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POLITICAL ECONOMY 250
ECONOMIC LIBERALISM AND ITS CRITICS
Fall 2014

This course explores the relationship between politics and economics by surveying influential works of political economy. Its first part examines major systems of thought in relation to the historical development of capitalism in Britain and the United States, from the classical liberalism of Adam Smith to the works of John Maynard Keynes. The second part considers more recent writings, with more of a focus on policy issues and the USA. The historical nature of the course permits you to appreciate the ongoing dialogue between classical and contemporary views of political economy.

The Political Economy major at Williams aims to prepare students for active engagement in public life. This course has two purposes in relation to the major: first, to expose you to the intellectual roots of the political-economic theories you will encounter in your senior courses; and second, to provide a space for you to reflect about the ethical issues that arise whenever one seeks not only to analyze public policy, but to make it.

This syllabus is the single most important document for the course. It has been annotated with some information about the authors and the themes of their work, in order to contextualize your reading and leave more class time for discussion of ideas. It also includes discussion questions, and occasionally “check your understanding” questions. The discussion questions are meant to alert you to some of the most important issues raised by the readings, and to provide topics for essays. “Check your understanding” questions are meant to solidify your understanding of basic conceptual, factual, or technical material that can be an obstacle to understanding unless you grapple with it. Both types of questions will also help orient our discussions in class, so be ready to address them.

REQUIREMENTS AND GRADING

1. 12 short essays. The best 8 essays account for 50 percent of your grade.

This course requires the discussion and thoughtful analysis of many outstanding works of political economy--asking you to understand them on their own terms, to relate them to one another, and to consider their current relevance. The large number of written assignments reflects this priority: twelve short essays commenting on the readings assigned for the day the essay is due. Of the twelve short essays, only the best eight count, together for 50 percent of your grade. Papers are due at the start of class. The class will divide into two groups, with one group turning in its papers on Mondays and the other on Thursdays. For each paper, you must submit a printed version in class and also an electronic version in a format compatible with MS Word through the Glow web site for the class (a separate handout explains how). Each essay written for this class is subject to a *strict* word limit of 650 words (this applies to the text of your essay, not counting the title page, citations, or references). We will stop reading at the 650th word. You must provide a word count at the end of your essay (any Word processing program can produce this). The rationale for this strict word limit is threefold: (1) allowing students to write longer essays than their classmates would make it difficult to grade the essays fairly; (2) learning to express your thoughts concisely is an extremely valuable skill; (3) having a substantial number of students write an essay on the day's reading for each and every class, and our ability to carefully read and comment on each of your essays, are critical to promoting informative discussion, engagement, and learning in this class -- but this is only possible for you and for us if you keep the essays short.

Most good essays address one of the “discussion questions” posed for that class on the syllabus below. (There are also some “check your understanding” questions for some classes – those are not intended to be essay topics, but you should be prepared to answer these questions in class, and figuring out the answers to these will help you write a better essay.) What makes a good short essay on material like this? The best ones have several things in common. A good essay should explicate what an author is saying in a certain passage, consider its logical and

practical implications, and make some kind of critical commentary (about assumptions, or logic, consistency or inconsistency with evidence, or implications). It should go beyond just summarizing, and should offer some of your own insight and value-added. In doing so, it should show an understanding of the author's position that is informed by the whole reading assignment and not just a few pages. A good approach is often to focus on answering a single discussion question. Don't try to answer multiple discussion questions in one essay, as it is impossible to do a good job of that in just 650 words. Your paper should say clearly up front what thesis you intend to argue for. Acknowledging and responding to the strongest counter-arguments and counter-evidence to your position makes for a better paper. Also, don't shy away from the challenging but important concepts. Students who tackle a higher degree of difficulty successfully will be rewarded in the grading. There is a natural and understandable tendency to want to navigate around the more challenging, technical, or non-obvious insights and arguments in the readings, and to instead take the path of least resistance. But we notice that and adjust for that in our grading. In our evaluation of papers, a good, accurate, and accessible explanation of a challenging insight or argument counts very positively, while superficial mentions of lots of conclusions, without presenting the logic or evidence that led to those conclusions, counts negatively. If you use technical jargon (e.g., "economic efficiency"), explain what it means. This demonstrates that you understand what you are talking about, and makes your writing clearer. Do not make strong empirical claims without backing them up with some empirical evidence. If you include empirical evidence, it is much better to briefly explain the nature of the evidence and why we should be convinced by it than to just appeal to authority. Think critically about evidence. For instance, how do we know the correlation you are describing is not caused by some other explanation than the one you are emphasizing?

We do not allow students assigned to write on Mondays to submit essays on Thursdays, or vice versa. If we let one person do this, everybody would want to do it -- at the end of the semester. Although the paper submission schedule is unusual, there is a good justification for it in terms of the goals of the class: to prompt a good number of people to turn in papers every day, so that each will be able to take a more active role in discussion. And we only count the best eight out of twelve papers to deal with situations where you have some legitimate excuse for not writing a paper some particular week. This will happen to everyone, on average, over a twelve-week period. If for some reason you can't write a paper one particular week, you do not need to let us know, since we expect that students will typically skip one or more of the twelve opportunities. If you submit a paper late, the paper will be penalized one full letter grade (e.g., A- changes to B-) for each day or portion of a day that the paper is late; one rationale for this is that handing in a paper after you've heard the class discussion on a topic provides an unfair advantage, and the penalty corrects for this.

2. Class attendance and participation account for 20 percent of your grade.

On class participation, the quality and succinctness of your interventions are most important. Think before you speak and avoid repeating yourself. The course works best with discussions that are informed, vigorous, civil, and widely shared. You should come to class prepared to answer the "check your understanding" and "discussion" questions listed on the syllabus below. Attendance, voluntary contributions to class discussion, and answers to questions we pose to you when we call on you in class will all be taken into account in computing the class participation grade.

3. A final exam accounts for 30 percent of your grade.

The final exam will be in-class, closed book, and will be scheduled by the Registrar during the normal final exam period. It will include a series of short-answer questions and integrative essay questions on readings selected from throughout the semester. We will provide more information on the final exam on the last day of class.

READINGS

The following required books can be found at Water Street Books:

Milton Friedman, *Capitalism and Freedom*;
Friedrich Hayek, *The Road to Serfdom*, Bruce Caldwell, ed. (Univ. of Chicago Press);
Albert Hirschman, *Exit, Voice and Loyalty*;
Paul Krugman, *End This Depression Now!*;
Arthur Okun, *Equality and Efficiency: The Big Tradeoff*;
Adam Smith, *The Wealth of Nations* (Glasgow edition, Liberty Press), and
Richard Thaler and Cass Sunstein, *Nudge* (revised and expanded edition).

The other readings are in printed reading packets and are also available as PDFs on the course Glow web site. The first printed course reading packet, covering readings through Keynes, is available now in the reading packet room, which is now located in the Class of '37 House, 51 Park Street, across from Paresky, and is open 8:00am – 3:00pm Monday through Friday year-round. Packets with readings from later in the semester will be made up after the enrollment is settled.

HONOR CODE

Observe the Honor Code guidelines for independent work (which can be found in the *Student Handbook* at <http://web.williams.edu/admin/registrar/handbook/policies.html#Academic>). Enclose direct quotations within quote marks and cite sources for these and for paraphrases. For purposes of this class, we ask that you put citations in footnotes. For course readings, short citations in a footnote, (e.g., Smith WN, 567) are fine; any outside sources (not encouraged) should include full reference information in a footnote. Citations in footnotes do not count against your 650 word limit (in Word, when you do your word count, you can uncheck the box for “Include textboxes, footnotes, and endnotes.”)

DIVISION OF LABOR

Starting with the second class, professors Bakija and Mahon will each lead half of the class meetings, and each professor will grade and comment on the essays written for the classes he leads. Each professor will lead an equal number of Monday and Thursday classes over the course of the semester. With rare exceptions, we will both be present at each class meeting, and the professor who is not leading the class that day will be there to contribute occasional questions or comments and to keep track of students' class participation.

GLOW COURSE WEB SITE

You can find the class web site in the new version of Glow <<https://glow2.williams.edu>>. You will submit your weekly essays electronically through the class Glow page (in addition to submitting printed versions in class), and you can also access PDF copies of all course readings aside from those in the books for sale at the bookstore.

SCHEDULE

(* denotes a reading from the packet)

Thu 9/4 Introduction and Organization

I. CLASSICAL THEORIES OF POLITICAL ECONOMY

A. Free-Market Liberalism: Adam Smith

Mon 9/8 Adam Smith: Principles of a Free Market Economy

- *The Wealth of Nations* (henceforth *WN*), Introduction through [referring to book.chap.sec.] I.iii.,8; I.iv.1-5, 11-18; I.v.1-10; vi, 1-10, 18-24; vii, 1-32 (pp.--text *not* general introduction--10-36; 37-39; 44-46; 47-51; 65-68, 69-80). [Here is some guidance on interpreting section and page references above. The references that are *not* in parentheses give you the book number, chapter number, and section number following Adam Smith's original numbering scheme. That's what you're required to read. The page numbers listed in parentheses at the end are particular to the specific edition that is available in the bookstore, and can be found in the upper right-hand corners of the pages of that edition. We provide the page numbers to make it easier for you to find what you are looking for. So for example, the part of the assignment above that says "I.iv.1-5" means you should read Book I, Chapter iv, sections 1-5. That starts on p. 37 of the text (not of the "General Introduction"), and ends in the middle of p. 39. You do not have to read all of page 39, just the part of p. 39 through the end of section 5.]

Adam Smith saw a direct link between the division of labor and human civilization. He considered this idea so important that he placed it first: the famous example of the pin factory is no digression but rather an illustration of what Smith considered fundamental to all that followed. The discussion goes on to relate the division of labor to market size and to money. Smith then turns to price determination in chaps. v.-vii. (which we will discuss also next time). There he employs what was in his time a fairly common scheme describing three great classes in society--those who earn their living from wages, those who live by profits, and those who receive rent. These definitions, based entirely on roles in production rather than on income levels (not to mention "lifestyles"), appear later in Ricardo and Marx. Smith assumed his readers were familiar with the typical economic structure of the English countryside, where laborers earning day-wages worked for farmers, who ran the enterprise in pursuit of profit and paid rent to landlords (who then of course spent most of it). Note: "corn" follows British usage to mean "grain;" "police" corresponds roughly to our "policy." "Stock" is just invested capital. "Corporations" are guilds.

Discussion questions:

1. Why is it, according to Smith, that some nations are rich while others are poor (i.)?
2. Do people really have a natural "propensity to truck, barter, and exchange one thing for another" (25)? How would Smith's argument differ if he had begun from Hobbesian premises—say, with a "propensity to steal"?
3. Compare the division of labor in Chapter I (the pin factory) with the examples given in Chapter II. Are they the same? In which are people working harder? In which are people more autonomous?
4. For Smith, how should we properly regard profit? How does he distinguish it from rent—economically and (it seems) ethically (vi.)?
5. What is the difference between "absolute demand" and "effectual demand" (73)? How do Smith's definitions compare with those of modern economics? Why is the distinction important?

