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POLITICAL ECONOMY 250
ECONOMIC LIBERALISM AND ITS CRITICS
Fall 2012

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

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

This syllabus is the single most important document for the course. It has been annotated with some information about the authors and the themes of their work, in order to contextualize your reading and leave more class time for discussion of ideas. It also includes study questions. These are meant to alert you to some of the most important issues raised by the readings. The study questions will also help orient our discussions in class, so be ready to address them.

REQUIREMENTS AND GRADING

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

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

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 (about assumptions, or logic, or implications). 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. Acknowledging and responding to counter-arguments to your position makes for a better paper. Many papers use a study question, or some portion of a study question, for their topics. All should say clearly up front what their focus is. Don't try to answer various study questions in one essay, as it is impossible to do a good job of that in just two pages. Also, don't shy away from challenging but important concepts. Students who tackle a higher degree of difficulty successfully will be rewarded in the grading. In our evaluation of papers, a good, accurate, and accessible explanation of a challenging insight or argument counts very positively, while superficial mentions of lots of conclusions, without presenting the logic or evidence that led to those conclusions, counts negatively. Do not use technical jargon without explaining what it means.

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

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

On class participation, the quality and succinctness of your interventions are most important. Think before you speak and avoid repeating yourself. The course works best with discussions that are informed, vigorous, civil, and widely shared.

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 classes.

HONOR CODE

Observe the Honor Code guidelines for independent work (which can be found in the *Student Handbook* at http://web.williams.edu/admin/registrar/handbook/policies.html#Academic). Enclose direct quotations within quote marks and cite sources for these and for paraphrases. For course readings, short internal citations (Smith *WN*, 567) are fine; any outside sources (not encouraged) deserve a full footnote.

READINGS

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

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

The other readings are in printed reading packets and are also available as PDFs on the course Glow web site. The first printed reading packet is available immediately, from Hollander Hall (NAB), room 026. Parts Two and Three will be made up after the enrollment is settled.

SCHEDULE

(* denotes a reading from the packet)

Thurs 9/6 Introduction and Organization

I. CLASSICAL THEORIES OF POLITICAL ECONOMY

A. Free-Market Liberalism: Adam Smith

Mon 9/10 Adam Smith: Principles of a Free Market Economy

- *The Wealth of Nations* (henceforth *WN*), Introduction through [referring to book.chap.sec.] I.iii.,8; I.iv.1-5, 11-18; I.v.1-10; vi, 1-10, 18-24; vii, 1-32 (pp.--text *no*t general introduction--10-36; 37-39; 44-46; 47-51; 65-68, 69-80).

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.

Study Questions:

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

Thu 9/13 Adam Smith: Prices, the Distribution of Income, and Economic Growth

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

The readings for this class focus on Adam Smith's views of the determinants of prices, income distribution, and economic growth. Here you can find some of his most trenchant critiques of the guild system along with a view of markets that places labor (and the laborer) front and center. You'll also find a great deal of attention to politics. Note: in Chapters x.a.2 and x.c, the "policy of Europe" refers to the mercantile system (which involved national economic strategy and had an important role for guild regulations). The reading by Allen provides data on wages and living standards in several different countries from the 14th through 19th centuries, to help us evaluate the extent to which Smith's arguments are consistent with the empirical evidence.

The final reading, by Mankiw, is available only as a scanned PDF on the class Glow site. It reviews what you should have learned about the supply and demand for labor and the determinants of labor productivity in your introductory economics classes. While the Mankiw reading is an optional review of what you should have already learned before, reminding yourself about this material would be very helpful for making sense of Smith's arguments and how they all fit together.

<u>Study Questions:</u>

1. Smith argues that the *level* of wages in a country will only rise above subsistence level if the *rate* of economic growth is continuously high. What are his arguments and evidence for this? How is it connected to fertility, mortality, and population growth? Does the argument make sense in terms of the supply and demand for labor? For example, if the population is growing, there are more people to demand goods and services. Why wouldn't this increase the demand for labor just as fast as it increases the supply of labor?
2. Smith contrasts living standards of typical people in the Britain and China of his day, and attributes the difference to Britain's newly emerging economic growth, and China's economic stagnation. Considering the full range of readings from today and from the previous class, what do you think Smith would say was causing the divergence in economic growth between Britain and China? Do you think he offers a compelling diagnosis?
3. In what ways are Smith's arguments and evidence in connection with questions 1 and 2 consistent or inconsistent with the data presented by Allen? Should we be more or less convinced by Smith in light of this newer, better data?
4. In chapter x., Smith discusses the sources of inequality among wage laborers. What are the real sources of these differences, according to Smith? Do they suffice to explain wage differences today—say, between an NBA star and a housepainter? Thinking about this in the framework of the supply and demand for different types of labor, is Smith leaving out any important determinants of differences in wages between occupations?On pp. 73, 79 and 116, Smith refers to a situation of "perfect liberty." What does he mean by this term? Do you think he would favor modern labor unions?
5. In your opinion, is Smith right about his assessment (pp. 264-67) of the degree of confluence between the particular interests of each of the three fundamental social groups (those who receive rent, profits, or wages, respectively) and the general interest?
6. Considering the day's reading as a whole, what kinds of income inequality do you think Smith would view as ethically justified, and what kinds of income inequality would he object to? Why?

