

1 2. The Poverty of Economic Theory

2 From [Managing for the Future](#) by [Peter Drucker](#)

3 I What creates wealth?

4 For the last 450 years, economists have either neglected the question, sought easy answers, or dismissed previous assessments.

5 Nonetheless, we have something to learn from every interpretation. ...

6 The first generation of economists, the mercantilists, said, "Wealth is purchasing power."

7 Their goal was to increase monetary wealth with an accumulation of bullion and a favorable trade balance.

8 Another theory stated that wealth is not created by man, but by nature – that land creates wealth. ...

9 Yet another group of theorists related wealth to man.

10 "Wealth," they said, "is created by human labor."

11 This tenet signaled the beginning of economics as a discipline because it related wealth to something that man creates.

12 And yet it was totally unsatisfactory.

13 It could not be made to predict or analyze anything. ...

14 A little more than 100 years ago the field of economics split in two.

15 The mainstream simply gave up the search for any answer to the question of the creation of wealth, became purely analytical, and stopped relating economics to the behavior of people.

16 Economics was a discipline that governed the behavior of commodities.

17 Ironically, analysis is a great strength of contemporary economics, but it also explains why the public at large is bored stiff by the field.

18 It has nothing to say to them because it lacks a foundation in value.

19 ***Another Wrong Answer***

20 Karl Marx understood this shortfall when he created the labor theory of value.

21 “Marxist economics” is a contradiction in terms – it has no analytical or predictive power – but it has a tremendous appeal precisely because it is grounded in a value.

22 It defines the creators of wealth – human beings, labor.

23 And yet, we know it’s the wrong answer, too. ...

24 For the last 100 years, therefore, we have had a choice between an economics that has great analytical power but no foundation in value and an economics that wasn’t economics at all, but a system based on the human being.

25 Today we’ve finally reached a point where that dilemma can be bridged, where we can begin to understand the right approach, if not the right answer.

26 We now know that the source of wealth is something specifically human: knowledge.

27 If we apply knowledge to tasks we already know how to do, we call it “productivity.”

28 If we apply knowledge to tasks that are new and different, we call it "innovation."

29 Only knowledge allows us to achieve those two goals.

30 ***Tradition of Labor***

31 This wasn't always true.

32 Two hundred years ago when Adam Smith wrote about "the tradition of labor," his examples were people in what is now central Germany, who, because of the heavy winters with lots of snow, learned to be woodworkers and make clocks and violins.

33 It takes 200 years to build such a tradition, Smith said, except for rare cases when refugees or immigrants bring their skills to a community. ...

34 Such was certainly the case when the U.S. won its independence.

35 Every American consul had an unlimited slush fund (which probably meant \$180???) to bribe an English craftsman and supply him with false papers to come to this country and teach us how to build textile machinery and dye cotton.

36 That's how New England became an industrial power around 1810. ...

37 During the nineteenth century, however, apprenticeship (a German invention) telescoped the 200 years into 5, and during the twentieth century, training (an American invention) telescoped 5 years into 6 months or even ninety days.

38 We invented training during World War I because we had no tradition of labor.

39 After World War II, our invention spread worldwide, which is one reason why nations can no longer compete on the basis of a labor tradition.

40 *Learning and Knowledge*

41 Indeed, until recently, the quickest way for a person living in a developed country to make a decent living was to become a semi-skilled machine operator.

42 After six weeks, he probably was better paid than associate professors, not to mention assistant deans.

43 But that's over.

44 Today he can make a middle-class living only through learning and knowledge. ...

45 (Consider that 30 years ago, there wasn't a person in Korea who had any tradition of skill or craft, if only because Japan didn't allow its neighbors to acquire any for 50 years.

46 Today, Korea can do almost anything any advanced industrial nation does, thanks to training.) ...

47 Of course, the realization that knowledge is the source of wealth has major implications for economics, which today is at a dead end.

48 Economics used to be an enjoyable discipline because it was so humble.

49 When someone asked an economist of 1925 a question, his answer was, "I don't know," which in many ways is a respectable answer.

50 (At least it's a modest one.)

