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POLITICAL ECONOMY 250
ECONOMIC LIBERALISM AND ITS CRITICS
Fall 2017

Economic liberalism holds that society is better off if people enjoy economic freedom. Its critics point to what they believe this position ignores or what it wrongly assumes, and hence, how it would make bad policy. This course explores the relationship between politics and economics by surveying influential works of political economy. Its first part examines major thinkers in relation to the historical development of capitalism in Western Europe and the United States. The second considers mid-20th-century writers who revise and critique economic liberalism from a variety of perspectives, and its gets into related philosophical debates over the roles that normative concepts such as economic efficiency and distributive justice ought to play in guiding public policy. The third part surveys significant recent contributions relevant to the themes of the course, with applications to current public policy issues. The combination of the historical focus of the early part of the course with discussion of modern policy issues and debates in the latter part 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 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 first are meant to alert you to some of the most important issues raised by the readings, while the second intend 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. We also plan to supply some ungraded quizzes on Glow to help you with various technical concepts addressed in the "check your understanding" questions, and will provide further information on that later.

Division of professorial 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.

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 word limit of 650 words (this applies to the text of your essay, not counting the title page, citations, or references). Please provide a word count at the end of your essay (any word processing program can produce this). The rationale for this limit is threefold: (1) allowing you to write longer essays than your 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 essays address one of the "discussion questions" posed for that class. What makes a good short essay on material like this? The best ones have several things in common. They explicate what an author is saying in a certain passage, consider its logical and practical implications, and make some kind of critical commentary. That commentary might address the author's assumptions, logic, consistency with evidence, interesting open empirical questions suggested by the work, or practical implications for policy. They acknowledge and respond to counter-arguments and counter-evidence. In other words, the best papers go beyond just summarizing to add something of value. In doing so, they show an understanding of the author's position that is informed by the whole reading assignment and not just a few pages. As this implies, it's not a good idea to try to answer multiple discussion questions in one essay. In any case, your paper should say clearly up front what thesis you intend to argue for.

By the way, we appreciate and reward papers that tackle a higher degree of difficulty. But beware of listing lots of conclusions without explaining the logic of your arguments. If you use technical jargon or even a common technical-sounding phrase (e.g., "economic efficiency"), explain what it means. This demonstrates that you understand what you are talking about, and makes your writing clearer. Also, we realize that these are short papers, but if you are going to make a strong empirical claim, please back it up with some empirical evidence and, if it's not obvious, say how this evidence supports your claim. For instance, how do we know the correlation you are describing is not caused by some other explanation than the one you are emphasizing?

Finally, given that you only have 650 words, you should avoid lengthy introductory and concluding paragraphs that reiterate what you say in more detail in the body of the essay. It's best to state your point clearly and briefly up front and then get to your full explanations and arguments quickly.

Observe the **Honor Code** guidelines for independent work (which can be found in the *Student Handbook* at <http://sites.williams.edu/honor-system/avoiding-violations/#general>). 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.") Citations are important both to give appropriate credit, and to signal what part of the text you are talking about and to help back up your claims regarding your interpretation of what the author means. It is wise to use quotations sparingly, as you only have 650 words and you need to demonstrate that you understand the ideas well enough that you can explain them clearly and accurately.

In this class we do not allow students assigned to write on Mondays to submit essays on Thursdays, or vice versa. We have found that if we let one person do this, everybody would want to do it -- at the end of the semester. The paper submission schedule works well 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 since we only count the best eight out of twelve papers, we understand if you cannot turn in a paper in a particular week. However, a paper submitted late gets penalized one full letter grade (e.g., A- changes to B-) for each day or portion of a day it is late. We intend the papers to serve as preparation for considering the material in class, and if a late paper benefits from class discussion, it has an unfair advantage in evaluation.

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. The ability to formulate good answers to randomly selected discussion questions and "check your understanding"

questions on the syllabus, and to correctly answer questions similar to the ungraded quiz questions we post on Glow, will be critical to a good performance on the final exam.

READINGS

The following required books should be available at the College bookstore on Spring Street:

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

All other readings, aside from the books listed above, will be made available in printed reading packets, and also as PDFs on the course Glow web site. The first printed course reading packet, covering readings assigned for classes through the end of September, is available now in the reading packet room, which is 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.

GLOW COURSE WEB SITE

You can find the class web site in the new version of Glow <<https://glow.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 9/7 Introduction and Organization

I. CLASSICAL THEORIES OF POLITICAL ECONOMY

A. Free-Market Liberalism: Adam Smith

Mon 9/11 Adam Smith: Principles of a Free Market Economy

- *The Wealth of Nations* (henceforth *WN*), read the “Introduction and Plan of the Work” plus [referring to book (I-V), chapter (i, ii, iii, etc.), then section or paragraph (1, 2, 3, etc.)]: I. i-iii; iv 1-5, 11-18; v 1-10; vi 1-10, 18-24; vii 1-32. (In the Glasgow/Liberty Press edition, the pages are 10-39; 44-51; 65-68, 69-80). [The references that are *not* in parentheses give you the book number, chapter number, and section number following Adam Smith's original numbering scheme. The page numbers listed in parentheses at the end are particular to the specific edition we're reading. 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" (ii 1, p. 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" (vii 8, p. 73)? How do Smith's definitions compare with those of modern economics? Why is the distinction important?

Thu 9/14 Adam Smith: Progress and Policy

- *WN* Book III. Chapter iv, paragraphs 1-7, 10-18; Book IV. ii 1-15, 23-45; IV. ix. 50-52; Book V. i.b. 1-2, 14-21, 25; V. i.c. 1-2; V. i.d. 1-8, 18-19; V. i.f. 1-7, 14-16, 47-61; V. ii.b. 1-6; V. ii.e. 6, 9-11 (Glasgow pp. 411-15, 418-22; 452-59, 463-72; 687-88; 708-10, 716-21, 722-26, 730-31; 758-60, 763-64; 781-88; 825-27; 842, 843-44).

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 of his argument about how to maximize national product (IV. ii. 5-9, 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 (V. ii.b., pp. 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 (IV. ii. 42-43, pp. 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? What happens to the lord's retainers?
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 (IV. ii. 24-30, pp. 463-65)? If the Acts of Navigation fall under it, what would not? (Would, say, a Chinese firm's purchase of a US avionics company?)
4. Thinking of Smith's discussion of justice and revenue (I. i.b. 13-23, pp. 715-22), and his discussions of human dispositions elsewhere, 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" V. i.c. 1-3 and d. 1-8, 18-19 (pp. 723-26 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?

- Smith indicts the division of labor for its effects on the minds of workers (V. i.f. 50-57, 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?

Mon 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:

- For Smith, how are our moral rules derived? What are the roles of reason, sentiment, and public life? Does Smith help us understand the stories about traffic in Bogotá and diplomatic parking tickets in Manhattan?
- 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)?
- 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?
- Does *The Theory of Moral Sentiments* solve the problems of *The Wealth of Nations*? In particular, does it suggest a) why our self-interest does not lead to a war of all against all, and b) where honest judges come from? How might the examples from Fisman and Miguel relate to these issues?

