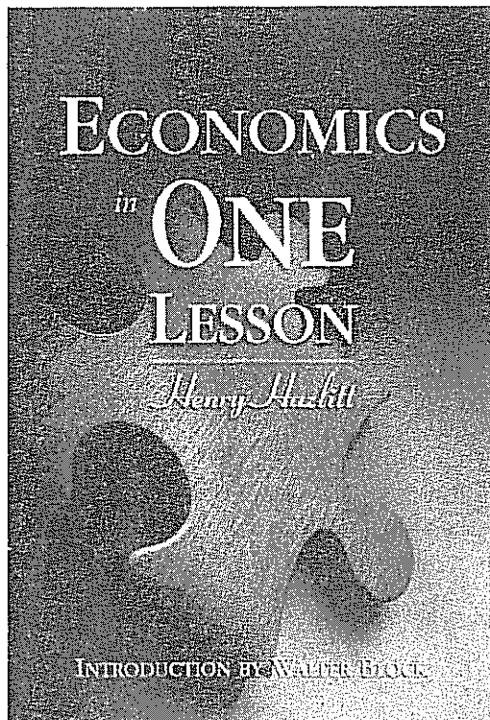
Economics in One Lesson

A Book Review by Gavin Putland



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The reader of a book review will rightly want to know the ideology of the reviewer. Very well: being of Georgist persuasion, I divide the "means of production" into two categories: those that can be produced or reproduced by competitors, and those that can't. On the former category, I'm as far Right as you can get, believing that such assets should be privately owned and exempt from tax, to encourage capital formation.

That may explain my mostly sympathetic reaction to a book much admired by advocates of free markets and small government: Economics in One Lesson (1946; revised 1978) by Henry Hazlitt (1894-1993).

His opening shot is: "Economics is haunted by more fallacies than any other study known to man." These fallacies are promoted in support of "endless pleadings of self-interest" and are assisted by "the fallacy of overlooking secondary consequences." Hazlitt's "one lesson" is then stated: "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."

That "lesson" is not Hazlitt's Big Idea, but only his method. His Big Idea is drummed out again and again as he demolishes a long list of interventionist policies and the fallacies that support them.

He begins with the "broken window" fallacy -- the idea that you can stimulate the economy by making work that wouldn't otherwise need to be done. In reality, of course, wasteful duplication of productive effort can only result in a net reduction in purchasing power. Later chapters deal with various guises of the broken window, including war, unnecessary public works, needless bureaucracy, opposition to labour-saving machinery, and demarcations of responsibility that cause multiplication of labour rather than division of labour.

A related fallacy treats purchasing power in terms of money instead of productive power, with the result that the alleged creation or saving of purchasing power leads to a misdirection of productive power (analogous to repairing the broken window). Numerous examples are given in the chapters on government-mandated lending, make-work schemes, tariffs, export subsidies, and price controls (including minimum wages and rent caps).

Labour-saving machinery multiplies the productive power of labour and the resulting capacity to pay for labour. Hazlitt gives examples in which mechanization of an industry, by reducing the prices of its products and thereby increasing sales and revenue, led to an increase in employment in that very industry.

But usually the new jobs are widely dispersed. In what

was originally the last chapter, Hazlitt admits the tendency of "even the disinterested observer" to notice concentrated losses rather than diffused gains, and says of the losers: "It is altogether proper...that the plight of these groups be recognized... and that we try to see whether some of the gains from this specialized progress cannot be used to help the victims find a productive role elsewhere." Obviously that won't happen without government intervention.

Nor is this the only example of Hazlitt's capacity for nuance. After ten pages denouncing tariffs he says: "As a postscript to this chapter I should add that its argument is not directed against all tariffs, including duties collected mainly for revenue, or to keep alive industries needed for war..."

His nuance extends to workplace relations (chapter 20). A strike, he says, is legitimate, but not if it involves pickets; and strikebreakers are legitimate, but not if they threaten violence, can't do the work, or are paid more than the strikers were. After concluding that minimum wages substitute unemployment for low wages (chapter 19) except for workers who are being paid less than the market-clearing rate, he suggests that the exception is better handled by unionization than by minimum wages.

But an elephant turns the page when he concludes (s.19.3): "We cannot in the long run pay labor as a whole more than it produces. The best way to raise wages, therefore, is to raise marginal labor productivity." Indeed we cannot pay labour more than its marginal product. But we can and do pay it considerably less, due to taxes that cause workers to cost more than their wages (payroll tax), to receive less than their wages (personal income tax), and to consume less than they spend (GST/VAT or sales tax).

How should the offending taxes be replaced? That brings us to the other category of "means of production" -- assets that can't be produced or reproduced by competitors. Georgists contend that the market values of such assets, being publicly created, are the proper source of public revenue. The most important example is land, whose value can be tapped by means of rates, "land tax" and "capital gains" tax.

Hazlitt doesn't have "land" in the index.

In three places in the text (ss. 11.4, 15.2 and 16.2), he lists the factors of production as land, labour and capital, but doesn't distinguish between them for purposes of argument. In s.16.2 he also mentions the "poorest land", "least competent farmers" (labour) and "poorest equipment" (capital), but again doesn't distinguish further.

Similarly in the chapter on credit, he doesn't care whether borrowed funds are spent on farms (land) or tractors (capital).