Mon 9/17 Adam Smith: Progress and Policy

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

Here is Smith on how good government can result from the spread of markets—and how, in turn, government can foster market expansion and national wealth. In both cases he uses an argument that forms the bedrock of liberal optimism—that freedom has non-obvious, usually unintended, but highly beneficial consequences. Book III gives a quick historical sketch of how state power was tamed by capitalism—an account that, in broad terms, was anticipated by Montesquieu and the physiocrats, and has been repeated by many others since Smith's time. Books IV and V give us some of Smith's best arguments for laissez-faire--and for government. The former begins with the "invisible hand" passage, which occurs at the conclusion his argument about how to maximize national product (pp. 455-57). Because of its importance, both to Smith's purpose (here is a formula that directly involves the wealth of nations) and to liberal optimism generally, the argument deserves close attention. Book V (introduced and summarized at the end of chapter ix, Book IV) is on fiscal policy, but it contains lots of philosophical and sociological asides. Its careful discussion of appropriate revenue sources—especially the four maxims on taxes (825-28)--is still relevant today. Also revealing is Smith's honest statement of his misgivings (V.i.f.) about the same division of labor he praised so highly at the outset. Note: the Law of Settlements (470-71) prohibited workers from moving from one parish to another.

Study Questions:

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

Thu 9/20 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. The Fisman and Miguel excerpt talks about the importance of culture in economic life in a way that links up nicely with Smith.

Study Questions:

1. What distinction does Smith make between beneficence and justice? What is the significance of each to the proper ordering of economic life? Are they really so different?
2. What is the role of public life—through human vanity and the sentiment of shame—in sustaining morality? Do traffic behavior in Bogotá and diplomatic parking tickets in Manhattan adequately illustrate this?
3. Do you think Smith (especially *TMS* 123) romanticizes the poor? How does the passage at 122-23 *sq*uare with his observation that we tend to despise the poor (78-79, 86-87)?
4. Can you reconcile the arguments in *The Theory of Moral Sentiments* with those in *The Wealth of Nations*? In particular, is personal morality necessary for markets to do a good job of channeling the pursuit of self-interest toward the general good? Or do markets solve the problem of conflict between self-interest and morality? How are the examples in Fisman and Miguel relevant to that question?
5. Smith seems to be arguing that people are trying to get something else as they pursue riches--and that there are other ways to get it. What is it? Does he think the pursuit of riches is the best way to achieve it?

B. The Radical Critique of Economic Liberalism

Mon 9/24 Marx and Engels

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

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

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

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

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

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

<u>Study Questions:</u>

1. What historical role do Marx and Engels assign to capitalism? Do they, for instance, reproach it for having destroyed indigenous cultures around the world? Could a serious Marxist be an investment banker?
2. Bourgeois intellectuals, according to Marx (p. 395), approve of rigorous planning and central control within factories, but are horrified at the prospect of extending such planning to the economy as a whole. Is there an important contradiction here?
3. Marx says that in his ideal society, "nobody has one exclusive sphere of activity but each can become accomplished in any branch he wishes," (and in the next, famous passage) "to hunt in the morning, fish in the

afternoon, rear cattle in the evening...just as I have a mind" (160). Does he want the division of labor abolished? Leaving aside his romantic examples of jobs, why does he think his scheme is feasible? What do you think?

4. What, for Marx, accounts for the existence of religion, and for its greater strength in the country (the USA) then distinguished by its lack of an established church?

