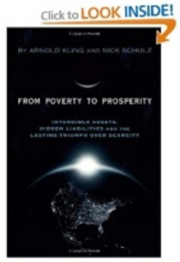
Chapter 1:

AN INTRODUCTION TO ECONOMICS 2.0



ECONOMICS IS NOT what it used to be. Over the last few decades, economists have begun a significant reorientation in how they look at the world. This shift rests on a large and growing body of research that we will explore with you in this book. And it has significant implications for politics, policy, and how we view the world around us.

To understand this change in orientation, consider one of the most basic notions in first-year economics, an economy's so-called "factors of production." We used to teach that there are three factors of production: land, labor, and capital. We described an economy consisting of amber waves of grain, routine unskilled work, and belching, clanking machines inside of giant factories.

But most people today do not live in that economy. Instead, we work in quiet offices situated on land whose value has nothing to do with its agricultural fecundity, doing tasks that are highly specialized and differentiated.

For years, the story economists told to describe the world around us was incomplete. What we had left out of the story were the positive forces of creativity, innovation, and advancing technology that propel economies forward. We did not describe the dynamic process that leads to new pharmaceuticals, cell phones, Web-based information services, computerized logistical systems that fill stores with inexpensive merchandise, and financial innovations that give more people access to credit.

We also left out the negative forces that can hold economies back: bad governance, counterproductive social practices, and patterns of taking wealth instead of creating it. We took for granted secure property rights, honest public servants, and the willingness of individuals to experiment and adapt to novelty.

This book presents the main ideas of what we call Economics 2.0. Economists have developed these ideas in order to explain the enormous differences in quality of life over history and across countries.

Economics 2.0 says that these differences reflect intangible assets and invisible liabilities. The intangible assets are knowledge bases. This category includes formal scientific findings, such as the quantum mechanics and chemistry that help engineers design integrated circuits. It also includes less formal learning from experience, such as the know-how that enables general contractors to put up housing developments on schedule and within budget.

Invisible liabilities, on the other hand, are institutional and cultural impediments to innovation and productivity. These range from the structure and conduct of government to the attitudes and customs of ordinary citizens.

Economics 2.0 offers a completely fresh perspective on the role of markets in society, one that will become clear over the course of this book. Traditionally, the debate over markets has been between the "Chicago school" and the "Harvard–MIT" school. The Chicago school says, "Markets usually work. That is why we need markets." The Harvard–MIT school says, "Markets often fail. That is why we need government."

Economics 2.0 says, "Markets often fail. That is why we need markets."

What do we mean by this? Economics 2.0 says that overcoming market failure requires innovation. Innovation is best delivered by markets. It is rarely delivered by government. Hence, the paradoxical conclusion is that markets are often the best solution to market failure.

Economics 1.0, whether at Chicago or Harvard, looks at the market as a mechanism for allocating a given amount of resources. Most importantly, the market is said to operate with a fixed, known set of production technologies. The debate between Chicago and Harvard centers on whether or not the government can out-guess the private sector in coming up with the best possible allocation.

In Economics 2.0, the market is a mechanism for stimulating and filtering innovation. Entrepreneurs are at the heart of the economy, pumping innovation through the system. Large bureaucracies, on the other hand, whether they belong to corporations or government, are more like cholesterol – inhibiting the circulation of new products and new methods.

If what you are looking to read is the next *Tipping Point* or *Freakonomics*, don't look here. Those books offer a smorgasbord of fascinating findings in economics and sociology. Each is a collection of interesting stories that are only loosely connected with one another.

Instead, this book tells one big story. It is a story that we have assembled out of a number of overlapping strands of research, undertaken by many economists who have received little or no attention in the media. A major goal in writing this book is to introduce these economists and their ideas to a broader audience.

A central figure in this story is Douglass North, who is practically unknown outside of the economics profession. Even among academic economists, North is little recognized, in spite of having been awarded a Nobel Prize. North's main area of research is economic history, a field that was overlooked by Economics 1.0. Many other economists you will meet in this book focus on economic development, another field which, like economic history, has been neglected by mainstream economics. Conventional economists prefer the comfortable precision of mathematical abstraction to the messy complexity of the real world, with all of its uncertainties, unknowns, and ongoing evolution.

Antecedents of Economics 2.0 can be found in the work of a group of economists known as the Austrian school. Joseph Schumpeter emphasized the importance of entrepreneurs, innovation, and what he called "creative destruction." Friedrich Hayek emphasized the roles of cultural norms, institutions, and "spontaneous order." However, the focus of this book will be on the ideas of living economists, and we leave it to curious readers to explore the intellectual genealogy themselves.

ECONOMICS 1.0 VS. ECONOMICS 2.0

Economics 1.0 is about scarcity. To understand what we mean by that, consider that textbooks define economics as the study of the allocation of scarce resources among competing ends. So if a society wants to produce more guns, then it will have less labor, land, and equipment with which to produce butter