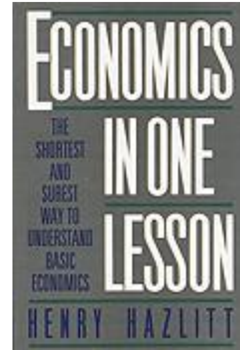
ECONOMICS IN ONE LESSON: The Shortest and Surest way to Understand Basic Economics



Review by Wayne Caswell, Homeowners of Texas, 4/16/10

This classic book by Henry Hazlitt was written in 1946 and has been promoted as **one of the Top 10 books every Republican Congressman should read**.

Conservatives say it promotes free market capitalism and debunks fallacies embraced by those who advocate government intervention in the economy, but I came to a completely different conclusion:

> *Good public policy is more about public interests versus special interests than about left-wing vs. right-wing, liberal vs. conservative, and Democrat vs. Republican politics. Likewise, good policy is more about governing and oversight than spending and taxing.*

If you too find yourself frustrated with politics, this book may give you new insights. The author reduced the whole of economics to a single lesson and even to a single sentence:

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

Excerpt with highlights and [comments]:

THE LESSON

Economics is haunted by more fallacies than any other study known to man. This is no accident. The inherent difficulties of the subject would be great enough in any case, but they are multiplied a thousand fold by a factor that is insignificant in, say, physics, mathematics or medicine – the special pleading of selfish interests.

While every group has certain economic interests identical with those of all groups, every group has also, as we shall see, interests antagonistic to those of all other groups. While certain public policies would in the long run benefit everybody, other policies would benefit one group only at the expense of all other groups. The group that would benefit by such policies, having such a direct interest in them, will argue for them plausibly and persistently. It will hire the best buyable minds to devote their whole time to presenting its case. And it will finally either convince the general public that its case is sound, or so befuddle it that clear thinking on the subject becomes next to impossible.

> [Big corporations and labor unions can hire armies of special interest lobbyists and attorneys to influence campaigns and policy, but who represents public interests? It's a great burden in time and expense for the small businessman, the middle class worker, the elderly, or people with low income to take off from work, travel to the Capitol, and influence policy in their favor. Consumer advocacy groups like Homeowners of Texas can be a great help, but they're notoriously underfunded and outgunned when it comes to battling wealthy special interests.]

In addition to these endless pleadings of self-interest, there is a second main factor that spawns new economic fallacies every day. This is the persistent tendency of men to see only the immediate effects of a given policy, or its effects only on a special group, and to neglect to inquire what the long-run effects of that policy will be not only on that special group but on all groups. It is the fallacy of overlooking secondary consequences.

In this lies the whole difference between good economics and bad. The bad economist sees only what immediately strikes the eye; the good economist also looks beyond. The bad economist sees only the direct consequences of a proposed course; the good economist looks also at the longer and indirect consequences. The bad economist sees only what the effect of a given policy has been or will be on

one particular group; the good economist inquires also what the effect of the policy will be on all groups.

The distinction may seem obvious. The precaution of looking for all the consequences of a given policy to everyone may seem elementary. Doesn't everybody know, in his personal life, that there are all sorts of indulgences delightful at the moment but disastrous in the end? Doesn't every little boy know that if he eats enough candy he'll get sick? Doesn't the fellow who gets drunk know that he'll wake up in the morning with a ghastly hangover? Doesn't the Don Juan know that he is letting himself in for every sort of risk, from blackmail to disease? Finally, to bring it to the economic though still personal realm, doesn't the spendthrift know, even in the midst of their glorious fling, that they are heading for a future of debt and poverty?

The tragedy is that we are already suffering the long-run consequences of the policies of the remote or recent past. Today is already the tomorrow which the bad economist yesterday urged us to ignore. The long-run consequences of some economic policies may become evident in a few months. Others may not become evident for several years. Still others may not become evident for decades. But in every case those long-run consequences are contained in the policy as surely as the hen was in the egg, the flower in the seed.

> [The book next includes 24 chapters giving examples of how The Lesson can be applied. Below is one of those chapters that seems to apply to the recent economic crisis.]