II. THE REFORMIST LIBERALISM OF MILL AND KEYNES

Thu 9/27 John Stuart Mill on the Ethics of Private Property and Taxation;
John Maynard Keynes on Finance and Investment

- John Stuart Mill, *Principles of Political Economy,* 5th edition, Vol. I (1864), pp.259-271, 278-291; and Vol. II (1877), pp. 396-402.*
- John Maynard Keynes, *The General Theory of Employment, Interest, and Money* (1936), Chapter 12 ("The State of Long Term Expectation," pp. 191-201 in the University of Adelaide e-book edition).*
- Paul Krugman, *End This Depression Now!* (2012), pp. 97-101 (section on "Notably Rare Exceptions.")
- John Cochrane, "Market Efficiency," (2011) excerpted from "How Did Paul Krugman Get it So Wrong?" *Economic Affairs*, June, pp. 36-37.*
- *The Economist*. "Efficiency and Beyond." July 16, 2009.*

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

<u>Make sure to read the following important guide to jargon in Mill!</u> When Mill speaks of "Communism" in the first pages of this selection, he is not referring to Leninist state socialism (which did not yet exist) but to factories, farms, and stores owned by workers or members of the community, like those of the Rochdale Pioneers. "Estate" is the total wealth that a person leaves behind when he or she dies. A "bequest" is the wealth that a person leaves to his or her heirs at death. An "inheritance" is the amount of bequest that a particular heir receives. "Intestate" (or in Latin, *ab intestado*) refers to people who die without having made out a will. Note that Mill advocates completely different policies for people who die intestate and people who leave a will, so pay careful attention to when he is talking about each situation. The discussion of what to do in cases where the decedent has a will is of much greater practical significance, since the vast majority of wealthy people do write wills. "Collateral inheritances" are those received by distant relatives or non-relatives – that is, people other than direct descendants (e.g., the decedent's own children or grandchildren) or direct ancestors (e.g., the decedent's parents).

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

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

For today, we'll read Chapter 12 from Keynes's *General Theory*, a particularly notable chapter where he memorably lays out his views on the role of "uncertainty" in finance and investment, and its consequences for the economy. The final three short readings, by economist and Nobel Laureate Paul Krugman, University of Chicago economist John Cochrane, and *The Economist*, provide differing modern perspectives on the issues discussed in the reading by Keynes.

Also make sure to read the following important guide to jargon in Keynes! First, remember that to an economist, *investment* can have two meanings: a purchase of physical capital (such as productive machinery, tools, or buildings, e.g., a factory); or a purchase of shares of ownership of such capital (i.e., corporate stocks), which is more precisely called "financial investment," and which from the perspective of the person doing the financial investment, is really a form of "saving" which the person essentially lends to the firm in exchange for a share of the profits arising from the firm's investments in physical capital (e.g., through dividends). Keynes uses the term "investment" in both senses in different places. Second, recall from introductory macroeconomics that *money* has a very specific meaning to economists (Keynes included). "Money" is essentially cash and checking accounts, and a key feature that distinguishes money from other non-money assets (such as stocks and bonds) is that money earns little or no interest, while other non-money assets do earn interest or interest-like returns (such as dividends). Third, recall that "liquidity" refers to how easily an asset can be converted into spending power that can be exchanged for goods and services. Money is the most liquid asset of all. Assets such as stocks and bonds are significantly less liquid than money, but by the time Keynes was writing, even these were *somewhat* liquid due to the development of modern stock exchanges and bond markets in places like New York and London. Houses and small businesses are particularly illiquid assets, and so forth. Finally, Keynes 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%.

Study Questions:

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

Mon 10/1 The Keynesian Explanation of Recessions and Depressions

- John Maynard Keynes, "The General Theory of Employment," *Quarterly Journal of Economics*, Vol. 51, No. 2 (Feb., 1937), excerpt, pp. 212-223.*
- Paul Krugman and Robin Wells, "Reconciling the Two Models of the Interest Rate," from *Macroeconomics*, 2nd ed., (New York: Worth Publishers, pp. 439-441).*
- Paul Krugman, "Zero Bounds and Butter Mountains." *New York Times*, February 6, 2012.*
- David Wessel, "Finding a Prescription for the U.S.'s Money Trap." *Wall Street Journal*, August 6, 2011.*
- Paul Krugman, *End This Depression Now*. (2012). Chapters 2-3, 8-11, and Postscript.

In today's class, we will try to understand Keynes's key insights about why recessions happen and what we can do about them, and then will consider their relevance to our current economic predicament. (Before getting started, make sure that you've read the "guide to jargon in Keynes" in the introduction to the readings for the last class). The first reading for today is an excerpt from an article Keynes wrote in the *Quarterly Journal of Economics* in 1937, in response to widespread controversy over his 1936 book *The General Theory of Employment, Interest, and Money*. Robert Skidelsky, the definitive biographer of Keynes, has called this article a "restatement of the 'essence' of *The General Theory*" and noted that many Keynes scholars view it as "the canonical statement of

