1.1 Preface

> 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", *Annu. Rev. Financ. Econ.* 2009. 1:19–35

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 70-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 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. As with many other bestsellers with similarly appealing titles, readers have embraced the message that all problems have a simple answer, and one that matches their own preconceptions.

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 developed in response to the Great Depression of the 1930s.

Both where he was right, and where he was wrong, Hazlitt's arguments remain relevant today, and have not been substantially improved on by today's advocates of the free market. Indeed, precisely because he was writing at a time when support for free markets was at a particularly low ebb, Hazlitt gave a simpler and sharper presentation of the case than many of his successors.

Hazlitt presented the core of the free-market case in simple terms that have not been improved upon 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.

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 free market 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 bestsellers like *The Secret* and *The Rules*, in providing a simple answer to problems that have puzzled humanity since the dawn of civilization. As with these other bestsellers, 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 Hazlitt's free-market policies 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.

Some of the key questions of economics are:

* Will Keynesian fiscal policies secure full employment?
* Should the government invest more in infrastructure ?
* Do minimum wages benefit workers?
* Can price controls stop inflation ?

Hazlitt answers 'No' to all these questions. His *One Lesson* is:

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.

As Hazlitt develops the argument, his meaning becomes clear. The direct benefits of more jobs and public works, higher wages and lower prices are obvious. But these benefits do not come without costs, often borne by groups far removed from the beneficiaries. The true measure of cost is not a money value, but the alternative use to which resources could have been put. In Hazlitt's words:

Everything … is produced at the expense of foregoing something else.

Economists call this foregone value 'opportunity cost'. The centerpiece of this way of thinking is the concept of opportunity cost. This key idea comes up in the first few weeks of any Economics 101 course, and the definition is easy enough to memorize and restate. Learning to think in terms of opportunity cost takes a lot longer, and many students (including some who go on to become professional economists) never do so.

But how does Hazlitt get from the idea of opportunity cost, accepted by nearly all economists, to the conclusion that government intervention in the economy is hardly ever justified? And

Hazlitt assumes that the opportunity cost of any good or service is its market price. So, he infers, any government interference with markets , such as the provision of 'free' services, must involve hidden costs that outweigh the immediate benefits.

So we can restate Hazlitt's Lesson as:

Assuming that market prices are equal to opportunity costs, government interventions that change the market allocation must have opportunity costs that exceed their benefits.

Hazlitt never spells out the relationship between prices and opportunity costs. As a result, he implicitly assumes that there is a unique market allocation, in which prices equal opportunity costs, and that the two can only differ as a result of government interference. This assumption is not, in general, true.

Decades before Hazlitt, economists such as Alfred Marshall and AC Pigou had developed the concept of 'externalities' that is situations in which market prices don't fully reflect social 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.

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 micro-economic policy begins with a catalog of market failures (ref Bator), 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 non-technical guide to micro-economic 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 a big issue; the problem of climate change has been aptly described 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 problem 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, determine opportunity costs.

That insight doesn't tell us what, if anything, governments can do to restore and maintain full employment. But it does point up a crucial point, 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, and means that opportunity costs cannot be assumed to equal 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 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 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 answer questions like "How much will a change in taxation of new automobiles affect employment in the steel 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 two lessons.

The first lesson, implicit in Hazlitt's is:

Lesson 1: Market prices reflect and determine opportunity costs faced by consumers and producers.

The second lesson is the product of more than two centuries of study of the way markets work, and the reasons that they often fail to work as they should:

Lesson 2: 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.

1.2 Outline of the book

The book is in four parts:

Part I is a discussion of Lesson 1, showing how a market economy functions under conditions that ensure prices are equal to the opportunity costs faced by producers and consumers.

Part II is a series of applications of Lesson 1. First, we will see how the price mechanism works, using the example of the market for oil. Next we will consider how policies based on the concepts of prices and opportunity costs can be used to achieve the goals of public policy.

Part III presents Lesson 2, showing that market prices do 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 importantly, 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 2 will help to show how these disparate problems can all be understood in terms of opportunity costs.

Part IV contains applications of Lesson 2 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. That is, 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.