

BOOK REVIEWS

Basic Economics: A Citizen's Guide to the Economy

Thomas Sowell

New York: Basic Books, 2004, revised and expanded ed., 438 pp.

Applied Economics: Thinking Beyond Stage One

Thomas Sowell

New York: Basic Books, 2004, 246 pp.

I can think of no better way for a conscientious U.S. voter to start out this election year than by reading one or both of these two remarkable books by Thomas Sowell. Taken alone or together, both volumes succeed admirably—each in its own way—in their intention to provide a broad public audience with clear and cogent guidance on how to apply basic principles of economic logic and analysis to a variety of complex issues, many of which are likely to be discussed during the election campaign and beyond.

Over the years, we have come to expect wisdom, ingenuity, broad knowledge, and creative insight from the writings of the prolific Chicago-trained economist who—capping his long, distinguished career as an academic scholar and public intellectual—is now the Rose and Milton Friedman Senior Fellow on Public Policy at Stanford University's Hoover Institution. A new book by Thomas Sowell is always an important intellectual event, and two coming out around the same time—one of them entirely new and the other a substantially enlarged and updated revision of an earlier edition—is an occasion for celebration.

Sowell's writings, both for the profession and for the public, are invariably articulate, relevant, readable, provocative, and persuasive. These latest offerings are aimed more at providing lay readers with an economic perspective—and with some fundamental, nontechnical tools of analysis—than at breaking new ground on intellectual controversies. But they do not disappoint. They will be valuable for undergraduate economics students as well as the general public and, in my view, an instructive treat even for professional economists—who sometimes need to be reminded

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of how the simple but powerful insights of their profession can be used to clarify complex and confusing public issues.

Each book stands on its own, but they may usefully be considered as complementary or companion volumes. The revised edition of *Basic Economics* is a substantially enhanced and updated version of the first edition published in 2000, aimed at educating the general public and beginning students of economics about fundamental principles through straightforward narrative. *Applied Economics* takes its own unique approach, invoking a recurrent theme—what the author terms “thinking beyond stage one”—in employing some of the same principles to analyze policy actions in terms of their ultimate unintended consequences versus their stated immediate goals.

Basic Economics

Basic Economics could in fact be used as the main textbook in a nontraditional course in economic principles aimed at providing students with an intuitive grasp of key analytical tools and the ability to apply them to public policy issues as members of an informed electorate. Such a course, if taught well, would undoubtedly also serve to lure students into further study of the more traditional economics curriculum. If so, then thanks to this book, they would come to the more advanced classes armed with an ability—rare among economics students—to apply the technical abstractions of economic theory to concrete situations.

Like the first edition, the revised edition starts out with a chapter discussing the subject matter and perspective of economics in terms of scarcity and tradeoffs. This is followed by six main topical sections, each subdivided into a few short chapters and concluding with an “overview” that wraps up the main topic of the section. The structure is essentially unchanged from the previous edition, but the narrative has been updated to include recent events through 2003, and it has been substantially expanded to incorporate more international and historical examples informed by basic economic insights.

As before, the six main parts of the book cover Prices and Markets, Industry and Commerce, Work and Pay, Time and Risk, The National Economy, and The International Economy. The revised edition concludes with a new section, Special Economic Issues—replacing the closing section of the previous edition that dealt with “popular economic fallacies.”

Without ever displaying even so much as a demand curve, Sowell takes the reader on an exhilarating tour of the fundamentals of microeconomics, macroeconomics, financial markets, and international trade, with pointed anecdotes and pertinent examples illustrating every analytical point—each presented in ways that will encourage the reader to think independently about other issues that may be amenable to similar analysis. The tone is conversational, and the author scrupulously avoids technical terms and economic jargon. Wisdom, erudition, and an underlying

rigor permeate every page; this is sophisticated economics, even though the material is presented in plain, everyday English.

Sowell never beats a single topic to death—he makes his points deftly with enlightening anecdotes and examples, and then moves ahead without getting bogged down—thus taking readers through a wide variety of topics. Starting out with the role of prices, readers will encounter, among other things, discussions of incentives, competition, the consequences of price controls, costs as forgone alternatives, tradeoffs and substitutes, taxes, and subsidies. The section on industry and commerce delves into the role of markets in coordinating production and distribution in the face of widely dispersed information, and moves on to profit and loss, specialization, monopoly, antitrust, economic regulation, and a comparison of markets versus central planning. The author presents a concise discussion of the social and economic consequences of minimum wages, and provides valuable insights into questions of income distribution, mobility, and poverty. The section on Time and Risk offers perspectives on financial markets, risk transfer, insurance, and the time value of money—concepts that are crucial to rational individual and business decisions but that seldom get treated adequately in introductory courses or popular expositions of general economics.