HOW CREDIT DIVERTS PRODUCTION

Government *"encouragement"* to business is sometimes as much to be feared as government hostility. This supposed encouragement often takes the form of a direct grant of government credit or a guarantee of private loans.

The question of government credit can often be complicated, because it involves the possibility of inflation. We shall defer analysis of the effects of inflation of various kinds until a later chapter. Here, for the sake of simplicity, we shall assume that the credit we are discussing is noninflationary. Inflation, as we shall later see, while it complicates the analysis, does not change the consequences of the policies discussed.

> [The following example refers to farmers but could just as easily apply to home buyers.]

A frequent proposal of this sort in Congress is for more credit to farmers. In the eyes of most congressmen the farmers simply cannot get enough credit. The credit supplied by private mortgage companies, insurance companies or country banks is never *"adequate."* Congress is always finding new gaps that are not filled by the existing lending institutions, no matter how many of these it has itself already brought into existence. The farmers may have enough long-term credit or enough short-term credit but, it turns out, they have not enough *"intermediate"* credit; or the interest rate is too high; or the complaint is that private loans are made only to rich and well-established farmers. So, new lending institutions and new types of farm loans are piled on top of each other by the legislature.

The faith in all these policies springs from two acts of shortsightedness. One is to look at the matter only from the standpoint of the farmers that borrow. The other is to think only of the first half of the transaction.

Now all loans, in the eyes of honest borrowers, must eventually be repaid. All credit is debt. Proposals for an increased volume of credit, therefore, are merely another name for proposals for an increased burden of debt. They would seem considerably less inviting if they were habitually referred to by the second name instead of by the first.

We need not discuss here the normal loans that are made to farmers through private sources. They consist of mortgages, of installment credits for the purchase of automobiles, refrigerators, TV sets, tractors and other farm machinery, and of bank loans made to carry the farmer along until he is able

to harvest and market his crop and get paid for it. Here we need concern ourselves only with loans to farmers either made directly by some government bureau or guaranteed by it.

> [The U.S. Government (i.e. the taxpayers) now guarantees over 80% of all U.S. home mortgages due to policies promoting homeownership, including tax deductions for mortgage interest, artificially low interest rates, federal loan guarantees, first time homebuyer tax credits, etc.
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> Many of the loans were risky – made with nothing down and no accountability to people with questionable credit. Still, they were insured by the FHA, VA, USDA, Fannie Mae or Freddie Mac.
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> Those policies arguably benefited the home building and finance industries more than consumers. This seems to make the government complicit in encouraging risky loans and bad business practices.]

These loans are of two main types. One is a loan to enable the farmer to hold his crop off the market. This is an especially harmful type, but it will be more convenient to consider it later when we come to the question of government commodity controls. The other is a loan to provide capital—often to set the farmer up in business by enabling him to buy the farm itself or a mule or tractor, or all three.

At first glance the case for this type of loan may seem a strong one.

Example A – Or here is a farmer struggling along with primitive methods of production because he has not the capital to buy himself a tractor. Lend him the money for one; let him increase productivity; he can repay the loan out of the proceeds of his increased crops. In that way you not only enrich him and put him on his feet; you enrich the whole community by that much added output. And the loan, concludes the argument, costs the government and the taxpayers less than nothing, because it is *"self-liquidating."*

Example B – Here is a poor family, it will be said, with no means of livelihood. It is cruel and wasteful to put them on relief. Buy a farm for them; set them up in business; make productive and self-respecting citizens of them; let them add to the total national product and pay the loan off out of what they produce.

Now as a matter of fact that is what happens every day under the institution of private credit. If a man wishes to buy a farm, and has, let us say, only half or a third as much money as the farm costs, a neighbor or a savings bank will lend him the rest in the form of a mortgage on the farm. If he wishes to buy a tractor, the tractor company itself or a finance company, will allow him to buy it for one-third of the purchase price with the rest to be paid off in installments out of earnings that the tractor itself will help to provide.

