from interventions that help people achieve more of what they truly want. Of course, there are important cases in which people act counter to the precepts of traditional economic rationality, “without regret,” as Robert Frank has written.

Business economists who want to know more about the new and important field of behavioral economics definitely should read *Predictably Irrational*. They will not regret it.

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#### EDITOR'S NOTES

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