Turning to the broader national and international arenas, Sowell analyzes the role and actions of governments in market and nonmarket economies and exposes some persistent fallacies that typically result in damaging policy initiatives. As in the previous sections, Sowell weaves in historical and contemporary examples from diverse corners of the world and widely differing cultures, and points out the common threads of economic principles that tie the examples together. Finally, he breathes life into a discussion of issues facing businesses and individuals as they confront an increasingly integrated world economy—providing a razor-sharp economic perspective on such questions as globalization, free trade, comparative advantage, foreign investment, imperialism, cheap labor, foreign aid, and immigration.

The concluding discussion of “Special Economic Issues” touches on philosophical concerns about values, morality, and greed, and moves on to the more specifically economics-related questions of price discrimination, brand names, and even the politically charged but economically empty “trickle-down” theory. The author concludes the book with some parting thoughts about the role of knowledge and incentives and the uses of economic logic.

In preparing this expanded edition, Sowell has drawn on his impressive breadth and depth of knowledge about economics, politics, and diverse cultures to find compelling illustrations from the real world of every economic principle he discusses—and to show how everything fits together.

Sowell is a great storyteller, with the ability to bring history, sociology, and biography to bear on his economic discussions. This facility, which comes across so clearly in *Basic Economics*, is equally in evidence in his

other new release, *Applied Economics*. In both books, the author shows readers how some simple tools of analysis and the power of economic logic can be used to cut to the heart of political decisions that are too often considered only in the context of the desired benefits.

Applied Economics

What do business tax increases, price controls, minimum wage provisions, layoff restrictions, anti-discrimination laws, denial of property rights, rent controls, land use limitations, pay-as-you-go social insurance, high-cost safety requirements, and third-world debt forgiveness all have in common?

The answer, as revealed through the cogent reasoning and articulate narrative of *Applied Economics*, is that they are examples of what Sowell calls “stage one thinking.” They are the result of political decisions that consider “policies, institutions, or programs in terms of their *hoped-for results*”—in contrast to decisions based on economic thinking that take into account the “*actual characteristics* of the processes set in motion” by a political initiative, irrespective of its goals (*italics in original*).

In matters of public policy, Sowell maintains, most thinking stops at stage one, considering only the avowed purpose and short-term effects of a law or regulation. But the ultimate results of a policy action unfold over a period of years, and often in a manner not contemplated by its proponents. And even when some of the longer-term consequences are foreseen, lawmakers and regulators are likely to apply a very high discount rate to expected future costs. Their goals are short-term, and they do not contemplate being held responsible for any unintended side effects that may occur years down the road.

Getting beyond stage one thinking is the recurrent theme of Sowell’s closely argued *Applied Economics*. Conversational, concrete, rigorous, and always compelling, the book carries the reader swiftly through dozens of accounts of the unfortunate effects of a short-term perspective, and the author demonstrates—by precept and example—how the informed citizen can learn to think beyond stage one about virtually any issue that might arise in current policy debates or even personal decisions.

Sowell observes that political decisions are “categorical,” whereas economic decisions are “incremental.” In the political arena, the decision boils down to whether to vote for a candidate or pass a law or impose a regulation. But the economic way of thinking looks at trade-offs—how much of what kind of items to purchase, and at what sacrifice in terms of lost opportunities.

The author contends that the unintended consequences of political decisions would often have been foreseeable from the outset if the processes set in motion by political authorities looking only at stage one “had been analyzed in terms of the incentives and constraints they created, instead of in terms of the desirability of the goals they proclaimed.” Those

incentives and constraints lead to predictable results, and readers will take away from this book an understanding of how to think about those processes in terms of the logical outcomes in “stage two,” “stage three,” and beyond.

Applied Economics is divided into seven chapters: Politics versus Economics, Free and Unfree Labor, The Economics of Medical Care, The Economics of Housing, Risky Business, The Economics of Discrimination, and The Economic Development of Nations. The earlier chapters provide abundant examples of stage one thinking and the consequences:

- In stage one, a major increase in business taxes may meet its immediate goal of boosting the revenues collected by a city, county, or state government. But not too far down the road, in stage two, companies experiencing higher costs and diminishing profitability will begin to shift existing production to other locations. And in stage three, many companies already affected by the tax and others that might be looking for a plant or office site will choose to locate their facilities elsewhere.
- In 2001–02, California state officials decided to control retail electricity prices—but not the rising costs of providing generation, transmission, and distribution services, which would have been difficult if not impossible to contain. Residential customers were happy in stage one to see their electricity rates per kilowatt-hour remain flat. But in stage two, as supply was constrained while demand continued unabated, blackouts were the inevitable result. The ultimate resolution, in stage three, saw Californians paying more for their electricity in the form of bigger utility bills, higher taxes, and reduced government services in other areas.
- In stage one, government raises the minimum wage, and entry-level workers get a pay increase. In stage two, fewer marginal workers are hired as employers stretch the existing staff to work harder and longer. Further down the road in stage three, the companies restructure their operations and invest in labor-saving equipment, substituting capital—now relatively cheaper—for the more expensive labor. As Sowell suggests, the effects on individuals and society are potentially devastating, as fewer young workers and other new entrants to the labor force find opportunities to learn the skills, discipline, and work habits that could carry them to future prosperity. The author points out that if you are an entry-level worker, you are thinking beyond stage one when you take a low-wage job hoping to acquire the traits and knowledge that could take you to new heights in stages two and three and beyond. Minimum wage laws cut off the bottom rung of the job ladder and severely curtail such opportunities.

