

INTRODUCTION



Moral: To understand economics you need to know not only fundamentals but also its *nuances*. Darwin is in the nuances. When someone preaches “Economics in One Lesson,” I advise: Go back for the second lesson.

—Paul Samuelson, An Enjoyable Life Puzzling
Over Modern Finance Theory, *Annual Review
of Financial Economics*, Vol. 1, p. 30

As the name implies, this book is, or at least began as, a response to Henry Hazlitt’s *Economics in One Lesson*, a defense of free-market economics first published in 1946. But why respond to a seventy-year-old book when new books on economics are published every day? Why two lessons instead of one? And where does opportunity cost fit into all of this?

The first question was one that naturally occurred to me when Seth Ditchik, my publisher at Princeton University Press, suggested this project. It turns out that *Economics in One Lesson* has been in print continuously since its first publication and has now sold more than a million copies. Hazlitt’s admirers have embraced the message that all economic problems have a simple answer, and one that matches their own preconceptions. Adapting Hazlitt’s title, this simple answer may be described as One Lesson economics.¹

¹ One-lesson economists do not describe themselves in these terms, typically preferring terms like “free market.” As I shall show, however, the concept of a “free”

Broadly speaking, Hazlitt's simple answer is "leave markets alone, and all will be well." This may be summed up, in the pithy expression of eighteenth-century French writer and free trade advocate, René de Voyer, Marquis d'Argenson, as *laissez-faire* (let [business] do it).

Hazlitt, as he makes clear, was simply reworking the classic defense of free markets by the French writer Frédéric Bastiat, whose 1850 pamphlets "The Law" and "What Is Seen and What Is Unseen" form the basis of much of *Economics in One Lesson*. However, Hazlitt extends Bastiat by including a critique of the Keynesian economic model, which was developed in response to the Great Depression of the 1930s.

Both where he was right and where he was wrong, Hazlitt's *One Lesson* is relevant today, and has not been improved on by today's advocates of the free market, who may fairly be referred to as One Lesson economists. Indeed, precisely because he was writing at a time when support for One Lesson economics was at a particularly low ebb, Hazlitt gave a simpler and sharper presentation of the case than many of his successors.

Hazlitt presented One Lesson economics in clear and simple terms that have not been sharpened by any subsequent writer. And, despite impressive advances in mathematical sophistication and the advent of powerful computer models, the basic questions in economics have not changed much since Hazlitt wrote, nor have the key debates been resolved. So, he may be read just if he were writing today.

market is illusory and misleading. All markets operate within legal systems that enforce certain kinds of property rights and contracts and disregard others. A free market is one in which currently existing private property rights take precedence over all others. There are many other terms used to describe One Lesson economics, mostly used pejoratively. These include "Chicago School economics," "neoliberalism," "Thatcherism," and the "Washington Consensus." In my previous book, *Zombie Economics*, I used the term "market liberalism."

Hazlitt worked in the tradition of “microeconomics,” that is, the study of the way prices work in particular markets. The central question, which will be the main focus of this book, is whether the prices of goods and services reflect, and determine, all the costs involved for a society in providing those goods and services, summed up in the concept of “opportunity cost.”

The opportunity cost of anything of value is what you must give up so that you can have it.

Opportunity cost is critical both in individual decisions and for society as a whole.

Reading Hazlitt, the centrality of opportunity cost isn’t immediately evident. Hazlitt states his One Lesson as:

The art of economics consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups.

This isn’t particularly helpful: it seems to say only that economists should do a thorough job. But, on reading *Economics in One Lesson* it becomes clear that Hazlitt, as an anti-government activist, wants to make a much stronger claim. When economics is done properly, Hazlitt argues, the answer is always to leave the market alone. So, the One Lesson may be restated as:

Once all the consequences of any act or policy are taken into account, the opportunity costs of government action to change economic outcomes always exceed the benefits.

The simplicity of Hazlitt’s argument is his great strength. By tying many complex issues to a single principle, Hazlitt is able to

ignore secondary details and go straight to the heart of the case against government action. His answer in every case flows from his “One Lesson.”

Hazlitt’s claim to teach *Economics in One Lesson* is similar in its appeal to other best sellers like *The Secret* and *The Rules*. He provides a simple answer to problems that have puzzled humanity since the dawn of civilization. As with these other best sellers, Hazlitt is offering a delusion of certainty. His One Lesson contains important truths about the power of markets, but he ignores equally important truths about the limitations of the market.

