

REVIEW OF
*ECONOMICS IN TWO LESSONS – WHY
MARKETS WORK SO WELL, AND WHY
THEY CAN FAIL SO BADLY* by John
Quiggin (2019, Princeton University Press)¹

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From WikipediA we learn that John Quiggin — born March 29, 1956 — is an Australian economist, a Professor at the University of Queensland, who was formerly an Australian Research Council Laureate Fellow and Federation Fellow and a Member of the Board of the Climate Change Authority of the Australian Government.

Quiggin also runs a blog producing “commentary on Australian and world events from a socialist and democratic viewpoint.” The fact that Quiggin is a self-avowed socialist can help in understanding and identifying some of the ideological biases, repeated erroneous interpretations and blind spots in his narrative. This being said, and despite these defects, the book is a tour de force and quite informative even for readers of a different ideological bent.

John Quiggin is dissatisfied with Henry Hazlitt’s great book *Economics in One Lesson* and in the book under review he makes an elaborate attempt to set its author straight. He says of Hazlitt: “His One Lesson contains important truths about the power of markets, but he ignores equally important truths about the limitations of the market.” (p. 4) Learning about these limitations is the second lesson that Quiggin sets out to teach us.

Economics in One Lesson by Henry Hazlitt (1894-1993) is the book that taught American supporters of the free market economics. Hazlitt was a journalist, literary critic, economist, philosopher and

¹ The book has previously been reviewed in Boettke 2019, Gordon 2019, Henderson 2019.

quite simply one of the most brilliant public intellectuals of the twentieth century. He authored several books, but his *Economics in One Lesson* had become his most enduring contribution. He wrote it to expose the popular fallacies of its day. A brilliant and pithy work first published in 1946, at a time of rampant statism at home and abroad, it taught millions the bad consequences of putting government in charge of economic life.

College students across America and the world still use it and learn from it. It may well be the most popular economics text ever written. His lesson is simple but profound: "The art of economics consists of 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." These lessons remain as relevant today as when the book was written.

Economics in One Lesson focused on the idea that sound economics considers not just a public policy's immediate, intended consequences but also its indirect, unintended consequences. Quiggin summarizes Hazlitt's message a little differently, however, as an argument that market prices fully reflect opportunity costs—that is, that the value of goods produced equals the value of the next best alternative use of the resources that went into them, resulting in perfect efficiency in exchange and production. Put simply, this would mean that the best of all possible worlds would be achieved through the market mechanism.

The second lesson, Quiggin tells us, is that markets suffer from external effects, monopoly power, under-provision of public goods, macroeconomic volatility, and inequality. Quiggin's book is well-written, and it sums up as well as any work the economic arguments for activist government. But it would be more convincing if the author were a bit more up to date on what has happened in the discipline since 1980. Quiggin acknowledges the contributions of the Austrian, Chicago, and New Institutional Schools of economics. But he argues, mistakenly, that these have since been theoretically and empirically refuted. Particularly, the book under review, although engaging, well-written and quite informative, exhibits instances of (a) misinterpretation and misunderstanding, (b) bias, and (c) blind spot.

Misinterpretation and misunderstanding

The reason why Quiggin's foray against Hazlitt misses its target should be clear: he tries to interpret Hazlitt from the perspective of neoclassical economics and applies several economic concepts, in particular the key concept of "opportunity cost" as they are used in neoclassical economics, taking as his benchmark a state of neoclassical equilibrium or something close to it. Hazlitt was an Austrian, however, who did not claim that markets are perfect. He discussed a series of real-world cases illustrating that interfering with the market often has bad consequences.

Quiggin's adherence to the neoclassical model and his failed attempt to apply it to his critique of Hazlitt's book is also clearly obvious where he interprets Hazlitt's book through the lens of the so-called Two Fundamental Theorems of Welfare Economics. With respect to the first of these theorems he writes:

"(T)he core of Lesson One is that, in a perfect competitive equilibrium, prices exactly match opportunity cost. There are no "free lunches" left. Any additional benefit that can be generated for anyone in the economy must be matched by an equal or greater opportunity cost. This opportunity cost may be borne by those who benefit from the change or by others."