B. The Radical Critique of Economic Liberalism

Thu 9/21 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 are 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 try to find out what he and Engels think 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 the 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 (pp. 395-96), 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 KEYNES

Mon 9/25 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.*
- Joel Slemrod and Jon Bakija, *Taxing Ourselves*, 5th ed. (2017), excerpts on "Why Recessions Happen," "Monetary Policy," "Fiscal Policy," "Budget Deficits and Surpluses," and "Tax Cuts to Force Spending Cuts versus Surpluses to Prepare for an Aging Population," pp. 147-161, 164-168.*
- 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.*
- Lawrence H. Summers. "The Age of Secular Stagnation: What It Is and What to Do About It." *Foreign Affairs*,

March / April 2016, pp. 2-9.*

- Tyler Cowen, “U.S. Can Afford Trump’s Radical Tax Cut.” *Bloomberg*, April 26, 2017.*

John Maynard Keynes (1883-1946) 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 next time. 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).

In today’s class, we will try to understand Keynes’s key insights about why recessions and depressions happen and what we can do about them, and then will consider their relevance to our current economic predicament. 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 in response to *The General Theory*. 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.”

While Keynes’ writing is full of brilliant insights and in some sense invented the field of macroeconomics, it is also easy to misinterpret, so you need to read carefully. As economist Paul Samuelson said about Keynes’s *General Theory*,

It is a badly written book, poorly organized; any layman who, beguiled by the author's previous reputation, bought the book was cheated of his five shillings. It is not well suited for classroom use. It is arrogant, bad-tempered, polemical, and not overly generous in its acknowledgments. It abounds in mares' nests or confusions. In it the Keynesian system stands out indistinctly, as if the author were hardly aware of its existence or cognizant of its properties; and certainly he is at his worst when expounding its relations to its predecessors. Flashes of insight and intuition intersperse tedious algebra. An awkward definition suddenly gives way to an unforgettable cadenza. When finally mastered, its analysis is found to be obvious and at the same time new. In short, it is a work of genius.

Given all this, below we offer a guide intended to help you avoid some confusions that often crop up when reading Keynes in the original.

In today’s reading, 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 logic behind 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 today’s 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.

When reading Keynes, remember that to an economist, *investment* can have two distinct meanings. In economics, “investment” usually means purchase of physical capital (such as productive machinery, tools, or buildings, e.g., a factory) and purchase of newly constructed homes. But “investment” is also sometimes used colloquially to mean 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 usually uses the term “investment” in the economics sense of the term (purchase of productive physical capital and newly constructed

homes), but occasionally uses it in the more colloquial sense of the term.

Also remember 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). Remember that “money” does not equal “saving” or “wealth!” Rather, money is just one kind of financial asset that people can choose to store their saving in, but it is only one among many possible portfolio choices. Households and businesses save their funds in many different forms, including not only money but also bonds, stocks, mutual funds, etc. Typically only a very small fraction of all saving (say, two percent) is done in the form of money. “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%.

Be careful when interpreting what Keynes means by “hoarding money.” He does *not* mean hiding cash under mattresses, or otherwise taking money out of banks and holding it as cash. Remember that money includes both cash and checking accounts, and when Keynes refers to “hoarded money,” he is mainly referring to money kept in checking accounts at the bank. Those funds will usually be lent out by the bank, not removed from circulation. Keynes’s theory is *not* about saved money being hidden under mattresses instead of being turned into investment – it is more sophisticated than that, so if you think that is all he is talking about, keep working at it. Keynes is also careful in several places to emphasize that his theory is *not* about what happens when there is an increase in the quantity of money that is hoarded. Rather, it is about what happens when there is an increase in the “propensity” or desire to hoard money, but the quantity of money supplied is fixed. Roughly speaking, Keynes’s “propensity to hoard money” translates in modern economic terminology into “demand for money.”

To understand Keynes in context, it is also helpful to keep in mind that at the onset of the Great Depression and for some years afterwards, the U.S., Britain, and most other industrialized nations were on the gold standard. Each country’s currency was fixed in value against a certain quantity of gold, and that effectively meant that all the countries on the gold standard had fixed exchange rates relative to each other. If a country wanted to maintain its gold standard, then it could not freely adjust its money supply to stabilize its economy. Rather, the money supply had to be set at whatever level would maintain the fixed exchange rate with gold. For example, if a country on the gold standard attempted to push down interest rates by expanding the money supply, people would respond by selling that nation’s currency on the foreign exchange market (for example because the country’s assets would no longer be attractive due to the lower interest rate). In that case the country’s central bank could only maintain the fixed exchange rate with gold by using its gold reserves to buy up its currency on the foreign exchange market. That would not be sustainable, as the country would eventually run out of gold reserves. This is one reason why Keynes did not consider the option of increasing the money supply in the reading – instead, most of his discussion proceeds assuming the supply of money in the economy is fixed.

The second reading, excerpted from a book by Joel Slemrod (economist at the University of Michigan) and Professor Bakija, provides an explanation of Keynes’s main insights regarding the causes of recessions and how monetary and fiscal policy might cure them. It also discusses the problem of the “zero lower bound” on nominal interest rates (Keynes wrote about this problem elsewhere, calling it a “liquidity trap”). The Slemrod and Bakija reading then considers how these ideas fit into modern debates over monetary policy, fiscal policy, and the government budget in the U.S.

The third reading by economists Paul Krugman and Robin Wells, “Reconciling the Two Models of the Interest Rate,” presents diagrams that you saw in introductory macroeconomics, and which can help you understand the economic logic behind the arguments laid out in the previous two readings. It presents 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”). The fourth reading, “Zero Bounds and Butter Mountains” by Krugman, uses the latter of those two diagrams to help illustrate what is going on in a “liquidity trap.”

The fifth reading is by Larry Summers, a leading modern economist who has also served as Treasury Secretary (under Bill Clinton) and President of Harvard. Summers discusses the Keynesian-inspired theory of “secular stagnation,” and explains why he is increasingly convinced that it explains our current economic

predicament. Summers argues for aggressive policy actions to boost demand in the economy, including major and sustained deficit-financed expansionary fiscal policy, even as others (including many on the U.S. Federal Reserve Board) are currently arguing that the U.S. economy has nearly returned to normal so that we should turn our attention again to keeping inflation at or below a 2 percent target and to cutting the government budget deficit.

The final brief reading by Tyler Cowen argues that the same logic that Summers uses to argue for expansionary fiscal policy in the form of deficit-financed government infrastructure investment also applies to tax cuts proposed by the Trump administration.

Check your understanding:

1. Work out the argument that Keynes is making in the first reading using the diagrams from the Krugman and Wells reading. Hints: start with a shock that shifts the demand for loanable funds curve to the left, and hold the supply of money fixed. Then figure out what happens next on both diagrams, and how this leads to a recession.
2. (Challenging!) Continuing the scenario and diagrammatic analysis from question 1, why and how would falling prices eventually (in the “long-run”) return the economy to its potential?
3. Would falling prices still help if we hit the zero lower bound on interest rates before the economy recovered? Or would that make things worse? Why?

