

## Opportunity Cost and the “Broken Window” Fallacy

by William F. Shughart II

In a pamphlet published in July 1850, the last he ever wrote, Frederic Bastiat defined a bad economist as one who sees only the immediate or visible effects produced by an act, a habit, an institution or a law. A good economist, by contrast, is able to deduce the effects arising from the same cause that are not evident immediately, but appear later or after deeper thought.

The pamphlet, titled “What Is Seen and What Is Not Seen”, tells the tale of Jacques Bonhomme, a French Everyman, whose delinquent or merely careless son is caught red-handed breaking a shop window. Whose window it happens to be does not matter, but imagine it to be that of a local baker. Seeing the boy surrounded by shattered glass on the sidewalk, passersby (and bad economists) are in unanimous agreement: “It’s an ill wind that blows [the baker] no good. [But] such accidents keep industry going. Everybody has to make a living. What would become of glaziers if no one ever broke a window?”

Does this story sound a bit familiar? In Hurricane Katrina’s wake, even the respectable and normally sensible *Wall Street Journal* expressed considerable remorse over the loss of lives and damage to property on the Gulf Coast, but then went on to gush about the economic boom that is sure to follow. Think of the thousands of jobs for construction workers, the hundreds of millions of dollars worth of materials needed to rebuild all of the roads, bridges, office buildings and residential neighborhoods leveled by the storm, not to mention the money that will pour in to finance new land-based casinos for Mississippi and a new levee system for New Orleans. One hears the same thing after every major natural disaster. Too bad it happened, but dark clouds do have silver linings.

Now return to the baker’s broken window. Forgetting the French analogy for the moment, suppose that replacing it costs \$100. A glazier is called to do his job, is paid \$100, and goes home offering a silent prayer for juvenile delinquents. That is what the passersby see, and that is what leads them erroneously to conclude that, because a job has been “created”, breaking the window was not such a bad thing after all.

What the passersby (and the bad economist) fail to see is that \$100 has been deducted from the baker’s bank account. Because he has been forced to spend \$100 to replace his broken window, he will not be able to spend that sum on anything else. Perhaps the baker will not now be able to replace his worn-out apron, to buy extra flour so he can bake more bread, or to pay a promised bonus to one of his employees. The glazier is better off, but the baker (or, depending on the circumstances, the apron manufacturer, the miller, or the employee) is equally worse off. Before Jacques Bonhomme’s thoughtless son appeared on the scene, the baker had both \$100 in the bank and a serviceable window; afterwards he has only a window.

Bastiat’s story, in short, is about opportunity cost. In the economic way of thinking, cost is not measured in terms of money spent, but is instead determined by the value of the next best alternative – the worth of what must be given up when one option is selected over another. The concept of opportunity cost teaches that there is no benefit to society in general when property is

destroyed, whether by young hooligans or by Mother Nature. Spending necessary to replace existing assets cannot be used to create new ones. Before Hurricane Katrina struck, the nation had \$200 billion and a habitable Gulf Coast; afterwards, it no longer has “whatever it takes” to recover.

People who successfully build and protect their wealth have grasped Bastiat’s lesson. The rate of return to any particular investment is meaningless if considered in isolation. What income is being sacrificed in the process? What financial goals are being neglected? The most important advice one can take from a good economist is to evaluate and regularly monitor every element of a financial portfolio, keeping in mind the inevitable tradeoffs between risk and return. When was the last time your life insurance agent asked how much you earn? When was the last time your stockbroker asked about the balance in your 401(k) plan or tax-sheltered annuity? If you don’t follow a holistic investment strategy, your financial house may end up with some broken windows.

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