Thu 9/11 Adam Smith: Prices, the Distribution of Income, and Economic Growth

- *WN* I.vii. 33-37; I.viii.1-33, 36-48; I.ix.1-4, 11-24; I.x.a., I.x.b.1-34; I.x.c.1-32, 60-63; I.xi.a.1-9; I.xi.p.1-10; II. Introduction.1-6 (pp. 80-81, 82-93, 96-102; 105-06; 109-15; 116-28; 135-46;157-59; 160-62; 264-67; 276-78).
- Mankiw, N. Gregory. 2008. "Chapter 18: The Markets for the Factors of Production" from *Principles of Microeconomics*, 6th edition. Mason, OH: South-Western Cengage Learning.*
- [OPTIONAL FURTHER READING; AVAILABLE ONLY ON GLOW] Robert C. Allen, *The British Industrial Revolution in Historical Perspective* (Cambridge University Press, 2009), pp. 33-42.

The readings for this class focus on Adam Smith's views of the determinants of prices, income distribution, and economic growth. Here you can find some of his most trenchant critiques of the guild system along with a view of markets that places labor (and the laborer) front and center. You'll also find a great deal of attention to politics.

The reading by Mankiw reviews what you should have learned about the supply and demand for labor and the determinants of labor productivity and wages in your introductory economics classes. It can be very helpful for making sense of Smith's arguments and how they all fit together.

Guide to jargon: In Chapters x.a.2 and x.c, the "policy of Europe" refers to the mercantile system (which involved national economic strategy and had an important role for guild regulations). Also, when Smith uses the term "stock," it is equivalent to what economists today refer to as "physical capital" (that is, productive machinery, tools, buildings, factories, etc.) and "working capital" (that is, funds a business has on hand to cover expenses such as wages between the time when things are produced and the time when those things are sold). The wealth of a nation is essentially the value of its capital stock – as Smith says in I.viii.21, "the increase of revenue and stock is the increase of national wealth." Finally, Smith talks of "dear years" and "cheap years." By "dear years" he means years when the price of food is high (for example due to drought), and by "cheap years" he means years when the price of food is low.

Check your understanding:

1. If the supply of labor increases, but the supplies of land and capital stay fixed, what happens to wages? Why?

Discussion questions:

1. Smith argues that the *level* of wages in a country will only rise above subsistence level if the *rate* of economic growth is continuously high. What are his arguments and evidence for this? What roles do fertility, mortality, and population growth play in his argument? Can you make sense of Smith's rather complex argument regarding these issues in terms of our modern economic understanding of the determinants of wages, as explained by Mankiw?
2. Smith contrasts living standards of typical people in the Britain and China of his day. (Note that Smith's impressions about relative economic conditions in Britain and China in the late 1700s stand up rather well when modern economic historians scrutinize the best available historical data, as suggested in the optional reading by Allen on Glow). Smith attributes the differences in living standards in Britain and China to Britain's newly emerging economic growth, and China's economic stagnation. Considering the full range of readings from today and from the previous class, what do you think Smith would say was causing the divergence in economic growth between Britain and China? Do you think he offers a compelling diagnosis?
3. In chapter x., Smith discusses the sources of inequality among wage laborers. What are the real sources of these differences, according to Smith? Do they suffice to explain wage differences today—say, between an NBA star and a housepainter? Thinking about this in the framework of the supply and demand for different types of labor, is Smith leaving out any important determinants of differences in wages between occupations?
4. On pp. 73, 79 and 116, Smith refers to a situation of "perfect liberty." What does he mean by this term? Do you think he would favor modern labor unions?
5. In your opinion, is Smith right about his assessment (I.xi.p.1-10, pp. 264-67) of the degree of confluence between the particular interests of each of the three fundamental social groups (those who receive rent, profits, or wages, respectively) and the general interest?
6. Considering the day's reading as a whole, what kinds of income inequality do you think Smith would view as ethically justified, and what kinds of income inequality would he object to? Why?

Mon 9/15 Adam Smith: Progress and Policy

- WN III.iv.1-7, 10-18; IV.ii.1-15, 23-45; IV.ix.48-52; V.i.b.1-8, 14-20, 25; V.i.c.1-2; V.i.d.1-8, 18-19; V.i.f.1-17, 14-16, 47-61; V.ii.b.1-6 (pp. 411-15; 418-22; 452-59, 463-72; 686-88; 708-13, 716-20; 722-26, 730-31; 758-60, 763-64; 781-88; 825-27).

Here is Smith on how good government can result from the spread of markets—and how, in turn, government can foster market expansion and national wealth. In both cases he uses an argument that forms the bedrock of liberal optimism—that freedom has non-obvious, usually unintended, but highly beneficial consequences. Book III gives a quick historical sketch of how state power was tamed by capitalism—an account that, in broad terms, was anticipated by Montesquieu and the physiocrats, and has been repeated by many others

since Smith's time. Books IV and V give us some of Smith's best arguments for laissez-faire--and for government. The former begins with the "invisible hand" passage, which occurs at the conclusion his argument about how to maximize national product (pp. 455-57). Because of its importance, both to Smith's purpose (here is a formula that directly involves the wealth of nations) and to liberal optimism generally, the argument deserves close attention. Book V (introduced and summarized at the end of chapter ix, Book IV) is on fiscal policy, but it contains lots of philosophical and sociological asides. Its careful discussion of appropriate revenue sources—especially the four maxims on taxes (825-28)—is still relevant today. Also revealing is Smith's honest statement of his misgivings (V.i.f.) about the same division of labor he praised so highly at the outset. Note: the Law of Settlements (470-71) prohibited workers from moving from one parish to another.

Discussion questions:

1. Consider Smith's tale of the merchants, landlords, and "civil government" in Book III. Is the argument plausible? How do the relations between lords and farmers (those who lease land from the lords) change? How about the relations between lords and merchants?
2. Everyone's heard of the "invisible hand" but few realize, even when reading it, that it illustrates the conclusion of a classical syllogism or formal logical argument. Can you find this argument—three premises plus conclusion? Do you find it persuasive? That is (assuming it is logically valid), are the premises realistic?
3. What do you think of Smith's exception for national defense (ii. 24-30)? If the Acts of Navigation fall under it, what would not? (Would, say, a Chinese firm's purchase of a US avionics company?)
4. In Smith's discussion of justice and revenue (715-20), how does justice emerge from the self-interested actions of sovereigns and litigants? Is Smith's account a convincing one—above all, does he answer a critic who alleges that auctioning judges' decisions to the party offering the greater bribe would be more "natural"?
5. Consider Smith's discussion of "publick works" (722-26 and 730-31). What examples does he give here of roles government should perform, and things that should be left to the private market? Why doesn't the "invisible hand" work well for the former kinds of things? What, in Smith's view, is the difference between roads and canals in this regard?
6. Smith indicts the division of labor for its effects on the minds of workers (pp. 781-86). Is his proposed remedy adequate? (Compare these passages also to his description of dissolute soldiers at IV.ii.42, pp. 469-71.) Does the increase in wealth from the division of labor make this sacrifice worthwhile in Smith's view, or in yours?

Thu 9/18 Adam Smith: The Moral Context of a Capitalist Society

- Excerpts of *The Theory of the Moral Sentiments* from Heilbroner, *The Essential Adam Smith*, pp. 65-69, 78-110, 118-23.*
- Raymond Fisman and Edward Miguel, *Economic Gangsters* (2008), Chap. 4, pp. 76-92, 102-05.*

Smith first published *The Theory of Moral Sentiments* in 1759, well before the *Wealth of Nations*, but he continued to think highly of it throughout his life. The book went through six editions, the last appearing in 1790 just after his death. In it we may find support for some of the moral premises of the later, more famous arguments; but there are also points on which, some allege, Smith may have changed his mind. (In the early nineteenth century German anti-liberal critics popularized the idea that he was seriously incoherent.) The book has lately enjoyed a surge of respect among social psychologists and in 2009 came out in a Penguin Classics edition. In particular, Smith puts economic activity in a moral and sociological context, which is something critics often fault classical or (especially) modern neoclassical economics for ignoring. Basically, Smith is saying that people, even people who pursue wealth avidly, want something other than wealth. A note on language: when Smith refers to "the great" or people "of rank and distinction," he is referring to the (hereditary) aristocracy, which roughly corresponds to those in the *Wealth of Nations* who make money by collecting rent. The Fisman and Miguel excerpt talks about the importance of culture in economic life in a way that links up nicely with Smith.

Discussion questions:

1. What distinction does Smith make between beneficence and justice? What is the significance of each to the proper ordering of economic life? Are they really so different?
2. What is the role of public life—through human vanity and the sentiment of shame—in sustaining morality? Do traffic behavior in Bogotá and diplomatic parking tickets in Manhattan adequately illustrate this?
3. Do you think Smith (especially *TMS* 123) romanticizes the poor? How does the passage at 122-23 square with

his observation that we tend to despise the poor (78-79, 86-87)?

4. Can you reconcile the arguments in *The Theory of Moral Sentiments* with those in *The Wealth of Nations*? In particular, is personal morality necessary for markets to do a good job of channeling the pursuit of self-interest toward the general good? Or do markets solve the problem of conflict between self-interest and morality? How are the examples in Fisman and Miguel relevant to that question?
5. Smith seems to be arguing that people are trying to get something else as they pursue riches--and that there are other ways to get it. What is it? Does he think the pursuit of riches is the best way to achieve it?

B. The Radical Critique of Economic Liberalism

Mon 9/22 Marx and Engels

- Karl Marx and Friedrich Engels, "The Communist Manifesto" [1847], part I; Karl Marx, excerpt from *Capital*, vol. 1, chap. 14, sec. 4; Marx and Engels, fragment from *The German Ideology*; excerpt from Engels, *Socialism, Utopian and Scientific*; Marx, opening passages from "Critique of Hegel's *Philosophy of Right*"; and Marx, "On the Jewish Question," part I. All from Robert Tucker, ed., *The Marx-Engels Reader* (1978, 1981), pp. 473-83; 392-99; 160 (begin at "Further,...") -163; 690-93; 53-54; 26-46.*
- Brad DeLong, "Understanding Karl Marx" (2009), pp. 1-8, 12-14.*

Smith's influence on political-economic thinking during the nineteenth century would be hard to overstate. But his early successors were more pessimistic than he was, largely due to the influence of Thomas Malthus and his famous population theory, according to which a geometric increase in population combined with an additive increase in food production entailed a future of increasing misery. This gloomy strain showed up in David Ricardo's influential argument about family size and the trend of real wages (*Principles of Political Economy and Taxation*, four editions, 1817-21, Chap. 5). It lay behind the arguments that won the abolition in 1834 of the Elizabethan poor laws (which provided subsidy payments based on family size, administered at the local parish level, and had been expanded in 1795) and the increasing use of punitive workhouses for the poor. These ideas and policies also animated Marx and Engels's rejection of "bourgeois ideology" in favor of a revolutionary alternative.