Discussion questions:

1. The key to Keynes’s explanation for why Say’s law breaks down, and thus why recessions can happen, is *money*. Explain Keynes’s argument about the central role of *money* in causing Say’s Law to break down, and explain why the peculiar social institution of money is critical to understanding how an economy can spiral into a persistent recession or depression. How does hitting the zero lower bound on nominal interest rates (discussed in subsequent readings) exacerbate these problems? How can public policy respond, and what is the logic for why the response would help?
2. As we write this syllabus, the unemployment rate in the U.S. is arguably back to normal, yet slow economic growth, low inflation, and extremely low interest rates persist, while the long-term future government budget problems discussed by Slemrod and Bakija loom. Larry Summers argues that persistently slow economic growth, low inflation, and low interest rates are best explained as symptoms of “secular stagnation.” What is secular stagnation, and how does it connect to Keynes’s ideas? Do you think Summers makes a compelling case for addressing secular stagnation by engaging in expansionary fiscal policy now? Does this justify Trump’s proposed deficit-financed tax cuts? Or, do you think it is time for the U.S. government to undertake reforms that would significantly reduce current and future budget deficits? Why? What does it depend on? What are the best arguments on each side?

Thu 9/28 Keynes on Uncertainty, Finance, and Investor Psychology, with Applications to the Recent Financial Crisis

- 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, [Excerpt, pp. 75-77 and 84-94].*
- Paul Krugman and Robin Wells, “The Slump Goes On: Why?” *NY Review of Books*, September 30, 2010.*
- Robert Shiller, “Infectious Exuberance,” *Atlantic Monthly*, July/Aug 2008.*
- Ing-Haw Cheng, Sahil Raina, and Wei Xiong, “Wall Street and the Housing Bubble,” *American Economic Review*, September 2014 [Excerpt, pp. 2797-2801].*

Today’s class on Keynes explores his views on uncertainty, finance, and investor psychology, and the implications for macroeconomic instability, and then connects these ideas to subsequent evidence and events such as the recent financial crisis. Make sure that you read the background information we have provided on the syllabus for Keynes from the previous class above (along with the readings for that class!), as those are critically important for helping you to interpret and understand the readings for today’s class.

We start with a brief reading by Frank and Bernanke which reviews basic economic principles regarding the determination of prices of assets such as 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.

Next, we 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 third 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 attempts to reconcile the efficient markets hypothesis 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.

Malkiel uses some possibly unfamiliar financial jargon, which we'll explain here. "Arbitrage" 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.

The Krugman and Wells reading discusses leading theories for why there was a boom and then bust in housing prices in the early 2000s that led to the worst financial crisis and recession in the U.S. (and many other countries) since the Great Depression. Readings by economists Shiller and by Cheng, Raina, and Xiong present additional relevant arguments and evidence about the housing "bubble."

Check your understanding:

1. Consider an asset that you expect will pay you a \$10 dividend per year forever, with no risk, and no expected capital gains or losses. 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?
2. 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 3? Why?

Discussion questions:

1. Considering the Keynes reading from the previous class and from today's class, what is the crucial distinction between "uncertainty" and "risk?" How does Keynes think investors make decisions in the face of uncertainty? What role do uncertainty, and the associated fluctuations in business confidence and "animal spirits," play in exacerbating the problems of macroeconomic instability highlighted in our previous class? What, if anything, does this imply for policy, and for how we should interpret the empirical evidence presented in today's readings?
2. 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? 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?
3. Do the ideas in the Keynes reading for today do a good job of explaining the rapid rise and then crash of housing prices during the early 2000s, and the subsequent financial crisis of 2008-2009? Which facts about housing and the financial crisis discussed in the other readings are consistent or inconsistent with Keynes's theories, and with competing explanations for the financial crisis discussed by Krugman and Wells? Why does any of this matter? (Note that it is not possible to address every possible argument and piece of evidence in a short essay, so choose what you think are the most compelling arguments and pieces of evidence, and defend your choices).

III. MID-20th-CENTURY ARGUMENTS

A. Defenses of the Market

Mon 10/2 Hayek's Cases against Central Planning and Excessive Government Interference in the Economy

- F. A. Hayek, *The Road to Serfdom*, Chaps. 3-6, portions of Ch. 9 (beginning through bottom of p. 154 in the Caldwell edition, omitting "The general endeavor to achieve security..." through end of chapter), and portions of Ch. 14 (beginning through top of p. 213 in Caldwell edition, ending with "impersonal forces.").

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. Hayek also addresses questions about what he thinks are appropriate and inappropriate government interventions into a free market economy.

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. 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?
3. Hayek thinks central planning is likely to kill democracy. Why? Do you think his arguments about this can be reasonably extended to modern social welfare states (e.g., Sweden, and possibly the U.S.) that have high levels of taxation, redistribution, and social insurance, but which are still basically free market economies not engaged in central planning? (In the preface to the 1976 edition, Hayek claimed they could). Why or why not? What historical evidence, if any, can you bring to bear on this?
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). Where do you think Hayek would draw the line between appropriate and inappropriate government intervention into a market economy, and why would he draw it there? What are the tradeoffs, and how would he balance them? Do you think he gets this right? Why or why not?
5. Hayek is willing to accept a significant amount of economic inequality as long as it is the result of a competitive market, and to let people suffer unexpected and permanent losses of income in response to natural changes in the market that promote economic efficiency. Does he take these positions because he believes that people morally deserve whatever income the competitive market pays them? What is his reasoning? Do you agree? Why or why not?

Thu 10/5 Milton Friedman I: 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 is not clear, what he calls "neighborhood effects" are now generally called "externalities.")

Discussion questions:

1. 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 (whether or not a Democrat)?
2. 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?
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). But later, when discussing restrictions that remain, he argues against government intervention with an example of two singers whose incomes depend on the public's musical tastes. What do you think?
 4. What kind of lottery is Friedman describing in his discussion of income distribution (162-63)? How does it relate to his other arguments?
 5. 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? Would Hayek? What would this position imply for, say, tax policy?

Mon 10/9 No class (Reading Period)

Thu 10/12 Milton Friedman II: Liberal Principles Applied

- *The Economist*, "State and Market," February 17, 1996.*
- Milton Friedman, *Capitalism and Freedom*, Chaps. 6, 11-13 (+ review Ch. 2).

The first reading from *The Economist* and parts of chapter 2 in Friedman which you read last time (and should review for this time) briefly discuss economic efficiency and market failure, concepts you should have learned about in some depth in principles of microeconomics. 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 of *Capitalism and Freedom*, 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.