[Keynes's] position." In it, Keynes explains the gist of his argument for why the economy is not "self-correcting" (as the classical economists had held), and why the economy can indeed plunge into recessions and depressions in a persistent way. In this article, Keynes is reacting against what he calls "Say's Law," which holds that inadequate aggregate demand, and therefore recessions, are *impossible* because "supply creates its own demand." The idea of Say's Law is that when people supply goods and services to the market, they receive income for doing so, and this income always turns into demand for something. When people spend their income on consumption, they create demand for consumption goods and services. When people save their income, that saving flows through banks or other financial intermediaries and is turned into investment, which in turn creates demand for investment goods. So for example, if there is a drop in consumption, Say's Law suggests there is no reason for that to cause a recession, because a drop in consumption necessarily means an increase in saving, and the increase in saving will push down interest rates enough to induce firms to use the saving to finance investments in physical capital. Thus aggregate demand never drops – any fall in consumption is matched by an equal and opposite rise in investment, and *vice versa*, with interest rates being the key mechanism that maintains equilibrium at full employment. In this first reading, Keynes lays out his argument for exactly what it is that he thinks makes Say's Law break down, making recessions and depressions possible.

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

<u>Study Questions:</u>

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

why it is supposed to work, explain one objection to it, and then consider whether Krugman's counter-argument to the objection is convincing or not and explain why.

III. 20th-CENTURY ARGUMENTS

A. Defenses of the Market

Thu 10/4 The Case Against Central Planning

- F. A. Hayek, *The Road to Serfdom*, Chaps. 3-7, and the first 2.5 pages of Chapter 9 (p. 147 through the end of the first paragraph on p. 149); Hayek's preface to the 1976 edition (pp. 53-55 in edition edited by Caldwell); and Milton Friedman's introduction to the 1994 edition (pp. 259-263 in the edition edited by Caldwell -- you can skip "Note on Publishing History").

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

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

Mon 10/8 No class (Reading Period)

Thu 10/11 Hayek's Critique of the Welfare State

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

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

Study Questions:

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

Mon 10/15 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. An early opponent of Keynesian economics (though not initially on public-finance grounds), he did important work on economic methodology, the consumption function, and most famously, on money. But he also wrote influential works of advocacy, like this one and the lighter *Free to Choose,* which have been important guides for Republicans in recent years. (Note: in case it's not clear, what he calls "neighborhood effects" are now generally called "externalities.")

Study Questions:

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

Thu 10/18 Liberal Principles Applied

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

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

The short reading from *The Economist* reviews what you should have learned about "market failures" in introductory economics. A "market failure" is a situation where the market, by itself, is not economically efficient. Although he sometimes uses different terminology, the concepts of economic efficiency and market failure are critical to almost all of Milton Friedman's recommendations on public policy.

In Chapters 6 and 11 through 13, Milton Friedman takes on the problems of public schools, public housing, pensions, and anti-poverty policy. The most enduring policy contributions of Friedman's book can be found here: vouchers for housing (see Section 8) and (in some places) education, proposals to privatize Social Security in the US (actually implemented, in large part, in a few other countries), and the negative income tax (which influenced the development of the Earned Income Tax Credit, now the largest U.S. government program providing cash assistance targeted to the poor). They share a conviction that government social programs should be narrowly tailored to leave the greatest possible sphere of choice to the recipient.

<u>Study Questions:</u>

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

Mon 10/22 Microeconomics and Renascent Liberalism: Ronald Coase

- Ronald Coase, "The Nature of the Firm." 1937. *Economica*, New Series, Vol. 4, No. 16 (November 1937), excerpt, pp. 386-398.*
- Ronald Coase, "The Problem of Social Cost." *Journal of Law and Economics*, 1960, Vol. 3, excerpt, pp. 1-10, 16-20, 27-35, and 39-44.*
- "The Gap between Supply and Demand," *The Economist* 9 Oct. 2008.*

The first two articles we discuss today are largely responsible for Coase's 1991 Nobel Prize in economics. In "The Nature of the Firm" (1937), Coase (b. 1910) asks an obvious but important question: 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. 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.

Study Questions:

1. The central puzzle of "The Nature of the Firm" occurred to Coase when he was an undergraduate and a socialist (he changed his politics soon after), 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? Does he answer this question adequately?
2. Following Coase, what effect might we expect, on the economically optimal size of firms, from recent advances in information technology?
3. According to Coase's famous argument about social cost, in the absence of transaction costs, the socially efficient use of resources will be obtained if property rights are clearly defined--regardless of their distribution. Are there any reasons to doubt this? If we had trade in human kidneys—see the *Economist* article--would it make any difference whether people were initially assigned property rights to the kidneys in their own bodies?
4. Coase recognizes that in many real-world legal disputes, transactions costs are often significant. In those cases, Coase argues that property rights should not necessarily be assigned based on who is deemed to be "at fault," but rather should be assigned to the party who would pay the most for the property rights. What is his argument here? How would the decision about how to allocate the property rights in these cases be made? What would Hayek think of this implication?