Marx and Engels criticize capitalism in a much more fundamental way than do any other authors in this course, but you can see how they also depend on Smith (via Ricardo). The "Manifesto" is the best expression of their historical materialist argument that capitalism inevitably undermines its own foundations. Most of the key terms of Marxist analysis are here, including the "bourgeoisie" (referring to the capital-owning class, ancestrally linked to the market-towns, with liberties granted by the crown and growing up in the interstices of feudal society, a member of which is called a "bourgeois") and the "proletariat" (the class of propertyless, named after the landless of ancient Rome, who have to work for wages in order to live, a member of which is called a "proletarian"). Note also that for Marx, "natural" does not mean "good."

In the other readings, of which the last are from the early Marx, we work backward temporally and philosophically to find out what he thinks it means to be genuinely free. The first reading refers to different kinds of division of labor—one in which independent producers exchange goods in a market and another in which a factory manager assigns jobs to workers. While it's easy to expect Marx's antipathy toward the second, note his pejorative description of the first. The next reading is about how *any* settled division of labor restricts freedom and has as its political counterpart an "illusory form of communal life." The passages about division of labor in *The German Ideology* do sound utopian, even though Marx and Engels always contrasted themselves as "scientific" against the utopian thinkers of their day. It is interesting that in a passage about Robert Owen from *Socialism: Utopian and Scientific*, Engels clearly put him in the utopian camp—but it is also evident that Owen's ventures represented for Marx and Engels a demonstration that there were actual, practical alternatives to capitalism as it was.

The last two excerpts direct the critique toward religion and its role in a capitalist society. When reading the last, especially difficult piece, remember the key premise: Marx is an atheist. Seeing religion as a man-made fantasy, he sets out to explain where it comes from and why it is so strong even in a place (the northern US) with relatively free and democratic institutions and no established church. As this suggests, there is much more here than a few soundbites about "the opiate of the masses." (Note: in "On the Jewish Question," be sure to distinguish between Marx's own words and his long quotes and paraphrases—as in pp. 26-29--of Bruno Bauer.)

DeLong is an economist at UC Berkeley and a former US Treasury official, as well as a noted center-left commentator on current political-economy and macroeconomics issues. He puts Marx's thinking into an economic and historical context, and offers his own views on where Marx was prescient and where he went astray.

Discussion questions:

1. What historical role do Marx and Engels assign to capitalism? Do they, for instance, reproach it for having destroyed indigenous cultures around the world? Could a serious Marxist be an investment banker?
2. Bourgeois intellectuals, according to Marx (p. 395), approve of rigorous planning and central control within factories, but are horrified at the prospect of extending such planning to the economy as a whole. Is there an important contradiction here?
3. Marx says that in his ideal society, "nobody has one exclusive sphere of activity but each can become accomplished in any branch he wishes," (and in the next, famous passage) "to hunt in the morning, fish in the afternoon, rear cattle in the evening...just as I have a mind" (160). Does he want the division of labor abolished? Leaving aside his romantic examples of jobs, why does he think his scheme is feasible? What do you think?
4. What, for Marx, accounts for the existence of religion, and for its greater strength in the country (the USA) then distinguished by its lack of an established church?

II. THE REFORMIST LIBERALISM OF MILL AND KEYNES

Thu 9/25 John Stuart Mill on the Ethics of Private Property and Taxation;
John Maynard Keynes on Finance and Investment

- John Stuart Mill, *Principles of Political Economy*, 5th edition, Vol. I (1864), pp.259-271, 278-291; and Vol. II (1877), pp. 396-402.*
- Robert Frank and Ben Bernanke, *Principles of Macroeconomics*, 3rd ed., pp. 301-304 (on finance).*
- John Maynard Keynes, "The State of Long-Term Expectation," from *The General Theory of Employment, Interest, and Money* (1936), Chapter 12 (pp. 191-201 in the University of Adelaide e-book edition).*
- Burton Malkiel, "The Efficient Market Hypothesis and the Financial Crisis," from Alan S. Blinder, Andrew W. Lo, and Robert M. Solow, eds., *Rethinking the Financial Crisis* (2012), Russell Sage Foundation and Century Foundation, pp. 75-98.*

In the nineteenth century, John Stuart Mill (1806-73) was just as famous for his political economy as for his other philosophical works. The *Principles* went through six editions in his lifetime (the readings come from the fifth of these). Through his father he was influenced heavily by Bentham's utilitarian thought, turning these principles in a reforming direction and staking out then-radical positions on free speech and women's rights. In these readings you see a lover of liberty with a relentlessly logical mind seeking to justify private property and limitations on it, even as his valued principles come into conflict.

In the basic thrust of his philosophy, John Maynard Keynes (1883-1946) can be seen as the heir of reforming liberals such as Mill. But his writing has a more practical cast, not only as a result of his training as a mathematician and economist and his important roles in policymaking and Liberal party politics between the wars, but also because of the economic convulsions taking place during his most active years in public life.

Keynes is now most famous for his *General Theory of Employment, Interest, and Money*, written in the depths of the Great Depression (1936), from which we will read an excerpt for today. But his celebrity actually began with the *Economic Consequences of the Peace* (1919), an effective polemic against the punitive Treaty of Versailles. Keynes thought the massive unemployment of workers before (especially in Britain) and during the Great Depression effectively refuted the classical liberal belief that capitalism would work well if only markets were left alone. A strong believer in personal liberty, he sought to rescue capitalism through government intervention at a time when lots of loud voices called for its abolition. At the same time, he was quite critical of the failings of *laissez faire* capitalism and finance. Keynes was himself an immensely successful stock market investor, yet he was notably skeptical of the 'collective rationality' of asset markets (the two positions are not incompatible—cf. George Soros).

For today, our section on Keynes starts with a brief reading by Frank and Bernanke which reviews basic economic principles regarding the determination of prices of stocks (shares of ownership in corporations) which you should have learned in introductory economics. Reviewing this material will be extremely helpful for understanding some of what Keynes is talking about. Then, we'll read Chapter 12 from Keynes's *General Theory*, a particularly notable chapter where he memorably lays out his views on the role of "uncertainty" in finance and investment, and its consequences for the economy. The final reading is by Burton Malkiel, a present-day economist at Princeton University. Malkiel is the author of the best-selling investment guide *A Random Walk Down Wall Street*, and one of the leading defenders of the "efficient markets hypothesis," which some have viewed as a refutation of the kinds of arguments Keynes made in the chapter we're reading for today. Malkiel, however, is an adherent to a "weak" form

of the efficient markets hypothesis, and he attempts to reconcile it with the sorts of things Keynes is talking about. Malkiel contends that while financial markets are not necessarily always “rational,” they are almost always “unbeatable.” He offers his own views on modern financial theory and evidence, and how it has evolved since Keynes’s day.

Guide to jargon: When Mill speaks of “Communism” in the first pages of this selection, he is not referring to Leninist state socialism (which did not yet exist) but to factories, farms, and stores owned by workers or members of the community, like those of the Rochdale Pioneers. “Estate” is the total wealth that a person leaves behind when he or she dies. A “bequest” is the wealth that a person leaves to his or her heirs at death. An “inheritance” is the amount of bequest that a particular heir receives (so every bequest is an inheritance). “Intestate” (or in Latin, *ab intestado*) refers to people who die without having made out a will. Note that Mill advocates completely different policies for people who die intestate and people who leave a will, so pay careful attention to when he is talking about each situation. The discussion of what to do in cases where the decedent has a will is of much greater practical significance, since the vast majority of wealthy people do write wills. “Collateral inheritances” are those received by distant relatives or non-relatives – that is, people other than direct descendants (e.g., the decedent’s own children or grandchildren) or direct ancestors (e.g., the decedent’s parents). In his discussion of income taxation, note that a “proportional” tax means a tax that is the same percentage of income for people of all income levels, whereas a “progressive” tax is a tax that is a larger percentage of income for people with higher income levels.

When reading Keynes remember that to an economist, *investment* can have two meanings: a purchase of physical capital (such as productive machinery, tools, or buildings, e.g., a factory); or a purchase of shares of ownership of such capital (i.e., corporate stocks), which is more precisely called “financial investment,” and which from the perspective of the person doing the financial investment, is really a form of “saving” which the person essentially lends to the firm in exchange for a share of the profits arising from the firm’s investments in physical capital (e.g., through dividends). Keynes uses the term “investment” in both senses in different places. Second, recall from introductory macroeconomics that *money* has a very specific meaning to economists (Keynes included). “Money” is essentially cash and checking accounts, and a key feature that distinguishes money from other non-money assets (such as stocks and bonds) is that money earns little or no interest, while other non-money assets do earn interest or interest-like returns (such as dividends). Third, recall that “liquidity” refers to how easily an asset can be converted into spending power that can be exchanged for goods and services. Money is the most liquid asset of all. Assets such as stocks and bonds are significantly less liquid than money, but by the time Keynes was writing, even these were *somewhat* liquid due to the development of modern stock exchanges and bond markets in places like New York and London. Houses and small businesses are particularly illiquid assets, and so forth. Keynes also frequently speaks of the “marginal efficiency of capital.” This simply represents the rate of return to an investment in an additional unit of physical capital (factories, buildings, productive machinery, etc.). So for example, if an additional investment in physical capital costing \$100 today is expected to produce \$10 in profit per year forever, its “marginal efficiency of capital” is 10%.

Finally, Malkiel uses the term “arbitrage,” which means taking advantage of differing prices for the same asset across time or space. For example, if you know that the price of a stock is lower today than it will be tomorrow, you can make money by buying the stock today and selling it tomorrow. If enough people do that, the increased demand for the stock today will quickly push the price up to what it is expected to be tomorrow, making the arbitrage opportunity go away. Malkiel also refers to a stock’s “Beta.” Beta is a measure of the degree to which a stock’s performance is correlated with the performance of the market as a whole, and is an important indicator of risk. A stock with a low Beta involves less risk, because it pays off consistently in both good times and bad, providing a bit of insurance against bad performance of the stock market as a whole; a stock with a higher value of Beta is riskier because it does worst when times are bad, which is exactly when you need the money the most.

Check your understanding:

1. What specific public policies towards inheritance does Mill actually advocate?
2. What income tax policy does Mill favor?
3. Consider an asset that you expect will pay you a \$10 dividend per year forever, with no risk, and no expected capital gains. Suppose the risk-free interest rate available in the economy is 10 percent, and is expected to stay there. What is the maximum price should you be willing to pay today for the asset that pays a \$10 dividend per year forever risk free? Why?
4. Continuing the example above, now suppose there is a 30 percent chance the asset will pay \$20 per year, a 40 percent chance it will pay \$10 per year, and a 30 percent chance it will pay nothing. If you are risk-averse, should the maximum price you are willing to pay for this asset be higher, lower, or the same as in question 2? Why?