And so it goes—throughout the book, Sowell provides example after example of stage one thinking and its effects. He observes that job

security laws—which in stage one successfully restrict employers’ ability to lay off workers—also foreclose any creation of new jobs as companies work the existing labor force overtime and eventually relocate plants and shift jobs elsewhere. Elsewhere in the book, the author considers civil litigation, noting that uncapped punitive damage awards in some states lead to skyrocketing medical malpractice insurance premiums, reliance on unwarranted and costly “defensive medicine” procedures, and ultimately a dearth of physicians willing to work in vulnerable fields such as obstetrics. Sowell never runs out of such anecdotes and illustrations, and at some point the reader catches on to the point that “thinking beyond stage one” probably applies to every decision in public and private life.

The final two chapters—*The Economics of Discrimination* and *The Economic Development of Nations*—occasionally move the discussion into territory that takes the reader well beyond economics. Still, the basic premises of economic logic hold up quite well. Consider anti-discrimination laws that essentially require employers to hire workers from racial or ethnic groups in proportions reflecting the demographic composition of the local community. The risk of job discrimination lawsuits may cause employers in stage one to hire and promote by the numbers, regardless of merit. But down the road, such practices are likely to reduce productivity and increase costs, and the threat of constant litigation makes it riskier to locate factories in minority areas. Work is shifted elsewhere, plants in the community close down, and new ones never materialize. Well-meaning laws may end up hurting the very people they were intended to help.

This obviously is not the only possible outcome, but it is one that is usually overlooked when proponents state the case for such legislation. “Those who do not think beyond stage one may assume that, whatever the level of discrimination, anti-discrimination laws reduce it,” Sowell writes. “Yet the incentives and constraints created by such laws can either increase or reduce the employment or other opportunities of minority groups, on net balance.” Although there may be honest differences of opinion, the author tellingly points out that, “The question itself does not arise until we look beyond stage one.”

Sowell makes a somewhat different use of his theme in the final chapter, *The Economic Development of Nations*. Discussing the importance of well-defined and legally enforced property rights in developing nations, he notes that such notions do not resonate well with those who fail to think beyond stage one and believe that property rights benefit only the people fortunate enough to own property. But as he points out, property rights are in fact “a key link in a chain of events that enable people without property to generate wealth for themselves and the whole society.” Sowell elegantly develops the idea that beyond stage one, property rights foster “the ability of people to convert physical assets into financial assets, which in turn enables them to create additional wealth, whether individually or in combination with others.”

The book closes a bit too abruptly, in my estimation, with an

exploration of such economic development themes as geography, population, and exploitation theories. The discussions are interesting and persuasive and certainly in keeping with the subject matter of the final chapter, but they do seem to be somewhat off the main point of “thinking beyond stage one.” If the author is ever moved to issue a “revised and expanded edition” of *Applied Economics*, he might want to consider connecting that unifying theme more explicitly to these final sections and perhaps appending a new concluding chapter that would restate and reinforce the main thesis and tie everything together.

One reason this book is so compelling is that its lessons are as applicable to personal decisions as they are to public policy. *Applied Economics* is also in the finest tradition of the writings of Frederic Bastiat, the perceptive and eloquent 19th century French economist, economic journalist, politician, humorist, and satirist (and this reviewer’s namesake). Bastiat’s last pamphlet, a classic essay completed shortly before his death in 1850, contrasted “what is seen and what is not seen” and pointed out the disastrous results of ignoring the unseen processes set in motion by political decisions. Sowell provides an inspired contemporary expansion of the enduring theme of Bastiat’s seminal essay.

John Maynard Keynes once characterized economic theory as “a method rather than a doctrine, an apparatus of the mind, a technique of thinking which helps its possessor to draw correct conclusions.” Economics, he insisted, “is a branch of logic, a way of thinking,” adding that he also wanted “to emphasize strongly the point about economics being a moral science.” In all of those aspects, both of these books—*Basic Economics* and *Applied Economics*—breathe new life into that enlightened vision of the purpose and power of economic analysis, in a manner that communicates their message elegantly and persuasively to the general reader.

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