In s.15.2 he adds that for an economy in "equilibrium", these factors are limited "at any moment", thus glossing over the fact that the supply of capital can build up or decay. Although Hazlitt is usually said to be of the Austrian school, this snapshot view of "equilibrium" is neoclassical, not Austrian; it was pioneered by J.B. Clark for the purpose of making capital look like land, so that land could be called a form of capital. Hazlitt includes Clark in his recommended reading list.

Henry Hazlitt (1894-1993)

Earlier (s.6.2), Hazlitt cites the "limited" supply of capital as an argument against government-guaranteed home mortgages, claiming that they cause "oversupply of houses as compared with other things" -- not that they pump up land prices.

But he mentions the need for capital accumulation elsewhere, especially in the chapter on saving, where his examples of "capital" include schools, colleges, churches, libraries, hospitals, private homes, and "the most wonderfully equipped factory", all of which include land components. This conflation of capital and land is neoclassical.

In contrast, Austrian economists emphasize that capital, unlike land, must be constantly renewed, that its life cycle may be long or short, and that loose monetary policy causes overinvestment in long-life capital, whose value then collapses, contributing to recessions.

Meanwhile Georgists notice that recessions follow bursting "property bubbles", which are really land bubbles because land prices, unlike prices of buildings (prime examples of "long-life capital"), are not constrained by construction costs.

Hazlitt's failure to make these distinctions may explain why his explanation for depressions (s.23.5) is so vague: "the real causes, most of the time, are maladjustments within the wage-cost-price structure... At some point these maladjustments have removed the incentive to produce, or have made it actually impossible for production to continue... Not until these maladjustments are corrected can full production and employment be resumed." All clear now?

Those who call themselves free-traders too often fail to apply their own standards to trade within their own countries. Witness those misnamed "free trade agreements" in which each country promises to impose the other's monopolies on its own citizens.

Hazlitt falls into this error in chapter 4, where he

considers an extra bridge between Easton and Weston and declares that "For every dollar that is spent on the bridge a dollar will be taken away from taxpayers." Not necessarily, because any such bridge will lower barriers to trade between Easton and Weston, especially the indispensable trade between employers and employees.

The benefit of the additional trade, net of any bridge tolls, will be shown in prices of access to locations served by the bridge -- in other words, land values. If the benefit exceeds the cost, it will be possible to cover the cost by clawing back a sufficient fraction of the uplift in land values, in which case the cost, although clawed back through the tax system, will not be "taken away from the taxpayers" but will be part of the new value created by the bridge.

The rest of that new value will be a net windfall to the property owners.

Hazlitt then turns to the Norris Dam (a New Deal project) and rubbishes the claim that "private capital could not have built it", because it was indeed built by private capital "expropriated in taxes... taken from people all over the country", causing the loss of "the private power plants, the private homes, the typewriters and television sets" that the expropriated funds might otherwise have bought. Thus the people of one district got richer at the expense of the rest of the country.

But it didn't have to be done that way. The earlier Don Pedro dam (completed 1923) was built by two Californian irrigation districts and financed entirely by local land-value taxes. The affected land owners were fiercely in favour of it because they knew the increase in their land values would outweigh the taxes. Even if the land-value taxes had been imposed by a higher level of government, the financing of the dam would still have been local, because only the local land values would have been affected by it. Private capital did not build it, because the uplift in land values that paid for it would not have occurred without it. Private agencies could not have organized it, because they would have had no way of tapping the uplifts in land values.

With an eye to current debates, I should conclude by praising Hazlitt for an insight that his latter-day admirers have ignored.

In explaining why "Taxes Discourage Production" (chapter 5), he says:

"When a corporation loses a hundred cents of every dollar it loses, and is permitted to keep only fifty-two cents of every dollar it gains, and when it cannot adequately offset its years of losses against its years of gains, its policies are affected." If individual investors "lose the whole dollar when they lose, but can keep only a fraction of it when they win," they are less likely to take risks.

The "World War II excess-profits tax", which Hazlitt condemns in chapter 22, was similarly one-sided.

If that's the problem, the obvious solution is to allow the tax bill to be negative when profit is negative. A cash-flow tax with full loss offset, also known as a Brown tax, does precisely that. Because a Brown tax reduces all cash flows by the same proportion, is doesn't affect the internal rate of return (IRR) of a series of cash flows and therefore doesn't distort investment decisions.

If credits for losses, instead of being immediately refunded, are carried forward at an "uplift rate" (interest rate) reflecting the risk that they will not be redeemed, then the total present value, hence the IRR, will be unchanged (unless redemptions of credits are incorrectly discounted at the target IRR instead of a rate reflecting the risk of non-redemption). The appropriate uplift rate obviously depends on the extent to which carried-forward credits are transferable, tradable or refundable.

Taxes of the latter sort have been proposed and even legislated. They have names like "PRRT", "RSPT" and "MRRT"! By Hazlitt's logic, the political Right should welcome such taxes as a means of reducing corporate income tax. But it conspicuously does the opposite -- for example by arguing that the uplift rate is not a sufficient return (the fallacy of the wrong discounting rate).

When it is suggested that a modified Brown tax should be used to eliminate corporate income tax altogether, the Right gets even more apoplectic, complaining that the new system would be distorted in favour of less profitable companies, when in fact the present one is distorted the other way because it increases the return needed to make an investment viable.

Thus Hazlitt's professed admirers have become leading peddlers of the sorts of fallacies that he decried.

"The assumptions which neoclassical economists make to get their Mickey Mouse models to work basically assume away any connection with reality. One could as well come up with an aerodynamic equation for flying pigs ...... assuming, of course, 'sufficient thrust'."

Anon