Discussion questions:

1. Does Mill's attitude to what he calls "communistic" schemes (Vol. I, pp. 259-271) seem inconsistent for an avowed liberal?
2. Mill says that "the laws of private property have never yet conformed to the principles on which the justification of private property rests" (Vol. I, p. 268). What does he mean by this, and how does he propose to remedy it?
3. Mill's long section on inheritance and bequest (Vol. I, pp. 281-291) underlies his position on inheritance taxes later in the book (Vol. II, pp. 398-402). What are the key pillars of his argument? What do you think of it?
4. In his discussion on taxation, Mill (Vol. II, p. 396-402) argues that income tax burdens should be distributed so as to demand an "equal sacrifice" from each person. He further argues that equal sacrifice would imply taking a larger amount of money (but possibly a similar percentage of income) from the rich than from the poor. What is his argument here? How do Mill's views about the ethical principles that ought to guide taxation compare to those of Adam Smith (*Wealth of Nations* Book V., pp. 825-28)? Which approach do you find more compelling, and why?
5. Keynes says that the stock market is like a beauty contest where we judge the contestants not on their beauty, but by how we think other people will judge their beauty. What is his argument? Is he right? How could he be wrong? How well do you think Keynes's argument stands up to modern economic theory and evidence on financial markets, as summarized by Malkiel? What, if anything, do you think the practical implications might be, either for personal financial investment strategy or for public policy?

Mon 9/29 The Keynesian Explanation of Recessions and Depressions

- John Maynard Keynes, "The General Theory of Employment," *Quarterly Journal of Economics*, Vol. 51, No. 2 (Feb., 1937), excerpt, pp. 212-223.*
- Paul Krugman and Robin Wells, "Reconciling the Two Models of the Interest Rate," from *Macroeconomics*, 2nd ed., (New York: Worth Publishers, pp. 439-441).*
- Paul Krugman, "Zero Bounds and Butter Mountains." *New York Times*, February 6, 2012.* [Note: this reading did not come out correctly in the 1st reading packet, so see beginning of 2nd reading packet for a readable version]
- David Wessel, "Finding a Prescription for the U.S.'s Money Trap." *Wall Street Journal*, August 6, 2011.* [Note: this reading did not come out correctly in the 1st reading packet, so see beginning of 2nd reading packet for a readable version]
- Paul Krugman, *End This Depression Now*. (2012). Chapters 2-3, 8-11, and Postscript.

In today's class, we will try to understand Keynes's key insights about why recessions happen and what we can do about them, and then will consider their relevance to our current economic predicament. (Before getting started, make sure that you've read the "guide to jargon" in the introduction to the readings for the previous class). The first reading for today is an excerpt from an article Keynes wrote in the *Quarterly Journal of Economics* in 1937, in response to widespread controversy over his 1936 book *The General Theory of Employment, Interest, and Money*. Robert Skidelsky, the definitive biographer of Keynes, has called this article a "restatement of the 'essence' of *The General Theory*" and noted that many Keynes scholars view it as "the canonical statement of [Keynes's] position." In it, Keynes explains the gist of his argument for why the economy is not "self-correcting" (as the classical economists had held), and why the economy can indeed plunge into recessions and depressions in a persistent way. In this article, Keynes is reacting against what he calls "Say's Law," which holds that inadequate aggregate demand, and therefore recessions, are *impossible* because "supply creates its own demand." The idea of Say's Law is that when people supply goods and services to the market, they receive income for doing so, and this income always turns into demand for *something*. When people spend their income on consumption, they create demand for consumption goods and services. When people save their income, that saving flows through banks or other financial intermediaries and is turned into investment, which in turn creates demand for investment goods. So for example, if there is a drop in consumption, Say's Law suggests there is no reason for that to cause a recession, because a drop in consumption necessarily means an increase in saving, and the increase in saving will push down interest rates enough to induce firms to use the saving to finance investments in physical capital. Thus aggregate demand never drops – any fall in consumption is matched by an equal and opposite rise in investment, and *vice versa*, with interest rates being the key mechanism that maintains equilibrium at full employment. In this first reading, Keynes lays out his argument for exactly what it is that he thinks makes Say's Law break down, making

recessions and depressions possible.

The next three very short readings connect the points made in the Keynes reading with concepts you should have learned about in introductory macroeconomics, which should help you make sense of Keynes's arguments. The reading "reconciling the two models of the interest rate," by Paul Krugman and Robin Wells represents a modern introductory macroeconomics textbook interpretation of how Keynes's theory of the interest rate can be reconciled in the long-run with the "classical" or "Say's Law" model of the interest rate (which in this reading is called "the supply and demand for loanable funds"). This should also help make it clear what can go wrong with Say's Law in the short run. The next Krugman reading, "Zero Bounds and Butter Mountains," concisely explains the Keynesian idea of a "liquidity trap," and discusses how it fits into this framework. The reading by Wessel also discusses the liquidity trap problem and some options for solving it. The final set of readings are selected chapters from Paul Krugman's book *End This Depression Now*, which is his effort to explain Keynes's key insights to a general audience, along with his argument for why he thinks they do a good job of explaining our current economic predicament.

Discussion questions:

1. The key to Keynes's explanation for why Say's law breaks down, and thus why recessions can happen, is *money*. Without that, Say's law works just fine. Explain Keynes's argument about the central role of *money* in causing Say's Law to break down, and why the peculiar social institution of money is critical to understanding how an economy can spiral into a persistent recession or depression. Consider also how Krugman and Wells' "Reconciling the Two Models of the Interest Rate," the Krugman article "Zero Bounds and Butter Mountains," and/or chapter 2 of *End This Depression Now* can help us understand what Keynes means here. (Important: make sure to remind yourself of what economists mean by "money" by reading the "guide to jargon" for the previous class).
2. To Keynes, what is the crucial distinction between "uncertainty" and "risk?" The Keynes reading from the previous class, and much of the Keynes reading for this class, are about how he thinks investment decisions are made in the face of "uncertainty." What role does this play in exacerbating the problems identified in the first discussion question for today?
3. What do Hyman Minsky and Irving Fisher (both discussed in chapter 3 of *End This Depression Now*) contribute to our understanding of why financial crises and recessions happen? What, if anything, do you think the practical implications are?
4. Using the Krugman-Wells framework ("Reconciling the Two Models of the Interest Rate"), explain how falling prices could eventually cure a recession automatically, with no government intervention needed at all. Then explain why, under certain conditions (including, arguably, those we face now), falling prices could instead make a recession much, much worse.
5. As Wessel says, when an economy is stuck in a liquidity trap, the Keynesian analysis of recession suggests three possible policy responses: deficit-financed government spending and/or tax cuts; actions taken by the central bank to get people to expect higher inflation in the future; or taking actions (such as leaving the Euro) that cause the country's exchange rate to depreciate substantially relative to other countries' currencies (thus making the country's exports cheaper and increasing demand for its products). Right now, in the U.S. and Europe, governments and central banks are basically not doing any of these things (at least not aggressively), and are sometimes even doing the opposite, despite continued high rates of unemployment and very low inflation. In *End This Depression Now*, Krugman considers many possible objections to the policy responses described above, and offers counter-arguments to the objections. Consider any one of the three solutions, explain the argument for how and why it is supposed to work, explain one objection to it, and then consider whether Krugman's counter-argument to the objection is convincing or not and explain why.

III. 20th-CENTURY ARGUMENTS

A. Defenses of the Market

Thu 10/2 The Case Against Central Planning

- F. A. Hayek, *The Road to Serfdom*, Chaps. 3-6, and 9; Hayek's preface to the 1976 edition (pp. 53-55 in edition edited by Caldwell); and Milton Friedman's introduction to the 1994 edition (pp. 259-263 in the edition edited by Caldwell -- you can skip "Note on Publishing History").

Perhaps the most important contribution of Friedrich Hayek (1899-1992) to social theory is his insistence that knowledge--of talents, capacities, scarcities, and potential consumer demands--is dispersed among countless individuals, so central planners cannot coordinate all this knowledge as effectively as markets. Along with laying the groundwork for this important point, *The Road to Serfdom* develops an argument that central planning not only produces poverty, but also destroys liberty and threatens democracy.

Discussion questions:

1. What does Hayek mean by “planning”? For Hayek, is all “planning” bad? What is Hayek’s argument for why “central planning” will not work well economically?
2. Hayek thinks socialism is likely to kill democracy. Why? Do you agree? Does the experience of Europe between the end of World War II and today shed any light on this?
3. Hayek describes democracy as one means for attaining the end of liberty. (Note that by “end,” Hayek of course means “goal”). Just saying something is democratic doesn’t mean it is good, because the democratically imposed will of the majority can be just as dangerous to freedom as the rule of the autocrat: “Democratic control *may* prevent power from becoming arbitrary, but it does not do so by its mere existence” (p. 111 in Caldwell edition). What do you think? For Hayek, just because a state formally codifies its decisions as laws, this does not necessarily mean that it practices “the rule of law.” Why not? Why is this distinction important?
4. In the middle of Chapter 3, Hayek allows that “the preservation of competition” is compatible with “an extensive system of social services” (p. 87 in the Caldwell edition). Then at the beginning of Chapter 9, he allows for “the certainty of a given minimum of sustenance for all” (p. 147), and says “the case for the state’s helping to organize a comprehensive system of social insurance is very strong” (p. 148). Can these really be consistent with the arguments he makes elsewhere in the assigned reading for the day?

Mon 10/6 Hayek's Critique of the Welfare State

- F. A. Hayek, *The Constitution of Liberty*, pp. 22-53; 306-323.*
- F. A. Hayek, "Competition as a Discovery Procedure."*

Thanks in no small part to the force of Hayek's logic, few people still believe in the desirability of central planning. He had won the argument by about 1955, but he did not stop there. These excerpts from the *Constitution of Liberty* (1960) are part of Hayek's attempt to demonstrate the continued relevance of his arguments in the era of the welfare state. Be sure you understand the difference between progressive and proportional (or flat) income taxation (in a progressive tax, the total tax burden is a larger percentage of income for higher-income people; for a proportional tax, the tax burden is the same percentage of income for everyone). In "Competition as a Discovery Procedure" (1968), Hayek returns to his theory of the market process, a theory which some have taken to be incompatible with and superior to the theory of the market in neoclassical economics.

Discussion questions:

1. According to Hayek, "the more civilized we become, the more relatively ignorant must each individual be of the facts on which the working of his civilization depends" (CoL, 26). What does he mean? Does he offer reasons why we should submit ourselves to “facts” we do not (or cannot) understand?
2. Hayek argues that inequality is a public good, in part because the rich act as consumption scouts, but that majorities would not vote for it. This proposition seems to rest on a key distinction: how much inequality is enough, in his opinion?
3. Early in his discussion of progressive taxation, Hayek says that the idea of the interpersonal comparability of utilities has been “generally abandoned” (*Constitution of Liberty*, 309). Yet many policymakers, economists, and ordinary people still think that a rich person gains less utility than does a poor one from income gains of the same magnitude. If we deny comparability, should we also abandon the Golden Rule because it enjoins us to consult our own preferences when we do unto others?
4. Why should proportional taxation be the best way to avoid unfair discrimination among taxpayers? Why not a poll or head tax, where everyone pays the same absolute amount?
5. According to Hayek, "Spontaneous order does not ensure that what general opinion regards as more important needs are always satisfied before the less important ones" ("Competition," 257-58). What reasons does he give to defer to the market on this? Are they sufficient for us to accept, for example, a rich lady's purchase of heart

surgery for her cat taking precedence over the public provision of such surgery for another person?

Thu 10/9 Liberty, State, and Market

- Milton Friedman, *Capitalism and Freedom*, Introduction; Chaps. 1, 2, 7, 10.