One note on terminology: when Friedman talks about "nationalization" versus "denationalization" of schools, he is not talking about whether education policy is set at the federal government level versus at the state or local government level. Rather, he uses the term "nationalized" to mean that the schools are owned and run by the government (at whatever level – national, state, or local), and "denationalized" to mean a system where the government provides the funding for the schools (e.g., through vouchers) but the schools are largely privately owned and run. In the 1950s and 1960s, "nationalization" was a commonly used term for government takeover of private businesses and industries (regardless of the level of government that did it), a practice that had occurred in many communist and some capitalist countries.

Check your understanding:

1. 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 maximize economic surplus)?

Discussion questions:

1. 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

B. Philosophies of Distributive Justice and the Tradeoff between Efficiency and Equity

Mon 10/16 Economic Efficiency, Social Welfare, and Distributive Justice

- David Friedman, *Hidden Order: The Economics of Everyday Life* (1997), Chap. 15.*
- Uwe Reinhardt, "How Economists Bastardized Benthamite Utilitarianism."*
- 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, Distributive Justice, and the Tradeoff between Equity and Efficiency" (2016)*
- David Weisbach, "Redistribution," from "Should Legal Rules be used to Redistribute Income?" *University of Chicago Law Review*, 70 (2003), pp. 440-446 only.*
- Richard Arneson. "Justice." in David Estlund, editor, *The Oxford Handbook of Political Philosophy*. Oxford: Oxford University Press, 2012, portions of pp. 58-75.*
- John Roemer, "Ideological and Political Roots of American Inequality." *Challenge*, September-October 2011 [Excerpt, portions of pp. 76-80 and 88].*

Milton Friedman's philosophy might be summarized as the almost single-minded pursuit of economic efficiency, tempered only by a desire to preserve freedom. Among economists, Friedman's heavy emphasis on economic efficiency is far from unique, although it is often tempered by an acknowledgement of other, sometimes competing, ethical goals beyond freedom. Nonetheless, the concept of economic efficiency plays an enormous role in economic policy analysis and is the most frequently appealed-to normative concept in economics. The readings for this class offer a deeper understanding of the concept of economic efficiency and its strengths and limitations. They then consider various philosophies of distributive justice and the arguments and debates about them, and show how concerns about efficiency and justice can, in principle, be integrated in an evaluation of what and how much government policy ought to do to mitigate economic inequality.

We start with a reading by David Friedman (son of Milton, and a physicist who teaches law at U. Santa Clara) which 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 it is a critical concept to understand.

In the second reading, Uwe Reinhardt, and economist at Princeton, takes a rather less sanguine view of idea that economic efficiency ought to be our sole normative criterion. Reinhardt concludes "It should be clear to you now that modern economic welfare analysis, based as it is on willingness to pay criteria, can easily end up favoring wealthier people who can bid higher money prices for a thing in question than can poorer people. In this sense, then, bastardizing Benthamite utilitarianism, as economists have done, is anything but objective science." Make sure to read this one carefully to get a clearer understanding of what the concept of economic efficiency actually means and implies.

The next reading, from Harvard economist Greg Mankiw's textbook, reviews what you should have learned about the economics of taxation in introductory economics. This should help you understand what is going on in the rest of the readings. The reading by Prof. Bakija discusses how economic efficiency and various concepts of distributive justice can be integrated in the evaluation of policy changes, including for example changes in taxation and transfers intended to address economic inequality, and considers how the "optimal" degree of redistribution varies depending on various factors such as the responsiveness of productive economic behavior to incentives. David Weisbach (a law professor at U. Chicago), elaborates on these same issues, illustrating in a different way the ideas of social welfare maximization under utilitarian and Rawlsian philosophical perspectives. The reading by Richard Arneson, a philosopher at UC San Diego, provides further discussion several different philosophies of distributive justice and debates among them, including among others utilitarianism, Rawlsianism, libertarianism, and "luck egalitarianism." Finally, John Roemer, a prominent luck egalitarian philosopher and economist at Yale University best known for his work on the concept of equality of opportunity, offers a philosophical discussion of what kinds of economic inequality he thinks are morally justified and what kinds are not, and gives some examples of what the practical policy implications might be.

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? In other words, is it an improvement in economic efficiency? Why or why not?
2. 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?
3. 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?
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 factors such as the degree of economic inequality and the curvature of the utility function affect the social welfare maximizing amount of redistribution in the utilitarian framework? Why?
6. Would a utilitarian support raising tax rates on the rich up to the peak of the Laffer curve? Why or why not?
7. Does the Rawlsian maximin principle imply that public policy should be designed so as to achieve complete equality of incomes across people? Why or why not?

Discussion questions:

1. Select any two of the philosophies of distributive justice below, and compare and contrast how they would evaluate the question of what, and how much, government policy should do to mitigate economic inequality across people (for example through taxes and transfers). In each case, discuss what factors the optimal policy would depend on, and how and why changes in each of those factors would affect the optimal policy. How would concerns about economic efficiency be factored in, if at all? Which philosophy do you find more compelling, and why? Or would you prefer some combination?
 - a) An ethic that only values economic efficiency
 - b) Utilitarianism
 - c) Rawlsianism
 - d) Luck egalitarianism
 - e) Nozick-style libertarianism

C. Economic Liberalism, Market Failure, and the Firm

Thu 10/19 Microeconomics and Renascent Liberalism: Ronald Coase

- Ronald Coase, "The Problem of Social Cost." *Journal of Law and Economics*, 1960, Vol. 3, excerpt, pp. 1-2, 8-10, 16-20, 27-35, and 39-44.*
- Steven Landsburg. 1993. "Of Medicine and Candy, Trains and Sparks." Excerpted from pp. 83-89 of *The Armchair Economist: Economics and Everyday Life*. New York: The Free Press.*
- Gary Becker and Julio Jorge Elias, "Introducing Incentives in the Market for Live and Cadaveric Organ Donations." *Journal of Economic Perspectives*, Summer 2007 (excerpts).*
- 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. Landsburg's piece offers an accessible discussion of some key insights in "The Problem of Social Cost" and their practical implications.

The third reading, by economists Gary Becker (a Nobel laureate) and Julio Jorge Elias, argues that it should be legal for someone to sell his or her own kidney. This raises some interesting questions about making property rights tradable, which is a central concern for Coase. Most people in the world right now do not have full tradable property rights to their own kidneys, because most governments have made it illegal for a person to sell one of his or her own kidneys. The article considers whether that should change.

In "The Nature of the Firm" (1937), Coase attempts to answer a question that occurred to 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 by Coase, 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, if transaction costs involved in bargaining are low enough, and if property rights are clearly defined and enforced, then the economically efficient use of resources will be obtained regardless of the distribution of property rights. How does this work? Given the importance of tradable property rights as stressed by Coase, do you think we should give people full property rights to their own kidneys, by making it legal for them to sell their kidneys? If we did have trade in human kidneys and if transactions costs were lower than the gains from trade, would it "matter" whether people were initially assigned property rights to the kidneys in their own bodies? How do the David Friedman and Uwe Reinhardt articles 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 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. For example, Coase contends that assigning property rights to a polluter can sometimes be a more efficient solution than a Pigouvian tax, even in the high-transaction cost case (41-42). What are his arguments 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 within-firm activity using methods similar to central planning, and is sacrificing some of the benefits of the competitive price system. Given this, why should firms exist at all? 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? Does Coase answer these questions adequately? Do you think Coase's arguments weaken Hayek's case for the price system and against central planning?
4. Following Coase, what effect might we expect, on the economically optimal size of firms, from recent advances in information technology?