So, we need *Economics in Two Lessons*.

Two lessons are harder than one. And thinking in terms of two lessons comes at a cost: we can sustain neither the dogmatic certainty of One Lesson economics nor the reflexive assumption that any economic problem can be solved by government action. In many cases, the right answer will remain elusive, involving a complex mixture of market forces and government policy. Nevertheless, the two lessons presented here provide a framework within which almost any problem in economic policy can usefully be considered.

One Lesson economics, of the kind propounded by Bastiat, had come under severe criticism from leading economists by the time Hazlitt rose to its defense. Decades before Hazlitt, economists such as Alfred Marshall and A. C. Pigou had developed the concept of “externalities,” that is, situations in which market prices don’t fully reflect all the relevant opportunity costs. The classic example is that of air or water pollution generated by a factory. In the absence of specific government policies, the costs of pollution aren’t borne by the owner of the factory or reflected in the prices of the goods the factory produces. To understand the problem, we need to go beyond individual opportunity costs and consider costs for society as a whole. We must modify the original definition (changes in capitals):

The SOCIAL opportunity cost of anything of value is what you AND OTHERS must give up so that you can have it.

Externalities are just one example of a large class of problems referred to by economists as “market failures.” In all these cases, prices differ from social opportunity costs. In some cases, but not all, the problems may be remedied by appropriately designed government policies. A typical intermediate course on microeconomic policy begins with a catalog of market failures and goes on to examine arguments about the desirability or otherwise of possible policy responses.

When I began writing this book, I envisaged it as a nontechnical guide to microeconomic policy, based on the concepts of opportunity costs and market failure. As I worked on the book, though, I felt dissatisfied.

Externalities and related market failures are big issues; the problem of climate change has been aptly described by Sir Nicholas Stern as “the biggest market failure in history.” But at a time of chronic economic recession or depression in much of the developed world, and of rapidly growing economic inequality, a book on market failure alone could scarcely justify the title *Economics in Two Lessons*.

I started to think more about the problem of unemployment and how it is treated in Hazlitt’s work. Much of *Economics in One Lesson* can be read as an attack on the work of John Maynard Keynes, the great English economist, whose *General Theory of Employment, Interest and Money* was published in 1936 and gave rise to the entire field of macroeconomics (the study of disturbances affecting aggregate levels of employment, interest rates, and prices).

Experience shows that the economy frequently remains in a depression or recession state for years on end. Keynes was the first economist to present a convincing account of how a market

economy could operate for long periods at high levels of unemployment. By contrast, despite the then-recent experience of the Great Depression, Hazlitt implicitly assumed that the economy is always at full employment—or would be if not for government and trade union interference.

As I worked on the problem, I reached the conclusion that the central issue could be stated in terms of opportunity cost. In a recession or depression, markets, and particularly labor markets, don't properly match supply and demand. This means that prices, and particularly wages, do not, in general, reflect or determine opportunity costs.

That insight doesn't tell us what, if anything, governments can do to restore and maintain full employment. But it does lead us to a crucial observation, ignored not only by Hazlitt but by the majority of mainstream economists today. It is normally assumed that, in the absence of obvious market failures in some particular part of the economy, Hazlitt's *One Lesson* is applicable. But a recession or depression affects the economy as a whole. Under conditions of recession, opportunity costs will not, in general, be equal to market prices in any sector of the economy.

The other crucial issue of the day is the distribution of income and wealth, which is becoming steadily more unequal. Although he does not say so explicitly, Hazlitt implies that the existing market distribution of income (or rather, the one that would emerge after the policies he dislikes are scrapped) is the only one that is consistent with his *One Lesson*.

The market outcome depends on the system of property rights from which it is derived. In fact (as we will see later), when markets work in the way Hazlitt assumes, any distribution of goods and resources where prices equal opportunity costs can be derived from some system of property rights. So, Hazlitt's *One Lesson* tells us nothing useful about the distribution of income or about government policies that may change that distribution.

While markets are exceptionally powerful social institutions, they cannot work unless governments establish the necessary framework in which they can operate. The core of the economic framework in a market economy, and a central role of government, is the allocation and legal enforcement of property rights. The choices that determine property rights are subject to the logic of opportunity costs just as much as the choices made within a market setting by firms and households.