For One Lesson economists like Hazlitt, that is all we need to know. On their reading of Lesson One, it tells us that once we are at a competitive equilibrium, it is impossible to improve on the outcome. In the technical jargon of economics, the competitive outcome is "Pareto-optimal," after the Italian economist Vilfredo Pareto, who first proposed this idea. In a more grandiose piece of jargon, this theoretical finding is referred to as the First Fundamental Theorem of Welfare Economics." As Prof. Huerta de Soto has repeatedly pointed out, however, neoclassical "welfare economics", resting upon the chimerical Paretian notion of efficiency, becomes irrelevant and useless, since its operative management requires a static environment of complete information, and such an environment never exists in the real world. Hence, more than on Paretian criteria, efficiency depends on and should be defined

in terms of the capacity of entrepreneurship to spontaneously coordinate the maladjustments which arise in situations of disequilibrium. (Huerta de Soto 2010)

Quiggin's strategy against Hazlitt is to argue that there are many cases where the neoclassical model fails to apply. In these cases, the opportunity cost to individuals deviates from the opportunity cost to society and government intervention can provide at least part of the solution. He writes:

"One problem with this argument is that the conditions it requires are never satisfied in practice. They would be even further from reality if it weren't for extensive government action to reduce unemployment, restrict monopoly power, and bring prices closer to opportunity costs (...)."

This means that Quiggin, in following mainstream welfare economics, comes close to committing the so-called "nirvana fallacy" which means that welfare economics draws its conclusions from a comparison of the working properties of real markets with idealized criteria. Then, confronted with the inefficiencies of reality compared to the idealized model, the market failure approach proceeds to suggest alternative measures which consist in real government interventions which are *assumed* to eliminate the inefficiencies. Thus, welfare economics runs the danger of becoming a "nirvana approach". (Demsetz 1969; Van Den Hauwe 1999)

Quiggin also misunderstands a point concerning the legal-theoretic and ethical foundation of One-Lesson Economics. He writes: "Hazlitt doesn't spell out the starting point for his analysis. However, his analysis is based on the implicit claim (spelled out in more detail by Bastiat) that there is a natural distribution of private property rights, and that this natural distribution exists prior to any government activity such as taxation and the payment of welfare benefits. This is nonsense. It is impossible to disentangle some subset of property rights and entitlements from the social and economic framework in which they are created and enforced." (p. 138) This is not quite correct. Hazlitt was a rule-utilitarian who did not accept natural rights. (Hazlitt 1964) For him, it is essential to a free and prosperous economy that people have stable legal rights to

property, but he does not exactly adhere to the idea Quiggin attributes to him.

Utilitarianism as conceived by Hazlitt, but also by Ludwig von Mises and later by Leland Yeager, is a doctrine whose test of ethical precepts, character traits, legal and economic systems, and other institutions, practices, and policies is conduciveness to the success of individuals as they strive to make good lives for themselves in their own diverse ways. Its fundamental value judgment is approval of happiness and disapproval of misery. As Leland Yeager was never tired of pointing out, one means to satisfying it is so pervasively requisite that it becomes almost a surrogate criterion. It is social cooperation, which means a well-functioning society — the whole complex of institutions, practices, and precepts whereby people can interact peacefully and to mutual advantage. Institutions, precepts, and traits of personal character are to be valued or deplored according as they tend to support or subvert social cooperation. Any genuinely appealing ethical system must be utilitarian in this broad sense. Social cooperation flourishes through institutions, rules, and practices that improve people's chances of predicting each other's behavior and coordinating their activities. Voluntary cooperation accords better than coercion with each person's having projects, purposes, and ideals of his own and with his having only one life to live. Emphasis on voluntary cooperation warns against imposing unfair sacrifices on individuals for the supposed greater good of a greater number. (Yeager 2001)