51 And then he said, "We don't know and therefore the intelligent thing to do is as little as possible and pray.

52 Keep taxes low, expenditures low, and pray."

53 **New Philosophy**

54 But my generation of economists became arrogant, largely as a result of an incredible performance during World War I.

55 In military terms, WWI is the all-time low of performance, but the civilian accomplishment was incredible.

56 Every country was bankrupt by December 1914, and according to the traditional rules of the game, should have had to stop fighting.

57 But they kept on killing each other for four more years because the civilian administrators were so incredibly competent.

58 And that competency corrupted and gave us delusions of grandeur. ...

59 When 1929 came along, suddenly there was a curious belief that government should be able to do something about the economy.

60 That was totally unheard of in earlier days, but it became a popular demand, similar to the question, "If you can put a man on the moon, why can't you do something about AIDS?"

61 And thus we saw the development of economics that knew the answers. ...

62 Keynes knew the answer: Whatever ails you, just create more purchasing power.

63 Milton Friedman, who may be the last surviving member of the great generation, refined it and said, "You don't even have to do that.

64 All you have to do is just make sure the money supply grows."

65 For the supply-siders it was even easier: just cut taxes.

66 What could appear nicer and more pleasant?

67 ***End of Euphoria***

68 In the nineteenth century economics was known as the "dismal science," because it always forced us to make choices, and we always had to forgo something.

69 Suddenly it became a euphoric science.

70 For 50 years, it's been a euphoric science, but believe me, that's over. ...

71 Economics hasn't worked.

72 Whatever we tried, it failed.

73 What's more, the basic assumptions of modern economic theories are unreasonable and invalid.

74 All of them assume that the sovereign state is alone in this world and can control its destiny.

75 If the five or six leading industrial nations would simply agree to hand over their economic policy to a czar, a commissioner, or a common organ, economic theory would work.

76 But chances are it won't happen; by comparison, winning a million dollars at a Las Vegas slot machine is a cinch. ...

77 Most economists have assumed, too, that the velocity of the turnover of money is a social habit and a constant – against all evidence.

78 When the U.S. tested the theory for the first time in 1935 and pumped a lot of purchasing power into American pockets, we did not spend, we hoarded.

79 The economy collapsed the following year, and it was much worse than in 1930 or 1931 because the American public sabotaged the economic policy.

80 The same thing happened under Mr. Carter and Mr. Reagan.

81 The velocity of turnover of money is about as mercurial as teenage fashions and even less predictable.

82 ***Invalid Theory***

83 In essence, macroeconomic theory is no longer a basis for economic policy because no one knows what is going to happen.

84 Mr. Reagan came to power promising to cut the budget, but government expenses have never grown faster in the history of any country.

85 He didn't betray his trust; politically, he had no choice.

86 Political leaders have no economic theory they can trust, a fact which escapes many businessmen. ...

87 The economics of tomorrow must do what economists have not been able to do: integrate the realms of the domestic and the world.

88 (Note the use of the word world rather than international.

89 International implies economies outside the domestic realm; world economies are "inside.") ...

90 Tomorrow's economics must also answer the question:
How do we relate the way we run a business to results?

91 What are results?

92 The traditional answer – the bottom line – is treacherous.

93 Under a bottom-line philosophy, we cannot relate the
short term to the long term, and yet the balance between
the two is a crucial test of management.

94 ***Two Guideposts***

95 The beacons of productivity and innovation must be our
guideposts.

96 If we achieve profits at the cost of downgrading
productivity or not innovating, they aren't profits.

97 We're destroying capital.

98 On the other hand, if we continue to improve productivity
of all key resources and our innovative standing, we are
going to be profitable.

99 Not today, but tomorrow.

100 In looking at knowledge applied to human work as the
source of wealth, we also see the function of the
economic organization. ...

101 For the first time we have an approach that makes
economics a human discipline and relates it to human
values, a theory that gives a businessman a yardstick to
measure whether he's still moving in the right direction
and whether his results are real or delusions.

102 We are on the threshold of post-economic theory,
grounded in what we now know and understand about
the generation of wealth.

103 [1987]