D. Defenses of Politics, Equality, and Workplace Democracy

Mon 10/23 Equality and Rights

- Arthur Okun, *Equality and Efficiency*, Chaps. 1 and 2 (skip pp. 51-61, "The Collectivized Economy"), plus pp. 91-100 ("The Leaky Bucket Experiment").
- John Pfaff, "A Mockery of Justice for the Poor," *NY Times*, 4/29/16.*

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 some important areas of conflict between market distribution and democracy. 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. The recent piece from

the *Times* discusses a realm of criminal justice in which dollars really do make a difference to outcomes.

Discussion questions:

1. Why, for Okun, must a clear line be drawn between dollars and rights? Do you agree with his reasoning?
2. Thinking about the problems described by Pfaff, we might draw this 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?

Thu 10/26 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, 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 factors drive 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?

Mon 10/30 Power and Autonomy at Work

- Daniel Pink, *Free Agent Nation* (2001), Chap. 1 (pp. 9-25) and pp. 179-181.*
- Lawrence Mishel, "Uber is Not the Future of Work," *The Atlantic* Nov. 2015.*
- Annie Lowrey, "Instacart and the On-demand Middle Class," *New York Magazine*, 8/17/15.*
- 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). Pink’s heirs are now out in force praising the “gig economy” and the “sharing economy.” Mishel is a critic while Lowrey’s first-person account suggests why contracting could give way to an employment relationship. 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? Could the “gig economy” fulfill Pink’s dream? Thinking especially of Lowrey’s article, what limits might there be to the economic advantages of free agency and contracting?
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. Psychology, Social Norms, Asymmetric Information, Manipulation, and Deception

Thu 11/2 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).

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 is the most compelling evidence 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. 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?
 3. 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?
 4. 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? What if a teen-ager or young adult decides the personal benefits of smoking outweigh the personal costs because of a strong preference for current utility over future utility, but his or her older self disagrees when diagnosed with cancer? What if the question were about heroin?

Mon 11/6 Is "More of the Same" Feasible? Positional Goods and the Norms of Capitalism

- David Brooks, “The Power of Altruism,” *NY Times*, 7/8/16.*
- 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, 117-18, 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, a recent David Brooks column, complains about our selfishness, while offering a summary of recent research on altruism as an inborn trait. The next one vividly depicts paycheck envy during the 1998-2000 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? For example, do they contradict Hayek’s argument about the rich as society’s consumption scouts (*CoL* 43-44)?
2. What does Hirsch mean by the "tyranny of small decisions" (40, 53-54)? Is it really a “tyranny”? What are its consequences? (Contrast him to Hayek, *Constitution of Liberty* pp. 50-51.)
3. 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?
4. For Hirsch, why do a society’s moral resources inevitably get depleted? What consequences does he see for capitalism? What does Brooks add to this argument?

Thu 11/9 George Akerlof: Asymmetric Information, Manipulation, and Deception

- “The Market for ‘Lemons’: Quality Uncertainty and the Market Mechanism,” *Quarterly Journal of Economics* 84:3. (Aug. 1970), skip sections II.B. (pp. 490-92) and III.D. (497-99).*
- “Secrets and Agents,” *The Economist*, 23 July 2016.*
- (With Paul Romer) “Looting: The Economic Underworld of Bankruptcy for Profit,” *Brookings Papers on Economic Activity* 1993:2, pp. 1-4 only.*
- (With Robert Shiller) *Phishing for Phools*, preface, Introduction, Chapters 1 (“Temptation Strews Our Path”), 2 (“Reputation Mining”) through summary only, 9 (“Bankruptcy for Profit”) and excerpt from Afterword (pp. vii-xvi, 1-37, 117-23, and 169-73).*

“Asymmetric information,” in which one party to a transaction knows a lot more than does the other about the quality of the good or service being traded, has been observed for as long as markets have existed, but economists and policymakers did not fully realize its importance--and the analytical usefulness of the concept--until it was elegantly re-described in Akerlof’s 1970 paper. The summary from *The Economist* gives some context and describes the paper’s influence on how economists think about labor and insurance markets. We then turn to another influential Akerlof paper, this time about organizations rather than markets, one that has been especially influential in the analysis of corporate governance and finance. We read only the first four pages, because its argument is summarized in our last reading.

Phishing for Phools generalizes a common thread in the “Lemons” and “Looting” arguments into a kind of Gresham’s Law of (rational) opportunism, by which bad behavior drives out good unless institutions or norms push back. It has some points in common with *Nudge* and with Hirsch. Note that when it speaks of “monkey-on-the-shoulder tastes” it is referring to what the authors of *Nudge* called “Homer Simpson” or “Human” (vs. “Econ”) preferences. But Akerlof and Shiller’s main point is about how these preferences have been discovered and systematically exploited by market agents engaged in “phishing.”

Discussion questions:

1. One institutional response to quality uncertainty is for sellers to bear the cost of poor quality, via guarantees of replacement, refund, or repair. But in many markets we do not see this. Why not? What distinguishes markets that do from those that do not have this sort of response? Is there a role here for government?
2. What is looting, for Akerlof and Romer? How is it related to government policies?
3. What is “phishing for phools,” for Akerlof and Shiller, and why is it important? Why do they think it is not avoided or stopped by some invisible hand? How might it relate to Hirsch’s argument?
4. How do Akerlof’s works modify the Smithian concept of self-regulating markets? If you think their effect is substantial, what are the broader implications for the role of government in economic life? If not, why not?

B. Social Insurance, Health Care, Economic Inequality, and Climate Change

Mon 11/13 Insurance and Health Care, Part 1

- Jon Bakija, “Insurance and Asymmetric Information” (2016).*
- David Cutler, *The Quality Cure*, Chapter 1. University of California Press (2014).*
- Thomas Buchmueller and Helen Levy, “Health Reform in the Age of Trump.” In Chad Brown, ed., *Economics and Policy in the Age of Trump*, pp. 23-32 (2017).*
- Margot Sanger-Katz, “Why Keeping Only the Popular Parts of Obamacare Won’t Work.” *New York Times*, Nov. 15, 2016.*
- Uwe Reinhardt, “Republicans Can Repeal Obamacare. They Can’t Repeal the Logic of Health Insurance.” *Vox*, Nov. 23, 2016.*

The Bakija reading explains why insurance against risk is economically efficient, and then discusses how insurance markets can fail or operate inefficiently because of asymmetric information between buyer and seller. The chapter from David Cutler, a health economist at Harvard, discusses the design of the Affordable Care Act (ACA), popularly known as “Obamacare,” and provides an overview of the main challenges facing the U.S. system of health insurance and health care. Buchmueller and Levy, health economists at the University of Michigan, provide some further discussion of the design of the ACA, present some preliminary evidence on its effects, and discuss the current debate on repealing the ACA. Margot Sanger-Katz, a journalist, and Uwe Reinhardt, a health economist at Princeton, discuss unintended consequences that could arise from piecemeal efforts at reforming or repealing parts of the ACA.