Bias

There is a critical imbalance between the ways in which Quiggin treats the phenomena of market failure on the one hand and those of government failure on the other. Quiggin is quick to notice the imperfections of free markets, but he says very little about the imperfections of government. Although he admits that the central lesson of *Two Lesson economics* is to examine both sides—market failures and government failures—he doesn't really follow through on this. Quiggin mentions but does not really engage with public choice, which applies the theories and methods of economics to

politics. Although the index mentions Tullock's 1967 paper "The Welfare Costs of Tariffs, Monopolies, and Theft" no reference is provided to the seminal *The Calculus of Consent* authored by Buchanan and Tullock, which confronted the market failure presumption of the new welfare economics by demonstrating that the problems associated with markets were ubiquitous, indeed entered the calculus of political consent arguably with far greater significance because of the indivisibility of collective action. The market failure concepts were applied evenhandedly to the alternative institutional arrangements, especially those of political control, and for the first time, various policy arguments could benefit from a consistent and balanced approach. (Van Den Hauwe 1999) Not so in Quiggin's *Economics in Two Lessons*, however.

Quiggin identifies climate change as a particularly critical issue which he believes the market is impotent to address. Since no one owns the climate, prices cannot communicate important information about how much of an effect an economic endeavor is having.

Without prices, economic actors cannot coordinate their plans in a way that incorporates information on climate change and then adapt and adjust accordingly. But here again Quiggin largely misses the point.

With respect to climate change he points out that his opponents, when their arguments fail, tend to retreat to denial of certain climate science claims but he himself does not come to grips with the fact that much of climate science is indeed still unsettled as has been brought to our attention recently by Koonin's *Unsettled* (2021). Nor does he engage with the position taken by such economists as Thomas Schelling and William Nordhaus. They instead have looked at the adjustments and adaptations that occur because of climate change, both in terms of relative price changes that direct economic activity toward more efficient utilization of scarce resources and in terms of technological innovations that are both less costly and more ecologically friendly. They've also explored the dysfunctions that can follow when government decision making isn't checked by the discipline of the market—for example, the environmental degradation that afflicts many publicly managed common-pool resources. A fortiori he does not mention or engage

with the contribution and arguments of consistent free-market economists in this field such as Walter Block. (Block 1990; 1998)

For these and other reasons, and as previous reviewers of the book have also pointed out, Quiggin's book has shown by omission that his case, to be made complete and convincing, is in urgent need of a third lesson in economics: on why government works so badly even when it intervenes in cases where markets work badly.

Blind spots

Arguably the two most important contributions of twentieth-century Austrian economics are those for which Hayek received the Nobel Memorial Prize in Economic Sciences in 1974: the exploration of the problems of central economic planning and the explanation of the business cycle, the latter being a particular application of the main idea underlying the former and both finding their origin in the work of Ludwig von Mises. Hayek's involvement in the Socialist Calculation Debate finally led to the publication of one of his finest papers, *The Use of Knowledge in Society*, published in 1945 in *The American Economic Review*.

Quiggin implicitly at least partially acknowledges this contribution since he quotes at length from Hayek's classic article. (p. 59-61) He pursues, however: "This is an excellent statement of the crucial idea behind One Lesson economics, showing how market prices signal opportunity costs. But Hayek stops his analysis there. Although he says, "The price system is just one of those formations which man has learned to use after he had stumbled upon it without understanding it," Hayek shows little interest in exploring alternative ways in which human societies manage the problems and opportunities associated with information." This evaluation is questionable, and it is rather Quiggin himself who shows little interest in exploring the far-reaching implications and ramifications of Hayek's information-theoretic insights, for all kinds and forms of government planning and intervention, including in the domain of macro-economic policy. Again, Quiggin does not seem to appreciate the fact that Hayek's information-theoretic insights

were to an important extent a corollary of his work on the problems and the impossibility of socialism and, by implication, of all kinds of state interventionism and government action.