Milton Friedman (1912- 2006) was Ronald Reagan's favorite economist. He did important work on economic methodology, the consumption function, and most famously, on money. But he also wrote influential works of advocacy, like this one and the lighter *Free to Choose*, which have been important guides for Republicans in recent years. (Note: in case it's not clear, what he calls "neighborhood effects" are now generally called "externalities.")

Discussion questions:

1. In his discussion of monopoly (28), Friedman says that exchanges are voluntary where both parties have alternative options that are nearly equivalent. Does he believe that market participants usually have such alternatives (13-14)? If so, is this a reasonable belief? If such alternatives do not exist, are we somehow unfree?
2. Friedman says that markets offer a kind of proportional representation (15). Proportional to what? Thinking of this passage and others (e.g., 23-25), would you say he is a democrat?
3. Friedman argues that minorities have wrongly blamed capitalism for the "residual restrictions" upon their lives when the market "has been the major factor enabling these restrictions to be as small as they are" (p. 109). He offers an example of two singers whose incomes depend on the public's musical tastes. What do you think?
4. Friedman (pp. 164-66) argues that we should make no ethical distinctions between inequalities derived from inherited property and inherited talent, and he even suggests including those arising from effort and thrift as inherited traits. All, he says, come about by luck. Do you agree? What would this position imply for policy?
5. Are inequalities resulting from chance easier to accept than those from other sources (pp. 165-66)? Compare Friedman to Hayek, (*TRtS*, middle of Chap. 7): "nothing makes conditions more unbearable than the knowledge that no effort of ours could change them..."

Mon 10/13 No class (Reading Period)

Thu 10/16 Liberal Principles Applied

- David Friedman, *Hidden Order: The Economics of Everyday Life* (1997), Chap. 15.*
- *The Economist*, "State and Market," February 17, 1996.*
- Milton Friedman, *Capitalism and Freedom*, Chaps. 6, 11-13.

David Friedman (son of Milton, and a physicist who teaches law at U. Santa Clara) describes the problems with measuring the "welfare" (well-being) of people in a society, and defends the idea that the pursuit of *economic efficiency* is the "least bad solution" to improving it. He explains the idea of an "economic improvement," and correctly notes that this is colloquially what economists mean when they say that a policy change "improves economic efficiency" or is "more efficient." (An "economic improvement" is also known as a "Hicks-Kaldor Improvement," a "Marshall Improvement," an "Increase in Economic Surplus," and a "*Potential* Pareto Improvement" – these are all essentially synonyms except in some weird and rare special cases that we won't worry about). This is a fundamental normative concept in economics (despite the fact that nobody can agree on what to call it) and is frequently used to evaluate whether a policy change is "good" or "bad." So it is a critical concept to understand.

The short reading from *The Economist* reviews what you should have learned about "market failures" in introductory economics. A "market failure" is a situation where the market, by itself, is not economically efficient. Although he sometimes uses different terminology, the concepts of economic efficiency and market failure are critical to almost all of Milton Friedman's recommendations on public policy. In Chapters 6 and 11 through 13, Milton Friedman takes on the problems of public schools, public housing, pensions, and anti-poverty policy. The most enduring policy contributions of Friedman's book can be found here: vouchers for housing (see Section 8) and (in some places) education, proposals to privatize Social Security in the US (actually implemented, in large part, in a

few other countries), and the negative income tax (which influenced the development of the Earned Income Tax Credit, now the largest U.S. government program providing cash assistance targeted to the poor). They share a conviction that government social programs should be narrowly tailored to leave the greatest possible sphere of choice to the recipient.

Check your understanding:

1. If a policy change makes person *A* worse off by \$150 and makes person *B* better off by \$100, but an additional dollar is worth twice as much utility to person *B* than to person *A* because person *B* is poorer, is the policy change an “economic improvement” as David Friedman defines it? Why or why not?
2. What are the four categories of “market failure?” In each case of market failure, what is the story for why the market, by itself, will fail to achieve economic efficiency (that is, why won’t the market achieve all available economic improvements)?

Discussion questions:

1. How would you explain the concept that David Friedman calls an “economic improvement,” its advantages, and its limitations, so that a typical voter (say, your grandmother) would understand it? Why should we care about achieving economic improvements (increasing economic efficiency) at all? If a policy is chosen on the grounds that it is an economic improvement as David Friedman defines it, what would you say to someone who loses out because of the policy?
2. For either one of the following two policy issues, address the following questions. What, if anything, does Milton Friedman think are good rationales for government involvement in this policy area? Given that, what does Milton Friedman think the best policy approach would be, and what is his argument for it? Do you agree with his diagnoses of the problems and his proposed solutions, or is he missing anything important that might affect the best policy approach? (In your essay, just focus on one of the policy issues, not both! Also, your paper could just focus either on the rationales or on the arguments for the policy proposals, if that helps you make a deeper argument. But be prepared to discuss all of these in class.)
 - a. Education
 - b. Poverty

Mon 10/20 Microeconomics and Renascent Liberalism: Ronald Coase

- Ronald Coase, "The Problem of Social Cost." *Journal of Law and Economics*, 1960, Vol. 3, excerpt, pp. 1-10, 16-20, 27-35, and 39-44.*
- Ronald Coase, "The Nature of the Firm." 1937. *Economica*, New Series, Vol. 4, No. 16 (November 1937), excerpt, pp. 386-398.* [Read the footnotes too!]

The two readings for today by Ronald Coase (b. 1910) are largely responsible for his 1991 Nobel Prize in economics. In "The Problem of Social Cost" (1960), Coase suggested that free markets were in fact able to correct many of the problems associated with externalities that conventional theory generally believed could only be addressed by government action. After attending a dinner party at which Coase presented these ideas before their publication, Milton Friedman commented that he had witnessed a revolution in economic thought. By the end of the twentieth century this had become the most often-cited article in economics.

In "The Nature of the Firm" (1937), Coase attempts to answer a question that occurred him when he was an undergraduate, after visiting Ford and GM: how could liberal economists fault the USSR for being run like a big factory when some very large firms are run efficiently? Or to put it more generally, if markets are so great, why do firms exist? Why aren't we all independent contractors? Here he introduces the fertile concept of transactions costs, a concept whose implications are still being explored by economists. It has political-economic implications, too. When reading both pieces, be careful to distinguish between Coase's paraphrases of others' opinions (which he will reject) and his own arguments.

Discussion questions:

1. According to Coase's famous argument about social cost, in the absence of transaction costs, the economically efficient use of resources will be obtained if property rights are clearly defined and enforced -- regardless of their distribution. What is his argument? What, if anything, do you think the policy implications are? If we had trade in human kidneys—see the *Economist* article—and transactions costs were low, would it matter whether

people were initially assigned property rights to the kidneys in their own bodies? How does the David Friedman article from last time help us think about this question?

2. Coase recognizes that in many real-world legal disputes, transactions costs are often significant. In those cases, Coase argues that property rights should not necessarily be assigned based on who is deemed to be “at fault,” but rather should be assigned so that the party who is in possession of the most economically efficient solution to the dispute will have the incentive to implement it. Coase further contends that assigning property rights might be a better solution than a Pigouvian tax even in the high-transaction cost case. What is his argument here? How would the decision about how to allocate the property rights in these cases be made? What would Hayek think of this implication?
3. Hayek made compelling arguments about the benefits of relying on the price system and competition to organize economic activity, and about the problems associated with central planning. As Coase emphasizes, when a firm brings economic activity “in house” instead of contracting it out, it is choosing to organize and direct that activity using methods similar to central planning, and is rejecting the use of the competitive market and the price system for organizing that activity. Given that, why should firms exist at all? Why isn’t all economic activity undertaken by independent contractors? Moreover, if the reasons for the existence of firms that Coase emphasizes are important, then what, if anything, limits the size and scope of firms? Why doesn’t a firm just bring *everything* “in house?” Does Coase answer these questions adequately? Do you think Coase’s arguments weaken Hayek’s case for the greatness of the price system and the awfulness of central planning?
4. Following Coase, what effect might we expect, on the economically optimal size of firms, from recent advances in information technology?

B. Defenses of Politics, the Welfare State, and Workplace Democracy

Thu 10/23 Equality and the Welfare State

- Arthur Okun, *Equality and Efficiency*, Chaps. 1 and 2 (skip pp. 51-61, “The Collectivized Economy”), plus pp. 91-100 (“The Leaky Bucket Experiment”).

Arthur Okun (1928- 1980) did most of his empirical work on labor markets and price theory. However, as a former policymaker and a lucid writer, he was also capable of writing a book that describes as clearly as any the areas of conflict between market distribution and political rules. He also offers us a nice review and commentary on authors we’ve read up to now, from Smith and Mill to Hayek and Friedman.

Discussion questions:

1. Why, for Okun, must a clear line be drawn between dollars and rights? Do you agree with his reasoning?
2. Here might be one implication from Okun’s placement of the line between dollars and rights. In the provision of counsel to criminal defendants, today the rich get the best defense money can buy and the poor often get an underprepared public defender. This vitiates equality before the law. We should make all defendants draw from the same pool by lot, paying all defense lawyers publicly (like we do prosecutors). What do you think?
3. Okun thought the link between private property and personal freedom was not so clear-cut. He claimed that “To evaluate the net gain in freedom provided by private ownership (rather than public access) for any asset requires a balancing of pluses and minuses. The plus is the enhanced scope of the owner through exclusive powers over the asset; the minus is the restriction the keep-off sign imposes on non-owners” (37). What do you think? Does one person’s property restrict the freedom of everyone else?
4. In his section on the ethics of rewards (pp. 40-50), Okun argues that some sources of inequality are more ethically (and implicitly, politically) acceptable than others. He also differs from other authors. Where do you stand and why?
5. Where, for Okun, might equality and efficiency *not* trade off? Do you agree?

Mon 10/27 An Economist Defends Politics

- Albert O. Hirschman, *Exit, Voice, and Loyalty*, Chaps. 1-4, 7 (all but pp. 83-98), and 8 (to page 114 only).

Albert Hirschman’s writing is distinguished for his adept and enlightening “trespasses” across the boundary

between politics and economics. His empirical works deal with power, trade, and economic development, but this book has been his most influential contribution to political economy. In what at first may seem a long statement of the obvious (or what is obvious to everyone except economists), he created a new vocabulary for looking at a wide range of problems. One of his underlying premises--that organizations are costly to create--is shared by what has lately become a whole new field called "the new institutional economics."

Discussion questions:

1. Hirschman criticized the typical economist's bias for "exit" over "voice" and later (Chap. 8) remarks upon an American preference for "exit" as well. What drives the choice between one and the other? Where does loyalty come in?
2. Compare Hirschman and Friedman on the issue of schooling. Are Hirschman's arguments (especially in Chapter 4) enough to undermine Friedman's argument for free choice and vouchers? Why or why not?
3. One novelty of Hirschman's book lies in its conception of "voice" (petitions to management, consumer complaints, ongoing communications between firms and their suppliers) as relevant to economic analysis. In your opinion, what are his most important lessons for managers of firms?
4. According to Hirschman (Chapter 7), why might irrational national chauvinism be an advantage for countries trying to advance economically in the modern world? How would a liberal object to this thesis?
5. Hirschman's book is sometimes criticized for not giving greater prominence (beyond passing mentions at 40-41 and 82-83) to the idea that the threat of exit is crucial to having one's "voice" taken seriously. What do you think? Are there situations in which such a threat has the opposite effect?