Check your understanding:

1. Suppose you face a risk that leaves you with a 10 percent chance of having bad luck, in which case your consumption is \$0, and a 90 percent chance of having good luck, in which case your consumption is \$40,000. Further assume that your utility function is $U = \sqrt{C}$. Suppose there are many people just like you, and firms in a competitive insurance market offer an insurance policy that pays a benefit of \$40,000 in the event of bad luck.

Each firm incurs an administrative cost of \$100 per insured customer (regardless of their luck). How much consumer surplus do you get if you purchase the insurance?

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. Suppose we were starting from a hypothetical free market for insurance. If government enacted a regulation that prohibited insurance companies from using genetic information to help set premiums, would this make the insurance market more efficient or less efficient? Would it be a good thing? Compare and contrast how any two of the philosophies of distributive justice we have discussed in class we evaluate the latter question. Which do you think provides the more compelling answer, and why? What, if anything, do you think are the practical policy implications of your answer?
2. The Affordable Care Act was primarily intended to address equity and efficiency concerns arising from people who had been going without insurance due to low incomes, poor health status that made their health insurance premiums very high, or adverse selection. How does the design of the ACA attempt to address these problems, and how do the different parts fit together to achieve the program's goals? What do you see as the greatest strengths and weaknesses of this approach? What, if anything, is wrong with just getting rid of the unpopular aspects of the program?

Thu 11/16 Insurance and Health Care, Part 2

- David Cutler, *The Quality Cure*, Chapters 2-4. University of California Press (2014).*
- Margot Sanger-Katz, "The Big Problem With High Health Care Deductibles." *New York Times*, Feb. 5, 2016.*
- Austin Frakt, "Accountable Care Organizations: Like H.M.O.s, but Different." *New York Times*, January 19, 2015.*
- Katherine Baicker, Amitabh Chandra, and Jonathan S. Skinner, "Saving Money or Just Saving Lives? Improving the Productivity of US Health Care Spending." *Annual Review of Economics*. 2012. [Excerpt, portions of p. 34 and 47-51]*
- Eric D. Schansberg, "A Free Market for Health Care: The Possible Dream?" *Milken Institute Quarterly*, 3rd Quarter 2011, pp. 55-64.*
- Margo Sanger-Katz, "The Problem With GOP Plans to Sell Health Insurance Across State Lines." *New York Times*, August 31, 2015.*

The readings for this class meeting focus on inefficiently high levels of spending and inefficiently low quality in the market for health care in the U.S., and what can be done about these problems. Rising health care expenditures are the dominant budgetary challenge facing the U.S. -- the Congressional Budget Office predicts that if federal tax revenues remain constant as a percentage of GDP in the future, then federal spending on social security and healthcare will exceed that level of tax revenue by around 2040, meaning either that there will be nothing left for other government programs, or taxes will have to be raised significantly. Quality is also a big problem in the health care industry – while advances in health care have helped produce big increases in longevity over time, David Cutler (a Harvard health economist who helped advise the Obama administration during the development of the ACA) points out that “the death rate from medical errors... is the equivalent of a medium-sized jumbo jet crashing daily.”

Chapters 2-4 of *The Quality Cure* by David Cutler summarize empirical evidence on what factors have been driving the rapid rise in health care expenditures and to what extent this reflects inefficiency, describe a variety of approaches to controlling costs that have been implemented or proposed here and in other countries, and then present examples of private health care systems in the U.S. that have succeeded in providing health care of high-quality and efficient quantity, and consider what characteristics those systems have in common.

The remaining readings consider a variety of reforms that are all intended to improve the efficiency and reduce the cost of the U.S. health care system. Roughly speaking, most of the reforms can be thought of as broadly falling into three categories: (1) reforms to the system of paying health care providers, which are intended to incentivize the providers to behave more efficiently, and more like the examples in Chapter 4 of Cutler's book; (2) reforms that incentivize patients to economize on health care spending by requiring them to share more of the costs of the health care services they consume; and (3) reforms that attempt to facilitate, or remove obstacles to,

competition in the markets for health care and health insurance. The first reading by journalist Sanger-Katz discusses some evidence on how consumers respond to health insurance plans with high levels of cost-sharing (high-deductible plans). Health economist Austin Frakt introduces concepts such as “accountable care organization” and “capitation,” which play a big role in discussions of how to reform the system of paying health care providers. Health economists Baicker, Chandra, and Skinner summarize theory and evidence on the major approaches to improving efficiency in the health care system. The reading by Schansberg argues for several different “free market” reforms to the health care system, including for example changing the tax code to create strong incentives for consumers to choose high-deductible “catastrophic” health insurance plans, deregulating health insurance, and hoping that the deregulated private insurance market adopts innovations such as “health status insurance” that would protect people against the risk of insurance premium increases when their health status changes (e.g., onset of an expensive chronic disease). The second reading by Sanger-Katz discusses obstacles to competition between insurers across state lines.

One might respond to these readings by saying “all the other rich countries have single-payer health care systems and much lower costs with little or no apparent sacrifice of quality, so why don’t we just do that, and forget about the things discussed in the previous paragraph?” But adopting a single-payer system does not obviate the need to think about how to make the system run efficiently and control costs. Countries that operate single-payer systems have to grapple with these same issues, and use a variety of techniques to control costs, including for example, high deductibles to encourage patients to economize on care. We also have to deal with all of these issues in our existing single-payer system for the elderly, Medicare. With that said, nationwide single-payer systems do often exploit their monopsony power to set low prices for health care services, which is not so easy with a system of competing private insurers.

Check your understanding:

1. According to Cutler, what are the most important reasons why health care in the U.S. is so inefficient and so much more expensive than it is in other rich countries? What evidence does Cutler supply to support these conclusions?
2. What does each of the following mean in the context of the markets for health care and health insurance, and what is the theory for why each one would help improve the efficiency of these markets?
 - Capitation
 - Accountable care organization
 - Bundled payment
 - Value-based insurance plan
 - Health status insurance
 - Health savings accounts

Discussion questions:

1. In most industries, competition leads to provision of the economically efficient quantity and quality of the product. It is plausible this could work in health care too – for example, one might expect that competition should reward insurers that develop innovative managed care schemes which give health care providers optimal incentives to provide efficient, low-cost, high-quality care, because then demand for that insurance company’s product by individuals and employers would increase. What are the most compelling explanations for why competition has not solved our health care inefficiency problems? What are the practical implications for policy?
2. The readings discuss a wide variety of possible reforms that could improve the efficiency of the U.S. health care system. Compare and contrast any two approaches to reform, and construct an argument for which approach seems most promising to you and why. How much would you rely on each of the different approaches? How would you change public policy in order to make this happen? A good answer should consider the following: if your preferred solution is so great, why is it not happening already?