Between them, microeconomics, macroeconomics, and income distribution cover all the critical issues in economic policy. To master any one of these fields requires years of study. In microeconomics, for example, it is necessary to deal with the theory of supply and demand, first by manipulating the graphical representations given in a typical Economics 101 course, and then with more complex algebraic and numerical techniques.

But this level of analysis is required only for specialists who need, for example, to give quantitative answers to questions like “How much will a change in tariffs on steel imports affect employment in the automobile industry?” For most of us, it’s sufficient to understand that protecting the steel industry will have an opportunity cost, and that part of that cost will be the loss of jobs in the automobile industry.

Most of the questions of principle involved in public policy can be illuminated by a careful application of the idea of opportunity cost and its relationship to market prices. For this purpose, as I argued above, we need only two lessons.

Lesson One: Market prices reflect and determine opportunity costs faced by consumers and producers.

Lesson One describes the way markets work and explains why, under certain ideal circumstances, Hazlitt’s One Lesson

economics provides the right answer. Lesson Two is the product of more than two centuries of study of the way markets work under circumstances that are less than ideal and why they may not deliver the desired results:

Lesson Two: Market prices don't reflect all the opportunity costs we face as a society.

The problem of how markets work and why they fail is at the core of most of the economic policy issues that drive political and social debate. I hope this book, and the two lessons it contains, will help to clarify these issues.

Outline of the Book

The book is divided into four parts, two for each lesson.

Lesson One, Part I, shows how a market economy functions under conditions that ensure that prices are equal to the opportunity costs faced by producers and consumers.

Lesson One, Part II, is a series of applications of Lesson One. We will consider how policies based on the concepts of prices and opportunity costs can be used to achieve the goals of public policy.

Lesson Two, Part I, shows that market prices may not reflect the opportunity costs faced by society as a whole. In fact, any market equilibrium is the product of social choices about the allocation of property rights. Market prices tell us nothing about the opportunity costs associated with those choices.

Equally important, not all opportunity costs associated with consumer and producer choices are reflected in the opportunity costs they face. There are many different ways in which market prices can fail to reflect opportunity costs. These "market

failure” problems include unemployment, monopoly, environmental pollution, and inadequate provision of public goods. Lesson Two will help to show how these disparate problems can all be understood in terms of opportunity costs.

Lesson Two, Part II, contains applications to a wide range of policy problems. First, we will consider the problem of income distribution. We will show that, more often than not, the best way to help poor people, at home and abroad, is to give them money to spend as they see fit, rather than tying assistance to particular goods and services. In other words, it is better to fix the inequitable allocation of property rights in the first place than to fix the resulting market outcome. Next we will consider how macroeconomic problems, the most important of which is mass unemployment, may be addressed using fiscal and monetary policy. Finally, we will examine a range of public policies more conventionally associated with the idea of market failure.

In an effort to make the book more readable, but still adhere to academic standards of referencing, I’ve dispensed with the standard, but cumbersome, apparatus of endnotes. Instead, I’ve included a short section at the end of each chapter, giving sources for factual claims and suggestions for further reading, which may be followed up using the bibliography at the end of the book. I’ve used footnotes sparingly, to cover peripheral issues and for occasional asides.

Further Reading

Hazlitt (1946) is still in print and is also available online at the Mises Institute. Apart from *Economics in One Lesson*, Hazlitt is best known for his (1959) book, *The Failure of the “New Economics,”* a line-by-line response to Keynes’s (1936) *General Theory of Employment Interest and Money*. Hazlitt (1993) is a

representative collection of his writing, published in the year of his death. Bastiat's writings have been translated into English a number of times (Bastiat 2012a, 2012b, 2013).

Marshall's *Principles of Economics*, first published in 1890, was the classic economic textbook of its day, and remained influential for much of the twentieth century. It went through many editions, culminating in the eighth edition (Marshall 1920), which remains the most-used and most-cited version. Pigou's (1920) analysis of *The Economics of Welfare* introduced the modern concept of "externality," which became one of the archetypal forms of "market failure." One of the first typologies of market failure was that of Bator (1958).

Other works cited in this introduction are Byrne's *The Secret* (2006), and Fein and Schneider's *The Rules* (1996). The quotation at the chapter opening is from Samuelson (2009).