But there is a decisive difference between the loans supplied by private lenders and the loans supplied by a government agency. Each private lender risks his own funds. (A banker, it is true, risks the funds of others that have been entrusted to him; but if money is lost he must either make good out of his own funds or be forced out of business.) When people risk their own funds they are usually careful in their investigations to determine the adequacy of the assets pledged and the business acumen and honesty of the borrower.

If the government operated by the same strict standards, there would be no good argument for its entering the field at all. Why do precisely what private agencies already do? But the government almost invariably operates by different standards. The whole argument for government entering the lending business, in fact, is that it will make loans to people who could not get them from private lenders. This is only another way of saying that the government lenders will take risks with other people's money (the taxpayers') that private lenders will not take with their own money. Sometimes, in fact, apologists will freely acknowledge that the percentage of losses will be higher on these government loans than on private loans. But they contend that this will be more than offset by the added production brought into existence by the borrowers who pay back, and even by most of the borrowers who do not pay back.

This argument will seem plausible only as long as we concentrate our attention on the particular borrowers whom the government supplies with funds, and overlook the people whom its plan deprives of funds. For what is really being lent is not money, which is merely the medium of exchange, but capital. (I have already put the reader on notice that we shall postpone to a later point the complications introduced by an inflationary expansion of credit.) What is really being lent, say, is the farm or the tractor itself. Now the number of farms in existence is limited, and so is the production of tractors (assuming, especially, that an economic surplus of tractors is not produced simply at the expense of other things). The farm or tractor that is lent to A cannot be lent to B. The real question is, therefore, whether A or B shall get the farm.

This brings us to the respective merits of A and B, and what each contributes, or is capable of contributing, to production. A, let us say, is the man who would get the farm if the government did not intervene. The local banker or his neighbors know him and know his record. They want to find employment for their funds. They know that he is a good farmer and an honest man who keeps his word. They consider him a good risk. He has already, perhaps, through industry, frugality and foresight, accumulated enough cash to pay a fourth of the price of the farm. They lend him the other three-fourths; and he gets the farm.

There is a strange idea abroad, held by all monetary cranks, that credit is something a banker gives to a man. Credit on the contrary, is something a man already has. He has it, perhaps, because he already has marketable assets of a greater cash value than the loan for which he is asking. Or he has it because his character and past record have earned it. He brings it into the bank with him. That is why the banker makes him the loan. The banker is not giving something for nothing. He feels assured of repayment. He is merely exchanging a more liquid form of asset or credit for a less liquid form. Sometimes he makes a mistake, and then it is not only the banker who suffers, but the whole community; for values which were supposed to be produced by the lender are not produced and resources are wasted.

Now it is to A, let us say, who has credit that the banker would make his loan. But the government goes into the lending business in a charitable frame of mind because, as we say, it is worried about B.

B cannot get a mortgage or other loans from private lenders because he does not have credit with them. He has no savings; he has no impressive record as a good farmer; he is perhaps at the moment on relief. Why not, say the advocates of government credit, make him a useful and productive member of society by lending him enough for a farm and a mule or tractor and setting him up in business?

Perhaps in an individual case it may work out all right. But it is obvious that in general the people selected by these government standards will be poorer risks than the people selected by private standards. More money will be lost by loans to them. There will be a much higher percentage of failures among them. They will be less efficient. More resources will be wasted by them. Yet the recipients of government credit will get their farms and tractors at the expense of those who otherwise would have been the recipients of private credit. Because B has a farm, A will be deprived of a farm. A may be squeezed out either because interest rates have gone up as a result of the government operations, or because farm prices have been forced up as a result of them, or because there is no other farm to be had in his neighborhood.

In any case, the net result of government credit has not been to increase the amount of wealth produced by the community but to reduce it, because the available real capital (consisting of actual farms, tractors, etc.) has been placed in the hands of the less efficient borrowers rather than in the hands of the more efficient and trustworthy.

Hazlitt summarizes his book this way:

> *Economics is a science of tracing the effects of some proposed or existing policy not only on some special interest in the short run, but on the general interest in the long run.*

His book is available for purchase or free in full text online. Just Google, *"Economics in one Lesson."*