Thu 10/30 Power and Autonomy at Work

- Daniel Pink, *Free Agent Nation* (2001), Chap. 1 (pp. 9-25) and pp. 179-181.*
- William C. Taylor, "These Workers Act Like Owners (Because They Are)," *NY Times* 5/21/06.*
- National Center for Employee Ownership, "ESOP Facts" (2014).*
- Richard Thaler and Cass Sunstein, *Nudge*, "Company Stock" section of chapter 7 (pp. 127-30 in the revised and expanded edition).
- Samuel Bowles and Herbert Gintis, *Democracy and Capitalism*, Chap. 3 (to p. 87 only).*

Here we return to the workplace, where we began with Adam Smith and visited later with Marx, Mill, and Coase. Nearly all of these readings present various arguments, on efficiency and equity grounds, against the existing structure of corporations. Pink's book welcomes the rise of independent white-collar jobs as an opportunity for self-actualization and resolving the conflict between work and family life (there may seem to be a lot of pages here but they read very fast). The work of Bowles and Gintis, economists at the University of Massachusetts, Amherst, makes the case that economic power should be just as accountable as formally constituted political power, ending up by advocating that a firm's employees should own it. (You may recall that employee ownership was also one of those places in which Okun thought equality and efficiency did not necessarily trade off.) The middle readings discuss that option in practice, with Thaler and Sunstein (you'll read more of this book later) looking at the disposition of employees' savings. By the way, although Bowles and Gintis are on the left politically, extensive employee ownership has long been championed by conservative Republicans, including Ronald Reagan.

Discussion questions:

1. Thinking of Coase, does Pink give us good economic or technological reasons to believe that the firm is now passé? What limits might there be to the feasibility of free agency?
2. What is the "labor commodity" proposition? Do you agree with Bowles and Gintis' critique of it? How does their position differ from Coase's idea that authority, not the market, governs relationships inside the firm?
3. How about the "asset neutrality" proposition? Do we have to assume that all good ideas get funded in order to regard capitalism as fair? Efficient?
4. Referring to the readings on employee-owned firms and the bit from *Nudge*, what are the advantages and problems of such firms? Are these understandable in the terms articulated by Bowles and Gintis?

IV. CONTEMPORARY CHALLENGES TO AND REVISIONS OF ECONOMIC LIBERALISM

A. Luck, Insurance, Asymmetric Information, Distributive Justice, and Economic Inequality

Mon 11/3 Luck, Insurance, Asymmetric Information, and Distributive Justice

- Jonathan Gruber, *Public Finance and Public Policy*, 2nd ed. (2007), Chap. 12 (“Social Insurance”), pp. 314-328 and 337-341 only.*
- Jon Bakija, “Why is Insurance Good? An Example,” (2013).*
- James Surowiecki, “Fifth Wheel,” *New Yorker*, 1/4/10.*
- Richard Arneson. “Justice.” in *David Estlund, editor, The Oxford Handbook of Political Philosophy*. Oxford: Oxford University Press, pp. 58-75.*

The readings for this class consider economic principles and philosophy relating to luck, risk, insurance, and asymmetric information, which, as we will see in future classes, are essential to understanding modern thinking about questions relating to health care, social insurance, income inequality, taxation, redistribution, and even climate change. Here we consider the basic principles and what they might imply about the moral and economic justifications for policy more broadly. The reading by Jonathan Gruber (an MIT economist) discusses why people dislike risk and why they value insurance. It then goes on to discuss “adverse selection” and “moral hazard,” two examples of market failures (situations where the market is inefficient) arising from asymmetric information between buyer and seller. These problems frequently arise in economic contexts involving risk and uncertainty. In 2001, George Akerlof, Michael Spence, and Joseph Stiglitz were awarded the Nobel Prize in Economics for their work on this topic. The Bakija reading provides a simple example to illustrate why insurance is good. The Surowiecki article discusses some inconsistencies in politicians’ efforts to preserve private health insurance while at the same time taking measures that make it illegal for insurers to discriminate against people with certain characteristics that affect their likelihood of incurring medical expenditures.

The final reading, by Richard Arneson, a philosopher at UC San Diego, discusses philosophies of distributive justice, including for example utilitarianism, Rawlsianism, libertarianism, and “luck egalitarianism.” Among other things, it highlights the central roles that luck and insurance play in modern political philosophy regarding the ethics of government policies intended to reduce inequality and help the less fortunate.

Check your understanding:

1. Suppose you face a risk that leaves you with a 20 percent chance of having bad luck, in which case your consumption is \$10,000, and an 80 percent chance of having good luck, in which case your consumption is \$90,000. Assume that your utility function is $U = \sqrt{C}$. What is the maximum premium you should be willing to pay for an insurance policy that pays you a benefit of \$80,000 in the event of bad luck?
2. Continuing the example from question 1, if there are many identical consumers exactly like you, insurance companies have perfect information about different customers’ probabilities of bad luck, insurance companies incur administrative costs of \$1,000 per customer, and the insurance market is perfectly competitive, what premium will an insurance company charge for the insurance contract described in question 1?
3. Continuing the example above, how much consumer surplus does each insurance customer receive from this insurance contract, and how much producer surplus does the insurance company get per customer?
4. Continuing the example above, now suppose that half of the people in the population actually have a 10 percent chance of bad luck, and half of the people have a 30 percent chance of bad luck. Further assume that people know their own probabilities of bad luck, but insurance companies only know the average probability of bad luck in the population. If insurance companies charge a premium based on the average probability of bad luck in the population (20%), what happens? How do you know?

Discussion questions:

1. As the science of genetic testing advances, it will become increasingly easy for insurance companies to adjust insurance premiums to more accurately reflect the risks of disease faced by each individual. If insurance companies were allowed to do this, would this make the insurance market more efficient or less efficient? Would it be a good thing? What, if anything, do you think are the practical policy implications of your answer?
2. If an insurance market suffers from an adverse selection problem, and government does not have better information about individuals’ risks than insurance companies do, then is there anything government policy can

- do to achieve an “economic improvement” (in David Friedman’s sense of the term)? How? Would this be fair?
- Arneson discusses several different philosophies of distributive justice. Which one do you find most persuasive? Or do you find some combination of them to be the best approach? Why? What do you think the practical implications are for public policy towards health insurance?

Thu 11/6 Economic Inequality and Public Policy

- David Weisbach, “Redistribution,” from “Should Legal Rules be used to Redistribute Income?” *University of Chicago Law Review*, 70 (2003), pp. 440-446 only.*
- N. Gregory Mankiw, “The Deadweight Loss from Taxation,” from *Principles of Microeconomics*, 3rd edition, Southwestern College Publishing, 2003 (excerpt, portions of pp. 160-170).*
- Jon Bakija, “Social Welfare, Income Inequality, and Tax Progressivity: A Primer on Modern Economic Theory and Evidence.”*
- Thomas Piketty, Emmanuel Saez, Stefanie Stantcheva, “Taxing the 1%: Why the Top Tax Rate Could be Over 80%” *VoxEU.org*, December 8, 2011.*
- N. Gregory Mankiw, “Defending the One Percent.” *Journal of Economic Perspectives*. Summer 2013, pp. 21-34.*
- Alex Tabarrok, “Nature, Nurture, and Income” *Marginal Revolution*, Nov. 29, 2004.*
- Noah Smith, “I Get What You Get in Ten Years, In Two Days.” *Noahpinion Blog*. 6/27/2013.*
- James J. Heckman. “Promoting Social Mobility.” *Boston Review*, September/October 2012. [Excerpt, pp. 1-13.]*
- Lane Kenworthy, “It’s Hard to Make it in America: How the United States Stopped Being the Land of Opportunity.” *Foreign Affairs*, November/December 2012, pp. 97-109.*

David Weisbach (a law professor at U. Chicago) explains the concept of “social welfare,” and discusses why progressive taxation and transfers might increase it. Weisbach emphasizes, however, that redistributive taxation and transfers can be costly in terms of economic efficiency. He explains what the “optimal income taxation” literature (which earned James Mirrlees the Nobel Prize in economics) suggests about how one might find the social-welfare maximizing balance between the benefits and costs of progressive taxes and transfers, and how this might differ depending on one’s philosophy. The next reading is by Greg Mankiw, economist at Harvard University and former chair of the Council of Economic Advisors under President George W. Bush. It reviews what you should have learned about the economics of taxation in introductory economics, which will be helpful for thinking through the logic of all of today’s readings.

The next reading, by Professor Bakija, provides an accessible overview of some of the latest economic thinking and empirical evidence on social welfare, income inequality, and tax progressivity. The reading by Thomas Piketty (economist at Paris School of Economics), Emmanuel Saez (economist at UC Berkeley and winner of the John Bates Clark medal for best economist under age 40), and Stefanie Stantcheva (economist at Harvard), presents some cross-country evidence on the relationship between tax rates on high-earners, share of income going to the top of the income distribution, and economic growth, and argues based on this evidence that the social welfare maximizing tax rate on top earners might be much higher than it is now in the U.S.

The next reading by Mankiw defends the high incomes of people in the top one percent of the income distribution, and argues against utilitarianism on ethical grounds, contending that people generally deserve to keep what they earn. The short reading by Tabarrok explains one piece of evidence presented in the Mankiw reading in a little more detail. Noah Smith, an economist at Stony Brook University, responds to Mankiw, defending utilitarianism and questioning Mankiw’s conception of “just deserts.”

The final two readings focus on the concept of “equality of opportunity” (a theme that also emerges in other readings for today, the previous class, and earlier in the semester). James Heckman, economist at U. Chicago and Nobel Prize winner, summarizes some of what social scientists have learned about the sources of inequality in cognitive and non-cognitive skills, the lasting impacts of early-life conditions, and the effectiveness of early-life interventions at improving long-term outcomes. Lane Kenworthy, a sociologist at the University of Arizona, discusses evidence on the degree to which the U.S. does or does not achieve “equality of opportunity,” and considers what this might imply for policy.

Check your understanding:

1. Suppose the government is considering a change in tax-and-transfer policy that makes person A worse off by \$150 and makes person B better off by \$100, without affecting anyone else. The difference between the \$150 and the \$100 reflects the additional deadweight loss caused by the increase in taxes and transfers, and the additional administrative costs associated with the increased tax and transfer. Further suppose that an additional dollar is worth twice as much additional utility to person B than to person A. Would a utilitarian support or oppose this proposed policy change? Why?
2. Continuing the example from above, suppose we are considering further increases in taxes on person A to finance further increases in transfers to person B. As we transfer more and more from A to B, what factors change that eventually cause the utilitarian's willingness to approve further taxes and transfers to change? Why?
3. Would a utilitarian support raising tax rates on the rich up to the peak of the Laffer curve? Why or why not?
4. Other things equal, if labor and other forms of productive economic activity are more elastically supplied (that is, people change their behavior more when their incentives change), does that increase or decrease the social welfare maximizing amount of redistribution in the utilitarian framework? Why?
5. How would people who subscribe to other philosophies of distributive justice evaluate the questions above?