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

Thu 10/25 Equality and the Welfare State

- Arthur Okun, *Equality and Efficiency*, Chaps. 1 and 2 (skip pp. 51-61, "The Collectivized Economy").

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

Study Questions:

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

Mon 10/29 An Economist Defends Politics

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

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

Study Questions:

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

Thu 11/1 Power and Autonomy at Work

- Daniel Pink, *Free Agent Nation* (2001), Chap. 1 (pp. 9-25) and pp. 179-181.*
- Farhad Manjoo, "United's ESOP Fable," *Salon.com* 12/12/02.*
- William C. Taylor, "These Workers Act Like Owners (Because They Are)," *NY Times* 5/21/06.*
- Richard Thaler and Cass Sunstein, *Nudge*, "Company Stock" section of chapter 7 (pp. 127-30 in the revised and expanded edition).
- Samuel Bowles and Herbert Gintis, *Democracy and Capitalism*, Chap. 3 (to p. 87 only).*

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

Study Questions:

1. How does Pink think the "free agent nation" changes the politics of work? Do you agree?
2. Thinking of Coase, does Pink give us good economic or technological reasons to believe that the firm is now passé? What limits might there be to the feasibility of free agency?
3. 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?
4. 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?
5. Referring to the magazine articles and the bit from *Nudge*, what are the advantages and problems of employee-owned firms? Are these understandable in the terms articulated by Bowles and Gintis?

III. APPLICATIONS OF ECONOMICS, PHILOSOPHY, AND PSYCHOLOGY TO POLICY ISSUES, AND NEW INSIGHTS ON MARKET IMPERFECTIONS

A. Economic Inequality, Social Insurance, and Asymmetric Information

Mon 11/5 Economic Inequality and Public Policy

- David Weisbach, "Redistribution," from "Should Legal Rules be used to Redistribute Income?" *University of Chicago Law Review*, 70 (2003), pp. 440-446 only.*.
- N. Gregory Mankiw, "The Deadweight Loss from Taxation," from *Principles of Microeconomics*, 3rd edition, Southwestern College Publishing, 2003 (excerpt, portions of pp. 160-170).*
- N. Gregory Mankiw. "Spreading the Wealth Around: Reflections Inspired by Joe the Plumber: Presidential Address." *Eastern Economic Journal*. Vol. 36, No. 3 (2010), pp. 285-298.*
- Peter Diamond and Emmanuel Saez. "Taxing High Earnings" From *The Occupy Handbook*, edited by Janet Byrne. Back Bay Books (2012), pp. 317-329.*
- Jon Bakija, Adam Cole, and Brad Heim, "Jobs and Income Growth of Top Earners and the Causes of Changing Income Inequality: Evidence from U.S. Tax Return Data" (2012) (excerpts).*

David Weisbach (a law professor at U. Chicago) explains the concept of "social welfare," and discusses why progressive taxation and transfers might increase it. Weisbach emphasizes, however, that redistributive taxation and transfers can be costly in terms of economic efficiency. He explains what the "optimal income taxation" literature (which earned James Mirlees the Nobel Prize in economics) suggests about how one might find the social-welfare maximizing balance between the benefits and costs of progressive taxes and transfers, and how this might differ depending on one's philosophy.

The next two readings are by Greg Mankiw, economist at Harvard University and former chair of the Council of Economic Advisors under President George W. Bush. The first Mankiw reading reviews what you should have learned about the economics of taxation in introductory economics, which will be helpful for thinking through the logic of all of today's readings. In the second reading by Mankiw, he reviews some evidence on the degree of income inequality and tax progressivity in the U.S., and argues that utilitarian social welfare maximization is not the right way to think about how we ought to distribute the burdens and benefits of government taxation and expenditure. He proposes an alternative ethical framework for thinking about the issue, inspired partly by philosopher Robert Nozick and by Adam Smith.

In the next reading, Peter Diamond, a Nobel prize winning economist at MIT, and Emmanuel Saez, economist at Berkeley and winner of the John Bates Clark medal for the best economist under age 40, argue that, given their interpretation of the empirical evidence on the deadweight loss from taxing high earners (some of which is illustrated in the next reading), maximizing utilitarian social welfare would involve much higher tax rates on the highest-income people than we have in the U.S. today.

Since the late 1970s in the U.S., income inequality has increased substantially, especially at the very top of the distribution. At the same time, marginal income tax rates on the highest income earners were reduced substantially. The reading by Bakija, Cole, and Heim summarizes various theories for why income inequality has been increasing, and presents some "stylized facts" and new data that are helpful for evaluating the different theories. Among other things, it discusses why the different explanations for rising income inequality have widely varying implications for how much economic efficiency is sacrificed through redistributive taxation.