Mon 11/20 Why Has Economic Inequality Been Increasing so Much and What Should be Done about It?

- Thomas Piketty, Emmanuel Saez, and Gabriel Zucman, “Economic Growth in the United States: A Tale of Two Countries.” *Washington Center for Equitable Growth*. December 6, 2016.*
- Jon Bakija, “Do Tax Cuts for the Rich Cause them to Earn More Pre-Tax Income?” from Jon Bakija, Lane Kenworthy Peter Lindert, and Jeff Madrick, *How Big Should Our Government Be?* (2016), pp. 121-133.*

- David Autor, “Skills, Education, and the Rise of Earnings Inequality among the ‘Other 99 Percent.’” *Science*, May 2015, pp. 843-851.*
- Lane Kenworthy, “America’s Social Democratic Future.” *Foreign Affairs*, January / February 2014.*
- Lane Kenworthy, “Is Big Government Bad for the Economy?” from *The Good Society* (2017)*

The first three readings, (the first by economists Tomas Piketty of Paris School of Economics and Emmanuel Saez and Gabriel Zucman of UC Berkeley, the second by Prof. Bakija, and the third by economist David Autor of MIT) document various dimensions of how economic inequality has been changing over time in the U.S. and other countries, discuss theory and evidence on the most likely causes of the changes over time, and consider what the policy implications might be. The remaining readings, by Lane Kenworthy, a sociologist at UC San Diego, make a case that U.S. public policy should respond to this increase in inequality by doing more to promote economic security, opportunity, and shared prosperity for more Americans, and should adopt policies that are more like those of a Nordic welfare state. He then provides an evidence-based response to concerns that this approach would be too economically costly.

Discussion questions:

1. What are the leading explanations for why the share of pre-tax income going to the top one percent of the income distribution has increased so much over time in the U.S.? Which explanations seem most consistent with the evidence, both from the U.S. and across countries? Consider how the implied optimal tax-and-transfer policy would differ depending on which of these explanations is empirically most important, drawing on one or more of the philosophies of distributive justice that we’ve considered in class.
2. Autor emphasizes that while earnings inequality has not grown nearly as dramatically within the bottom 99 percent of the income distribution as it has between the top one percent and everyone else, the increase in inequality within that bottom 99 percent has still been quite significant. By some metrics it has a larger impact on a larger number of peoples’ lives. As the reading discusses, the factors that are most important in driving rising inequality at the very top versus in the rest of the distribution may be quite different. What are the most convincing theories and pieces of evidence for why economic inequality has risen over time within the bottom 99 percent of the income distribution? What do you think the policy implications are, and why?
3. Kenworthy presents a broad-ranging argument for why the U.S. should respond to rising income inequality by adopting various public policies that are more like those in the Nordic countries, and offers a number of specific proposals. Which of his proposals are most promising or most objectionable to you, and why? What kinds of evidence or philosophical or economic arguments can be brought to bear to help us evaluate whether any of the proposed policy changes are likely to be good?
4. Based on evidence and arguments presented in the reading (perhaps also drawing from current events and the news), evaluate the following hypothesis. Countries where the majority of people receive a larger share of the benefits of economic growth, either because of lower pre-tax income inequality or because of redistributive government programs, tend to be more willing to support other public policies (e.g., free trade and light regulation of business) that in theory are economically efficient and promote growth.
5. Kenworthy presents a variety of arguments and pieces evidence to support his contention that if the U.S. were to increase the size of its government to achieve his policy aims, the economic costs would not be high. How could this be true in theory, and what evidence supports it? Explain at least one evidence-based argument, discuss its implications for policy, and consider the strengths and weaknesses of the evidence. What further questions does it raise? On balance, do you find it persuasive or not? Why?
6. Consider how Hayek or Milton Friedman would critique any of Kenworthy’s arguments, and how Kenworthy would respond. Who do you think wins the argument and why? Where, if anyplace, do you think they would share common ground?

Thu 11/23 No class (Thanksgiving)

Mon 11/27 Climate Change, Discounting, and Intergenerational Equity

- Brad Plumer, "Conservatives are Now Debating Carbon Taxes. Here's Why They're Still Skeptical." *Vox*. June 12, 2015.*
- Jon Bakija, "A Primer on Discounting, Climate Change, and Intergenerational Equity" (2016).*
- David Weisbach, "Climate Change Blindness," from Stephen M. Gardiner and David A. Weisbach, *Debating Climate Ethics* (2016), pp. 205-208.*
- Gernot Wagner and Martin L. Weitzman, *Climate Shock: The Economic Consequences of a Hotter Planet*, Princeton University Press (2015), Preface, Chapter 1, and Chapter 3.*
- Cass Sunstein, "U.S. Should Act Unilaterally on Climate Change." *Bloomberg*. January 23, 2013.*

Opinions on climate change in the U.S. have become increasingly polarized along political lines. Some think it dwarfs all of our other problems, while others deny that it is a problem at all. Since this is a political economy course and not a science course, for purposes of this class we'll take the consensus scientific estimates of the mean and probability distribution of future temperature increases under different scenarios for future carbon emissions as given, and will also take as given that there's a lot of uncertainty around those estimates. The readings for today discuss some of the most important economic, ethical, and political issues around climate change.

The first article by journalist Brad Plumer discusses a carbon tax proposal intended to garner conservative political support, and conservative reactions to it. It makes clear why it is so hard to reach a compromise that would lead to progress, and what some of the key points of contention are. The next reading is from the book *Climate Shock* by Gernot Wagner (lead economist of the Environmental Defense Fund) and Martin Weitzman (an environmental economist at Harvard). The first excerpt from their book provides background information on key issues, and makes an economic case for putting a high price on carbon emissions, either through a tax or a cap-and-trade scheme. The Bakija reading clarifies what "discounting" is and why it plays such a central role in the debate over what to do about climate change. It clarifies that the "market discount rate" and the "social discount rate" are answers to two different questions, and summarizes why some other economists (including Wagner and Weitzman) argue that market discount rates are the ones to use when setting a price on carbon. The Weisbach reading introduces the "climate change blinders" argument, which is part of his case for setting carbon taxes based on efficiency rather than equity considerations. Then we return to Chapter 3 of *Climate Shock*, where Wagner and Weitzman argue that if we take risk into account appropriately, we should discount future climate damages at a very low or even negative rate, implying a very high carbon tax. The reading by Cass Sunstein, a Harvard law professor, makes a case for unilateral action by the U.S. to fight climate change. Since Sunstein wrote, the vast majority of countries around the world, including the U.S. and China, committed to the Paris Climate Accord, and then the Trump administration subsequently announced that it intended to withdraw the U.S. from the agreement. Each country agreeing to the accord pledged to voluntarily meet certain targets for reductions in carbon emissions by certain future dates. However, there are no sanctions for failing to follow through. Making significant progress towards meeting the targets will require adoption of policies that may face significant political opposition back home, so there's plenty of worry that countries might not follow through on their commitments, making Sunstein's arguments still quite relevant.