Discussion questions:

1. The share of the nation's pre-tax income that is received by people at the very top of the income distribution has increased dramatically in the U.S. since the 1970s. The readings discuss many possible explanations for why this has happened. Which explanation or explanations do you think are most consistent with the facts, and why? How do the implications for public policy differ depending on which explanations for rising inequality are correct?
2. In "Defending the One Percent," Mankiw argues against using tax and transfer policy to reduce inequality. What do you think his strongest and weakest arguments are? Do you think any of the other readings offer compelling reasons to disagree with Mankiw's reasoning or his conclusions?
3. How would you define "equality of opportunity?" Is equality of opportunity a better normative goal than maximizing utilitarian social welfare? Or would you prefer some combination of the two, or neither? Why? In what ways, if at all, do you think the practical policy implications of attempting to achieve equality of opportunity differ from those of efforts to maximize utilitarian social welfare, and in what ways would the policy implications be similar?
4. Mankiw argues that we're already doing a pretty good job of achieving equality of opportunity in the U.S., while Heckman and Kenworthy argue that we should be doing better. Whose arguments and evidence do you find to be most compelling, and why?
5. All things considered, do you think public policy in the U.S. should be doing more or less to address economic inequality than it is now? What if anything should it be doing differently? Why?

Mon 11/10 Health Care

- Paul Krugman and Robin Wells, "The Health Care Crisis and What to Do about It," *NY Review of Books* 53:5 (March 2006).*
- David Goldhill, "How American Health Care Killed My Father," *Atlantic Monthly* Sept. 2009.*
- Atul Gawande, "The Cost Conundrum," *New Yorker*, June 1 2009.*
- Sherry Glied and Dahlia Remler, "What Every Public Finance Economist Needs to Know about Health Economics," *National Tax Journal* 55:4 (Dec. 2002).*

Even after the passage of the Affordable Care Act, health care is still a huge, controversial policy issue. A thorough understanding of the issues and options would take a lot more than one class. In this class meeting, we will focus on a few aspects of the debate. People from across the political spectrum seem to agree that among the list of dysfunctional markets, the market for health care is Exhibit A. But they disagree about why. The readings for this class consider many different ways in which the market for health care in the United States deviates from the kind of market that classical liberals love so well. They consider both the problems inherent in the market itself that might in principle be fixed by government intervention, and the problems that seem to be exacerbated by that government intervention.

The first reading by Krugman and Wells makes the case that the U.S. health care system is particularly dysfunctional because of the large role played by the private sector, and argues for a greater role for insurance

provided by the government. Goldhill considers many problems with the health care system, but concludes that the critical problem is that people have “too much” insurance. He proposes replacing the current system with a system of insurance that only pays for catastrophic health expenses (say, those above \$50,000), and that requires individuals to pay for anything less than a catastrophic expense out of their own pockets. Gawande considers a case study of a place (McAllen, Texas) where medical expenditures are especially high, and presents an argument that market competition has destructive and inefficient effects in an environment where patients and doctors have extremely asymmetric information. Glied and Remler argue that recent advances in health care economics suggest that the nature of inefficiencies in the health care market are more subtle and complicated than even many experts recognize, and that these subtleties may have important implications for the best policy approach. They also raise the question: if the problem with our health care system is really “too much” insurance, why is the free market giving us as much insurance as it is?

Discussion questions:

1. Goldhill argues that the best solution to our health care problems would be to limit health insurance to covering catastrophic expenses (those in excess of \$50,000 per year, he suggests), and require people to pay out-of-pocket for all health care expenses below that. Do you think this is a good solution? Why or why not? If this is such a good idea, why isn't the market giving it to us already? Does Goldhill have an adequate response to that? What would Glied and Remler say?
2. Both Gawande and Glied and Remler emphasize the problem of asymmetric information between doctors and patients. What empirical evidence do we have that this is an important source of inefficiency in the U.S. health care system? What if anything can be done about this? There is of course no perfect solution to this problem, but is there any reason to think private insurance companies might come up with reasonably good responses to the problem? If not, what, if anything, do you think the government should do about it? Do you think Goldhill's approach would substantially ameliorate this problem?
3. Krugman and Wells argue that the best solution to efficiency and equity problems in health care would be to extend something like Medicare to the entire population, or maybe even to follow the model of the Veteran's Administration, where the health care is provided by government employees. Almost all other rich countries do something like one or the other of those two options. Do you agree that this would be the best solution? Why or why not? Do any of the other readings suggest compelling reasons for why health insurance companies deserve to live?

B. Is Capitalist Growth Sustainable? Is It Efficient? Is It Fair to Future Generations?

Thu 11/13 Is "More of the Same" Feasible? Positional Goods and the Norms of Capitalism

- Jonathan Kaufman, “Striking it Richer: Amid Economic Boom, the ‘Haves’ Envy the ‘Have-Mores’,” *WSJ* 8/3/98.*
- Fred Hirsch, *Social Limits to Growth* (1976), Chaps. 1, 3, 8, and 10 (pp. 1-12, 27-54, 77-82, 117-22, and 137-43 and 150-51).*

Conventional economics focuses on the policies most conducive to rapid and sustainable economic growth, since it is commonly held that economic growth promotes human happiness and well-being. Writing in 1976, Fred Hirsch asked if, over time, growth might instead result in more disappointment and strife. His key step was a focus on relative rather than absolute gains or satisfactions, coining the term “positional goods.” He foresaw a conflict between the pursuit of such goods and the maintenance of the norms that sustain liberal capitalism. The first article vividly depicts paycheck envy during the dot-com boom; similar things were written around 2006 about the attitudes of merely rich Wall Streeters toward hedge-fund managers.

Discussion questions:

1. What are positional goods, and why does Hirsch think they have important implications for our thinking about the political economy of affluent societies?
2. Hirsch believes that “education”...“is a filter as well as a factory” (p. 48). What does he mean by this? Would we all be better off if Williams College were reduced to an Office of Admissions that handed out certificates of virtue to five hundred people a year, leaving them to learn relevant skills immediately in actual jobs?
3. How does Hirsch mean by the “tyranny of small decisions”? Is it really a “tyranny”? What are its

consequences? (Contrast him to Hayek, *Constitution of Liberty* pp. 50-51.)

4. For Hirsch, why do a society's moral resources inevitably get depleted? What consequences does he see for capitalism?
5. Why does Hirsch think we are "reluctant collectivists"? Does he think this collectivism offers a solution?

Mon 11/17 What do We Owe Future Generations?

- Eric A. Posner and David Weisbach, "Future Generations: The Debate over Discounting." from *Climate Change Justice* (Princeton University Press, 2010), pp. 144-168.*
- Jon Bakija, "The Social Discount Rate, and Historical Data on Rates of Return." (2013).*
- Bob Litterman, "What Is the Right Price for Carbon Emissions?" *Regulation*, Summer 2013, pp. 38-43.*
- Robert Pindyck, "Pricing Carbon When We Don't Know the Right Price." *Regulation*, Summer 2013, pp. 43-46.*
- Paul Collier, *The Plundered Planet*. (Oxford University Press, 2010), pp. 15-34 and 200-203. *

Some of the most pressing issues facing political economists relate to the consequences of our actions for future generations. This comes up especially in discussions of the environment and natural resources, but is more broadly relevant to all sorts of questions, such as budget deficits, Medicare, and Social Security. The Posner and Weisbach reading contends that discussions about public policy towards climate change often conflate two conceptually distinct questions: (1) the "ethicist's" question of "*how much* should we do for future generations?"; and the "positivist's" question of "*which projects* should we do for future generations?" Although Posner and Weisbach do not refer directly to "utilitarianism," their article largely amounts to an explanation of how utilitarian analysis would go about answering each of these questions. The reading by Professor Bakija clarifies some technical aspects of the Posner and Weisbach discussion of the "social discount rate." The brief readings by Bob Litterman (an economist and hedge-fund manager) and Robert Pindyck (an economist at MIT) discuss risk and uncertainty, topics which are not addressed adequately by Posner and Weisbach, and consider what role they ought to play in thinking about climate change. Paul Collier, an Oxford University economist, provides a less technical summary of the utilitarian reasoning that pervades the first three readings, and then argues that a rights-based approach to thinking about these ethical issues would be more fruitful.

Check your understanding:

1. If the interest rate is 10 percent per year, what is the present value today of \$121 to be received two years from now?
2. Suppose the real risk-free market interest rate is one percent per year, and we are sure that the marginal utility of an additional real dollar among people 100 years from now will be one-third of what it is today, because people in the future will be so much richer. In that situation, would a utilitarian advocate saving more today in order to benefit people 100 years from now? Why or why not?
3. How would a utilitarian answer question 2 if the real risk-free market interest rate were two percent per year instead of one percent per year?

Discussion questions:

1. How, exactly, would a utilitarian go about answering the question "how much should we do for future generations?" What factors affect the answer, and how do they affect it? How should risk and uncertainty affect the answer?
2. Were past generations too generous to us, or not generous enough? Why do you think that? What implications, if any, might this have for thinking about whether there is any hope that we will do enough for future generations in the sense of the first question?
3. How would a utilitarian go about answering the question "among the various possible alternative things we *could* do for future generations, is aggressive and prompt action to fight climate change (e.g., a high carbon tax) one of the things we *should* do, or should we do something else instead?" What factors affect the answer, and how do they affect it? How should risk and uncertainty affect the answer? Can you think of any factors not mentioned in the reading that ought to be taken into account?
4. Collier is critical of the utilitarian ethical framework when it comes to thinking about intergenerational equity, climate change, and natural resource depletion. What is his critique, and what is his alternative? Which approach do you find more persuasive?

5. All things considered, what do you think we should do about climate change, and why? How do your arguments relate the philosophical and economic frameworks for thinking about the issues discussed above?

C. Economic Nationalism and New Trade Theory

Thu 11/20 The Return of the Repressed? Economic Nationalism and New Trade Theory

- Patrick Buchanan, *The Great Betrayal* (Little, Brown, 1998), first part of Chap. 3 (“How Free Trade Is Killing America”), pp. 44-58.*
- Lester Thurow, *Head to Head* (Morrow, 1992), middle section of Chap. 4 (pp. 117-24).*
- Ha-Joon Chang, *Bad Samaritans* (Bloomsbury, 2008), first part of Chap. 1, two excerpts from Chap. 3.*
- Dani Rodrik, *The Globalization Paradox* (Norton, 2011), Chap. 4.*
- Christina Romer, “Do Manufacturers Need Special Treatment?” *New York Times*, February 4, 2012.*
- Laura D’Andrea Tyson, “Why Manufacturing Still Matters.” *New York Times Economix Blog*, February 10, 2012.*

Modern economic nationalism can be seen as neo-mercantilism in the pursuit of industrial growth, usually with some reference to international security as justification. Nationalists often appeal to what in international relations is known as Realism or *realpolitik*—namely, that states rationally pursue power because the world is anarchic and, as a consequence (to quote the Athenians recorded by Thucydides) “the strong do as they will and the weak do as they must.” Because it usually favors trade protection for infant or strategic industries, this viewpoint appears to collide head-on with Adam Smith. Recall that he anticipated and responded to the infant-industry argument, IV.ii.13-14), but he also favored the Navigation Acts on what sounded like nationalist grounds (*ibid.*, 24-30). In the nineteenth-century USA, protection (inspired by Alexander Hamilton) was the rule rather than the exception, especially after the Civil War defeated the strongest economic bloc then in favor of free trade, the slave-owning class of the South. In its contemporary manifestations, economic nationalism in the USA is more likely to be an apology for other forms of industrial policy; elsewhere, it tends to argue that globalization is actually reducing poor countries’ ability to catch up economically. Beneath these arguments, its champions also often diverge from economic liberalism on more basic philosophical points about human nature. We will compare these points to Smith not only in *The Wealth of Nations* but also in *The Theory of Moral Sentiments*.