Study Questions:

1. Exactly where and how would a utilitarian strike the optimal balance between efficiency and equity? If the first few dollars of redistribution from rich to poor increase utilitarian social welfare, why is it that we eventually reach a point where any further redistribution would *reduce* social welfare? What factors affect where the optimal balance lies, and how do they affect it?
2. In "Spreading the Wealth Around…," what is Mankiw's critique of utilitarian social welfare maximization, and what alternative does he offer as a normative criterion to guide policy? Do you find his critique and/or alternative persuasive? If so, do you agree with what he says the policy implications are? Why or why not?
3. What do the different explanations for rising income inequality imply about the cost of redistribution in terms of economic efficiency? Which explanations do you find most compelling and why?
4. All things considered, how progressive do you think the U.S. tax system should be? More progressive than today? Less? Why?

Thu 11/8 Insurance, Asymmetric Information, and Equality of Opportunity

- Jonathan Gruber, *Public Finance and Public Policy*, 2nd ed. (2007), Chap. 12 ("Social Insurance"), pp. 314-328 and 337-341 only.*
- Jon Bakija, "Why is Insurance Good? An Example," (2011).*
- James Surowiecki, "Fifth Wheel," *New Yorker*, 1/4/10.*
- Hal R. Varian. "In the Debate over Tax Policy, The Power of Luck Shouldn't Be Overlooked." *New York Times* (2001), May 3, p. C2.*
- John E. Roemer, "Equality and Responsibility," *Boston Review* (1995) April/May.*

In this class we go over important economic principles relating to information and risk, which are key to understanding financial and insurance markets in subsequent classes. Here we consider what these ideas might imply about the moral and economic justifications for policy more broadly. The reading by Gruber discusses why people dislike risk and why they value insurance. It then goes on to discuss "adverse selection" and "moral hazard," two examples of market failures (situations where the market is inefficient) arising from asymmetric information between buyer and seller. These problems frequently arise in economic contexts involving risk and uncertainty. In 2001, George Akerlof, Michael Spence, and Joseph Stiglitz were awarded the Nobel Prize in Economics for their work on this topic. The Bakija reading provides a simple example to illustrate why insurance is good – please come to class prepared to discuss this example and the questions posed at the end of this reading. The Surowiecki article discusses some inconsistencies in politicians' efforts to preserve private health insurance while at the same time taking measures that make it illegal for them to discriminate against people with certain characteristics that affect their likelihood of incurring medical expenditures. The articles by Hal Varian and John Roemer discuss why they think the optimal amount of redistribution, and possibly the way redistributive policies are designed, should depend on the degree to which income is caused by random chance as opposed to effort, and note some connections between arguments for redistribution and arguments for social insurance.

Study questions:

1. On average, people lose money by buying insurance. So why should anybody buy insurance? Moreover, how could it be that transactions between an individual and insurance company that would make both sides better off would fail to occur in the market? If that happens, can government policy achieve an "economic improvement" here? If so, how?
2. Answer the two questions posed at the end of the reading "Why is Insurance Good? An Example." Do not write your essay on them, but do come to class prepared to explain your answers to those questions, as we will call on people randomly to answer them.
3. 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. Would this make the insurance market more efficient or less efficient? Would it be a good thing?
4. Varian argues that the optimal amount of tax progressivity and redistribution depends on the degree to which income arises from random chance. Part of the logic behind this argument, not spelled out in the article, is that policies that are commonly viewed as "redistributive" are to some extent playing a social insurance role, so that their negative effects on efficiency due to distorting incentives (which can be thought of as moral hazard), are offset to some degree by positive effects on efficiency, because they cure insurance market failures. Do you think this is an important consideration? How much of income do you think is due to luck, and how much is due to effort?
5. Roemer argues that society is ethically obligated to undertake redistribution that compensates for factors that are beyond the individual's control, but is also ethically obligated to *avoid* redistribution that undoes differences in well-being arising from factors that are within the individual's control. Do you agree? Why or why not? How does he propose that we should do this? What do you think of his approach?
6. It is easy to point out practical problems with the specific policy proposals that Roemer presents, but can you think of practical ways we might change specific public policies that would move us closer to the ideals Roemer espouses -- so that government policy does more to compensate for differences that are due to luck, and does less to compensate for differences that are due to effort? Consider for example health care, or education.

Mon 11/12 Health Care

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

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

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

<u>Study Questions</u>:
All of the readings agree that there is a great deal of economic inefficiency in the U.S. health care system, but they disagree on the most important causes of the problem and the best solutions. For each of the following potential sources of inefficiency in the market for health care, consider the empirical evidence suggesting that it is (or is not) a major problem, possible responses to the problem by the private market, and possible responses to the problem by the government. Which problem do you think is most important, and which response do you think is best? Why?