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. Journalist David Roberts has said (accurately) that among economists, the seemingly technical issue of what discount rate to use when computing the "optimal" price of carbon emissions is "the difference between apathy and panic" about climate change. What are the issues here? What is the gist of Wagner and Weitzman's argument on this topic? Roughly what discount rate do you think should be used for pricing carbon, and why?
2. The article by Plumer summarizes a Senate proposal designed to garner conservative support for a carbon tax.

What do you think of that proposal? Pick any one of the objections to the proposal. (Or offer your own objection). Do you think other readings from today (or from elsewhere in the course) offer compelling responses to the objection? Why or why not? What else would you want to know?

C. Finance

Thu 11/30 What Is Finance For?

- Charles Geisst, *Beggar Thy Neighbor: A History of Usury and Debt* (Penn, 2013), Chap. 1.*
- [List of financial crises in history](#) (Wikipedia)*
- Noah Smith, “How Finance Took Over the Economy,” *Bloomberg View*, 4/20/16.*
- John Cochrane, “Finance: Function Matters, Not Size,” *Journal of Economic Perspectives* 27:2 (Spring 2013).*
- Nelson Schwartz, “How Wall Street Bent Steel,” *NY Times* 12/6/14.*
- Michael Corkery and Ben Protess, “[How the Twinkie Made the Super-rich Even Richer](#),” *NY Times*, 12/10/16.*

Understanding the political economy of finance requires a command of technical details but also an ability to rise above those details to ask what they all mean. Naturally but unfortunately, those who master the technical part (say, by gaining experience on Wall Street) often become to the same degree convinced that the structure of the US financial system is necessary and optimal. But lots of rich OECD countries (especially non-Anglophone ones) have financial systems quite different from those of the US and the UK, with their prominent role for capital markets. Beyond this, and apart from its historical tendency to undergo consequential and (to many contemporary observers) baffling cycles, finance has long been considered morally different from other market activities, notably by major monotheistic religions (e.g., usury doctrine).

We proceed from the historical and ethical to the structural and institutional aspects of finance. The first reading introduces a recent history of usury doctrine and its uneasy relationship with economic practices. It is followed by a list of historical financial crises. Smith then introduces a macroeconomic issue often heard from critics: the financial sector has grown too big, it is not efficient, and this has hurt the real economy. Cochrane attempts to rebut this argument, getting into the weeds about price discovery and financial markets. His main target is the assertion that the growth of the financial sector in recent decades has taken place in parallel with an increasing overall cost of asset management (as in mutual funds, etc.), due in large part to proportional fees on expanding asset bases. This happened despite the fact that it is extraordinarily rare for a money manager to outperform major indexes over anything but the short run, especially if we calculate the return net of fees. We conclude with a look at how high-flying finance sometimes interacts with the rest of the economy, first with the story of Timken and then with the revival of Hostess Twinkies (on the second, the link contains a lot of pictures and interesting graphics that did not come out in the printed version).

A few technical notes for those unfamiliar with contemporary financial terms. The “alpha” of a stock is its risk-adjusted return relative to a market index like the S & P 500. So alpha would be positive if the stock earned the same as the index but with lower variance or more than the index with the same variance. In perfectly efficient markets, where differences in these variables across assets provide agents with arbitrage opportunities, the expected value of alpha for any asset is zero because lower (higher) risk-adjusted returns will be exactly matched by lower (higher) prices. Alpha can be calculated for managed portfolios too, as a measure of a manager’s performance relative to an index.

Discussion questions:

1. Geisst might be arguing that the historical prevalence of usury prohibitions and stigmas attached to finance ought to signal ongoing, policy-relevant differences between finance and “normal” profit-making activities, even if the financial activity in question does not fit the traditional definition of usury as lending at excessive interest. Drawing on the other readings (the role of debt finance in the last two stories might be a good place to start), do you think this is right?
2. Critics of contemporary finance often begin from the idea that while some financial firms and exceptional performers might make outsized profits, a sector that mostly trades with itself should roughly break even, because every shift of assets that creates a profit for one agent creates a corresponding loss for another. If so, the fact that financial profits and salaries are still very high must therefore mean either that the sector is somehow producing unusual value or that it is hurting other sectors. Do you agree with this premise? Thinking of the last two stories, which is it—unusual value or damage to the non-financial economy?

3. Citing Hayek, Cochrane argues that we should not even be in the business of judging the right size for the financial sector. How might Smith or Geisst respond? What do you think?

D. Economic Nationalism and New Trade Theory

Mon 12/4 The Return of the Repressed? Economic Nationalism and New Trade Theory

- Peter Dizikes, “When (and Where) Work Disappears,” MIT News Office, 2/24/12.*
- Noah Smith, “There’s Great News on Inequality and Poverty,” *Bloomberg View*, 6/20/16.*
- 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.*

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.*, paras. 24-30). In the nineteenth-century USA, trade protection via tariffs (inspired by Alexander Hamilton) was the rule rather than the exception, especially after the Civil War defeated the strongest economic bloc then in favor or free trade, the slave-owning class of the South. In its contemporary manifestations, economic nationalism in the USA is just as 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*.

The first reading is a quick summary of what was then a working paper by Autor, Dorn, and Hanson, to be published in 2013 in the *American Economic Review*, detailing the impact of the “China shock” on manufacturing employment in the US. The second is an overview of recent work and data regarding world poverty and inequality. We then turn to a polemic by the man who preceded Donald Trump in introducing an ethnonationalist-inflected critique of trade into recent US politics, Patrick Buchanan. 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 from a book with a foot in each camp, in order to remind us of the case for free trade and how its complications might relate to the nationalists’ worries.

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. How might a convinced nationalist like Buchanan or Trump respond to Noah Smith? Who has the better argument, in your opinion?
3. Thurow bases much of his argument on an account of human psychology at odds with mainstream economics. He says “man is a tool-using animal” for whom “work is not a disutility...it determines who one is” (118). And “humans are individuals, but they are also herd animals,” for whom “the desire for equity”...“is a glue that can be used to generate solidarity and a willingness to sacrifice for the welfare of the group” (122). How different is all this from the Adam Smith of *Moral Sentiments*? What do you think?
4. Does Chang adequately address the objections of Smith to the “infant-industry” argument? How do we tell when the “infants” no longer deserve protection? Can we count on them to tell us?
5. Do Rodrik’s arguments offer any insight into the complaints of Buchanan?

IV. CONCLUSION: BACK TO POLITICS AND MARKETS

Thu 12/7 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).*
- Rosen, Harvey. 2005. "Rent-Seeking" excerpted from *Public Finance*, 7th ed., New York: McGraw-Hill, pp. 129-132.*
- 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, a short excerpt from a *Public Finance* textbook by economist Harvey Rosen that elaborates on the rent-seeking idea with a diagram, and a snippet from the *WSJ* that shares Buchanan's 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? Or, do any critics pose a decisive challenge to James Buchanan? (Answer with reference to one or two particular critics.)