We begin with Buchanan because he is most typical of the genre. Thurow (Williams '60) shows the divergence from liberalism in key philosophical assumptions, while the excerpts from Chang present a perspective from developing countries. The next reading by Dani Rodrik, a Harvard economist, is an excerpt from a book with a foot in each camp, in order to remind us what the case for free trade is and how its complications might relate to the nationalists’ worries. The two final, short readings by Christina Romer and Laura D’Andrea Tyson, both Berkeley economists and former chairs of the Council of Economic Advisors (under Obama and Clinton, respectively), elaborate on some of the economic arguments that Rodrik alludes to, and present contrasting views on the practical implications for the wisdom of government intervention to promote or protect a country’s manufacturing industries.

Discussion questions:

1. Is Smith’s exception for defense (recall his discussion of the Acts of Navigation in *WN*) large enough to warrant Buchanan’s position?
2. Much of what Buchanan argues can be seen as an appeal to patriotism and national community sentiments—in particular, that we ought to value these attachments over narrow economic interest (say, Wal-mart’s low prices) or international transactions. What do you think? How far is this from Smith in *Moral Sentiments*?
3. “Man is a consumer, but he is also a tool-using animal. As a tool-using animal, work is not a disutility. It determines who one is. Belonging, esteem, power, building, winning, and conquering are all human goals just as important as maximizing consumption and leisure” (Thurow, p. 118). Is this right? How might a living Adam Smith (or maybe Coase) respond?
4. “Humans are individuals, but they are also herd animals. In herd or pack species the desire for equity (a share of the earnings) is not a perverse human desire that has to be suppressed but a glue that can be used to generate solidarity and a willingness to sacrifice for the welfare of the group” (Thurow, p. 122). Is this right? How different is it from the Smith of *Moral Sentiments*?
5. Does Chang adequately address the objections of Smith to the “infant-industry” argument? How do we tell

when the “infants” no longer deserve protection?

6. Do the arguments in the Rodrik, Romer, or Tyson readings offer any insight into the anxieties of Buchanan, or of Chang? Do they differ in their policy implications?

D. Irrationality and Financial Crises

Mon 11/24 Psychology, Irrationality, and Economics

- Richard Thaler and Cass Sunstein, *Nudge* (2007), Introduction and Chaps. 1-4, 6, and 17 (pp. 1-82, 103-119, 239-54 in the revised and expanded edition).
- Robert Shiller, “Infectious Exuberance,” *Atlantic Monthly*, July/Aug 2008.*

In their breezy bestseller *Nudge*, Chicago economist Thaler and law professor Sunstein summarize some of the most important findings of “behavioral economics” (the study of the role of psychology in economic behavior), discuss what they see as the policy implications, and argue for a “third way” between liberalism and *dirigisme* that they label “libertarian paternalism.” The key idea is the “nudge,” the deliberate, reasoned structuring of choices in order to promote good ones (but without making other choices too difficult), for example by setting a socially optimal choice as the default option and counting on inertia to make it the most common one. To make their argument more comprehensible they label agents who act according to the rationality premises of neoclassical economics “Econs” and those who act as revealed by behavioral economics “Humans.” This involves a further duality, between our “reflective” (rational) part and the part which, for Humans, often actually makes the decisions. We read the opening chapters, one on retirement savings, and one in which the authors answer assorted objections.

The short reading by Shiller makes the case that irrational psychology helps explain the dramatic changes in housing prices in recent years. He also considers some possible policy responses.

Discussion questions:

1. What does “rationality” mean to an economist? What evidence do we have that people behave in irrational ways? Can we really be so sure that this evidence of irrationality can’t actually be explained as plausibly rational if you think about it a different way?
2. One critique of behavioral economics is that its findings are often derived from artificial laboratory experiments where the economic stakes are very small. Perhaps when more is at stake, people are more careful to behave rationally. Do you think there is enough compelling evidence of irrationality in decisions where the stakes are large to support Thaler and Sunstein’s arguments?
3. According to Thaler and Sunstein, what are the situations in which nudges are most needed or justifiable? Why? Can you think of any examples from your own experience?
4. Thaler and Sunstein claim that the good choices resulting from their “nudges” are in fact what the people making them really want. How do they know this? Why shouldn’t we take what people actually do as the best indicator of what they really want?
5. Does libertarian paternalism go too far, or not far enough? For example, it has been estimated (by Jon Gruber) that the negative externality from smoking cigarettes is about \$1 per pack, but the expected present value of damage to one’s future self from smoking is about \$35 per pack. Should government nudge people to smoke less, charge a \$1 tax per pack of cigarettes, charge a \$35 tax per pack of cigarettes, ban smoking, or do something else?

Thu 11/27 No class (Thanksgiving)

Mon 12/1 The Recent Financial Crisis: A Failure of Capitalism?

- Robert Solow, “How to Understand the Disaster: a review of Richard Posner, *A Failure of Capitalism*,” *New York Review of Books* 5/14/09.*
- James Kwak and Simon Johnson, “Securitization, CDOs, and Banking Capital,” and “Credit Default Swaps.” from *The Baseline Scenario* blog (<http://baselinescenario.com>), 2008.*
- Michael Lewis, “The End,” *Portfolio*, December 2008.*

- Janet Yellen, “A Minsky Meltdown: Lessons for Central Bankers,” *FRBSF Economic Letter* 2009-15 (May 1).*
- Russell Roberts, “Gambling with Other People’s Money: How Perverted Incentives Caused the Financial Crisis,” Mercatus Center, George Mason University, May 2010, read summary and sections 1-2, 8-9, skim the rest.*
- Paul Krugman and Robin Wells, “The Slump Goes On: Why?” *New York Review of Books* 9/30/2010.*
- Barry Ritholtz, “Examining the Big Lie: How the Facts of the Economic Crisis Stack Up” *Washington Post* 11/19/2011.*
- Noah Smith, “How Much Value Does the Financial Industry Create?” *NoahOpinion Blog* 20 Jan. 2013.*
- Bruce Bartlett, “‘Financialization’ As a Cause of Economic Malaise,” *NY Times Economix Blog*, 6/11/13.*

The first reading by Solow provides an accessible overview of standard economic explanations of the recent financial crisis. The Kwak and Johnson reading offers concise explanations of “collateralized debt obligations” and “credit default swaps,” which played a big role in the crisis in the USA. The next reading is an engaging story about what was happening on Wall Street in the years leading up to the financial crisis, told by Michael Lewis (author of best-sellers such as *Liar’s Poker* and *Moneyball*).

The next several readings are more comprehensive and systematic in their search for causes and policy implications of the crisis. Yellen spotlights the financial instability hypothesis of Hyman Minsky (although she assumes her audience’s familiarity with it), and Krugman and Wells mention him in passing too. In a nutshell, Minsky posited that borrowing for asset purchases could be of three types: hedging (in which the borrower can expect to pay back both interest and principal from earnings on the invested capital); speculative (in which the borrower can pay back only interest, so must roll over the principal portion of the loan); and Ponzi (in which the borrower cannot fully pay even the interest due, and can only remain solvent as long as appreciation of the asset allows renegotiation of loan terms or its sale can pay off the loan). Minsky thought that financial instability was born out of financial stability: long periods of stable asset markets and low risk premia would breed confidence among agents about the likelihood of stable or rising prices in the future; in this environment, as market participants naturally sought greater yield, their borrowing would move from hedging to the speculative and Ponzi types. Once the last two come to dominate the universe of borrowers, the stage is set for a meltdown. Roberts points in a different direction: to moral hazard. This was created by what he regards as reasonable expectations (based on past bailouts) of a government bailout of creditors of private financial firms, as well as the expectation that the GSE’s (Fannie and Freddie) would enjoy a government backstop in the event of a crisis (as in fact they did). Krugman and Wells and Ritholtz check in with lists of facts and arguments about the crisis that they think should orient how we assess its causes and policy implications. They offer useful empirical challenges to several of the other readings.

The final two readings zoom out and ask an even harder question: how big a financial sector is economically optimal? Smith summarizes several papers in a widely cited 2013 issue of *Journal of Economic Perspectives*, as well as a few responses to them, while Bartlett casts the net even wider in his discussion of recent research on the topic.

Discussion questions:

1. Choose one example of a private institutional structure or relationship (say, investment banks, mortgage brokers, CDO markets, rating agencies) and one of a public structure or regulation (say, the Fed, the GSE’s, Gramm-Leach-Bliley) that arguably contributed to the financial crisis. What is the evidence for the role of each? Against?
2. How does taking account of the experiences of other countries during the 2004-09 period change our assessment of the likely causes of the financial crisis in the United States?
3. Why would rational actors participate in an asset bubble? In answering this question, how would a Minsky model differ from one preferred by Roberts? Based on what we’ve read about the recent crisis and other experiences, which is a better answer?
4. In the wake of the crisis and recession, do you think central bankers should act to deflate asset bubbles? Does the answer differ depending on which assets are experiencing the inflation? What might be some of the political obstacles to doing so?
5. Is “financialization” a natural product of mature capitalism, or is it evidence of rent extraction based on informational asymmetries, and therefore parasitic upon productive enterprise? Or is this a question which, perhaps in the spirit of Hayek, we should not ask?

IV. CONCLUSION: BACK TO POLITICS AND MARKETS

Thu 12/4 Failures of Government

- James Buchanan, "Rent Seeking and Profit Seeking." Chap. 1 from James M. Buchanan, Robert Tollison, and Gordon Tullock, eds., *Toward a Theory of the Rent-Seeking Society* (Texas A&M University Press, 1980).*
- Greg Rushford, "Don't Bother to Compete; Hire a Lawyer," *WSJ* 9/21/95.*

We give liberals the last word. As we have noted in passing, liberal theorists are skeptical that government officials necessarily act according to some broadly conceived general interest. They argue that we should assume that public officials act according to their narrow self-interest, just as businesspeople and consumers are usually assumed to do. In particular, those businesspeople will waste resources trying to influence government instead of staying focused on improving their product and running their businesses more efficiently. As this suggests, "public choice" theorists maintain that the problem of "government failure" is often more costly than the problem of "market failure" that government intervention seeks to cure.

For the concluding class, we have assigned a short piece by another Nobel Prize-winning economist, James Buchanan, and a snippet from the *WSJ* that shares his ideas.

Discussion question:

1. Do these readings pose a decisive challenge to the various critics of liberalism we have studied in the second half of the course? (Answer with reference to one or two particular critics.)