1. Moral hazard caused by the fact that people with health insurance pay less than the full price of medical care
2. Moral hazard caused by doctors’ informational advantage over patients
3. Adverse selection

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

Thu 11/15 Is "More of the Same" Feasible? Positional Goods and the Norms of Capitalism

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

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

Study Questions:

1. What are positional goods, and why does Hirsch think they have important implications for our thinking about the political economy of affluent societies?
2. Hirsch believes that "education"..."is a filter as well as a factory" (p. 48). What does he mean by this? Would we all be better off if Williams College were reduced to an Office of Admissions that handed out certificates of virtue to five hundred people a year, leaving them to learn relevant skills immediately in actual jobs?
3. How does Hirsch mean by the "tyranny of small decisions"? Is it really a "tyranny"? What are its consequences? (Contrast him to Hayek, *Constitution of Liberty* pp. 50-51.)
4. For Hirsch, why do a society's moral resources inevitably get depleted? What consequences does he see for capitalism?
5. How do Hirsch and Marx differ—and agree--on the role of religion in capitalist society?

Mon 11/19 What do We Owe Future Generations?
Climate Change, Exhaustible Natural Resources, and Sustainability

- Eric A. Posner and David Weisbach. "Future Generations: The Debate over Discounting." from *Climate Change Justice* (Princeton University Press, 2010), pp. 144-168.*
- J. Bradford DeLong. "The Stern Review on Global Climate Change Once Again." Blog post, 12/ 30/06.*
- Paul Collier, *The Plundered Planet*. (Oxford University Press, 2010), pp. 15-34 and 200-203. *
- Herman E. Daly. "Economics in a Full World." *Scientific American*, Sept 2005, pp. 100-105 and 107.*
- Partha Dasgupta. "Counterpoint." *Scientific American*, Sept 2005, p. 106.*

Some of the most pressing issues facing political economists relate to the consequences of our actions for future generations. This comes up especially in discussions of the environment and natural resources, but is more broadly relevant to all sorts of questions, such as budget deficits, Medicare, and Social Security. The Posner and Weisbach reading tackles the ethical question "*how much* should we do for future generations?" and the economic question of "how should we choose *what* to do for future generations?" DeLong adds some thoughts on the role that risk and uncertainty should play in our answers to these questions. Paul Collier provides a less technical summary of the utilitarian reasoning that pervades the first two readings, and then argues that a rights-based approach to thinking about these ethical issues would be more fruitful. Herman Daly (an economist at the University of Maryland) addresses these same issues, but emphasizes his belief that there are the biological and geophysical limits to growth, and that we have already started to push too close to those limits. Partha Dasgupta responds to Daly's arguments from a more mainstream economic point of view.

Study Questions:

1. The first three readings all address the utilitarian perspective on the questions of "how much and what should we do for future generations?" (This may not always be obvious, because they don't always use the term "utilitarian"). Collier offers a concise non-technical overview of the utilitarian position (and then criticizes it). Posner and Weisbach's "ethicists' position" and "positivist position" represent the utilitarian answers to the questions of "how much" and "which sorts of things" we should do for future generations, respectively; and DeLong discusses how a utilitarian analysis would factor in risk and uncertainty. How exactly would a utilitarian analysis go about answering a question such as "what should we do today to address climate change?" Do you think such an analysis would suggest aggressive action to combat climate change now?
2. Collier is critical of the utilitarian ethical framework when it comes to thinking about intergenerational equity, climate change, and natural resource depletion. What is his critique, and what is his alternative? Which approach do you find more persuasive?
3. How do you think Herman Daly would respond to the first three readings? In what ways would he agree or disagree? Who do you think provides the best framework for thinking about these issues?
4. Risk and uncertainty are clearly critical issues when it comes to climate change and natural resource depletion. We face risk and uncertainty about future economic growth, future interest rates, how much global temperatures

and sea levels will go up, the economic costs of global warming, and future technological innovations, among other things. How does the existence of risk and uncertainty affect the optimal policy response to climate change and/or natural resource depletion in the utilitarian framework? What role, if any, do you think it would play in Collier or Daly's frameworks for thinking about the issue?

5. The readings provide several different ideas about what the "optimal" treatment of future generations would be with respect to climate change and natural resource depletion. Are individual actions in the context of a free market likely to get us to any of these? Why or why not? Is democracy likely to do any better?
6. Were past generations too generous to us, or not generous enough? Why? What, if any, implications might this have for thinking about climate change and exhaustible natural resources?

Thu 11/22 No class (Thanksgiving)

C. Irrationality and Financial Crises

Mon 11/26 Psychology, Irrationality, and Economics

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

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

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

Study Questions:

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

form of cash, or provide them what we think they need in-kind?