At least from an Austrian perspective the book certainly needs some updating in the field of macroeconomic theory and policy. Quiggin's knowledge of Austrian business cycle theory is largely lacking. He tells us that "Hayek was not particularly notable among the critics of *The General Theory*. The supposed Hayek-Keynes contest really reflects Hayek's latter-day reputation as the prophet of market liberalism and the 'Austrian school' of economics." (p. 36, note 5) Quiggin is correct that Hayek, to his later regret, did not write a response at the time to *The General Theory*, but there was indeed a contest between the two economists. Hayek wrote a devastating critical review of Keynes's *A Treatise on Money*, and Keynes criticized Hayek's view of the business cycle and encouraged Piero Sraffa to do so as well.

One of the weakest parts of the book is thus undoubtedly Quiggin's treatment of macroeconomic policy. Even if one could understand Quiggin's under-appreciation or even ignorance of Austrian macroeconomics — which even at this time remains a heterodox and somewhat marginalized approach in the global macroeconomic landscape — one would expect him to be at least familiar with the important work by Milton Friedman and Anna Schwartz on how the Federal Reserve's monetary policy helped cause the Great Depression. He completely misses Federal Reserve monetary policy as a cause of the Great Depression and writes that One Lesson economics "produced the Great Depression." In the same context, he claims that expansionary monetary policy at the start of last decade's financial crisis "proved unable to stimulate a return to normal economic conditions." But he does not acknowledge the fact that the Fed sterilized, by selling assets, much of its monetary injection and, in October 2008, chose to pay interest on bank reserves, thus giving banks an incentive not to lend to the public. In other words, monetary policy was not expansionary during that time.

Other blind spots are manifest from the book; we learn little or nothing about law and economics (which applies economics to the analysis of law); property rights economics (the study of property

as an underlying economic institution); and market-process economics (which sees the market order as being fundamentally about exchange and the institutions within which exchange takes place). Once these ideas are considered, however, the sort of market failure theory that Quiggin claims as the second lesson of economics turns out to be more complicated than he makes clear to his readers.

His analysis of the monopoly issue is misleading or at least incomplete. In many parts of the book, he criticizes monopoly but he doesn't mention unions as an important government-enforced monopoly; he provides a distorted treatment of the effects of trusts that became prominent in late 19th century America by not mentioning the 1985 article in the *International Review of Law and Economics*, in which Loyola University Maryland economist Thomas DiLorenzo found that between 1880 and 1890, when real GDP rose by 24%, real output in the seven trusts for which data were available rose on average by 175%. In six of the seven trusts for which he had data, inflation-adjusted prices fell dramatically.

Because monopolists tend to restrict output and charge high prices, both the output and the price data are strong evidence against the idea that the trusts were monopolistic.

In conclusion we remind that Hazlitt understood that a market is never perfect, nor is it in equilibrium. The price system guides individuals to discover mutual gains from trade, prodding them to find the most valuable uses for scarce resources and thus moving the whole system into more efficient resource allocation. Markets are always in a process of becoming, and that process is where the constant adaptation and adjustments that coordinate economic activities over time can be seen. Hayek called this complex coordination through the market a marvel.

Since Hazlitt wrote more scholars have recognized that human beings are imperfect and that we interact with each other in an imperfect world mediated by imperfect institutions. In the words of Peter Boettke, we must deal with bumbling bureaucrats as well as erring entrepreneurs. That requires institutions that provide feedback and stimulation—that direct and redirect our efforts, so we can act less erroneously than previously. As Boettke reminds, the second lesson of economics isn't really that markets fail; it's that institutions matter. Institutions matter because they structure

the incentives that economic decision makers face, and because they transmit the information that actors must process to negotiate the environments they find themselves interacting within. It is institutions that determine how we pursue productive specialization and whether we will be able to realize peaceful social cooperation through mutually beneficial exchange. The second lesson thus leads naturally to the third lesson of economics: that it requires a comparative institutional analysis of market and nonmarket decision making. Quiggin's book, that sees solutions only through the concerted effort of governmental authority, misses some of the important lessons provided not only by Hazlitt but also by Hayek, Huerta de Soto and others, lessons that constantly have to be learnt and relearnt.

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