Thu 11/29 The Current Financial Crisis: A Failure of Capitalism?

- Robert Solow, "How to Understand the Disaster," review of Richard Posner, *A Failure of Capitalism*, *New York Review of Books* 5/14/09.*
- James Kwak and Simon Johnson, "Securitization, CDOs, and Banking Capital," and "Credit Default Swaps." from *The Baseline Scenario* blog (http://baselinescenario.com), 2008.*
- Michael Lewis, "The End," *Portfolio*, December 2008.*
- Lawrence White, "What Really Happened?" *Cato Unbound* blog 12/2/08.* [Or a similar readings TBA.]
- Paul Krugman and Robin Wells, "The Slump Goes On: Why?" *New York Review of Books* 9/30/2010.*

The first reading by Solow provides an accessible overview of standard economic explanations of the recent financial crisis by Robert Solow. The Kwak and Johnson reading offers concise accessible explanations of "collateralized debt obligations" and "credit default swaps," which played a big role in the story of the financial crisis. The next reading is an engaging story about what was happening on Wall Street in the years leading up to the financial crisis, told by Michael Lewis (author of best-sellers such as *Liar's Poker* and *Moneyball*). The readings by White and by Krugman and Wells engage in a back-and-forth about what they see as the fundamental causes of the recent financial crisis.

Study Questions:
The different writers emphasize different problems that contributed to causing the financial crisis, each of which is summarized below. Considering both the theoretical arguments, and the facts presented in the readings, which explanation do you think is the most important cause of the financial crisis, and why? In what ways are the different arguments consistent with, or inconsistent with, the facts, and how does that affect your answer? How might the practical policy implications vary depending on which of these explanations is most important?

1. The incentives of market participants were distorted by the government.
2. The cause of the crisis was instability and incentive problems inherent in the market itself, not so much distortions created by the government.
3. People behaved irrationally (or stupidly).
4. Capitalism has been undermining its own moral foundations.

IV. CONCLUSION: BACK TO POLITICS AND MARKETS

Mon 12/3 The Return of the Repressed? Economic Nationalism

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

Modern economic nationalism can be seen as neo-mercantilism in the pursuit of industrial growth, usually with some reference to international security as justification. Nationalists often appeal to what in international relations is known as Realism or *realpolitik*—namely, that states rationally pursue power because the world is anarchic and, as a consequence (to quote the Athenians recorded by Thucydides) "the strong do as they will and the weak do as they must." Because it usually favors trade protection for infant or strategic industries, this viewpoint appears to collide head-on with Adam Smith. Recall that he anticipated and responded to the infant-industry argument, IV.ii.13-14), but he also favored the Navigation Acts on what sounded like nationalist grounds (*ibid.*, 24-

30). In the nineteenth-century USA, protection (inspired by Alexander Hamilton) was the rule rather than the exception, especially after the Civil War defeated the strongest economic bloc then in favor or free trade, the slave-owning class of the South. In its contemporary manifestations, economic nationalism in the USA is more likely to be an apology for other forms of industrial policy; elsewhere, it tends to argue that globalization is actually reducing poor countries' ability to catch up economically. Beneath these arguments, its champions also often diverge from economic liberalism on more basic philosophical points about human nature. We will compare these points to Smith not only in *The Wealth of Nations* but also in *The Theory of Moral Sentiments*.

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

Study Questions:

1) Is Smith's exception for defense (recall his discussion of the Acts of Navigation in *WN*) large enough to warrant Buchanan's position?
2) Much of what Buchanan argues can be seen as an appeal to patriotism and national community sentiments--in particular, that we ought to value these attachments over narrow economic interest (say, Wal-mart's low prices) or international transactions. What do you think? How far is this from Smith in *Moral Sentiments*?
3) "Man is a consumer, but he is also a tool-using animal. As a tool-using animal, work is not a disutility. It determines who one is. Belonging, esteem, power, building, winning, and conquering are all human goals just as important as maximizing consumption and leisure" (Thurow, p. 118). Is this right? How might a living Adam Smith (or maybe Coase) respond?
4) "Humans are individuals, but they are also herd animals. In herd or pack species the desire for equity (a share of the earnings) is not a perverse human desire that has to be suppressed but a glue that can be used to generate solidarity and a willingness to sacrifice for the welfare of the group" (Thurow, p. 122). Is this right? How different is it from the Smith of *Moral Sentiments*?
5) Does Chang adequately address the objections of Smith to the "infant-industry" argument? How do we tell when the "infants" no longer deserve protection?
6) Do the arguments in the Rodrik, Romer, or Tyson readings offer any insight into the anxieties of Buchanan, or of Chang? Do they differ in their policy implications?

Thu 12/6 Failures of Government

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

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

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

<u>Study Question</u>:

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