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POLITICAL ECONOMY 250
ECONOMIC LIBERALISM AND ITS CRITICS
Fall 2016

Economic liberalism holds that society is better off if people enjoy economic freedom. Its critics point to what they believe this position ignores or what it wrongly assumes, and hence, how it would make bad policy. This course explores the relationship between politics and economics by surveying influential works of political economy. Its first part examines major thinkers in relation to the historical development of capitalism in Western Europe and the United States: the classical liberalism of Adam Smith, Karl Marx's revolutionary socialism, and the reformist ideas of John Stuart Mill and John Maynard Keynes. The second part considers mid-20th-century writers who revise and critique economic liberalism from a variety of perspectives, including Friedrich Hayek, Milton Friedman, Ronald Coase, Arthur Okun, and Albert O. Hirschman. The third part surveys significant recent contributions relevant to the themes of the course, with applications to current public policy issues, including topics such as: power relations and autonomy in the workplace; asymmetric information and social insurance; economic inequality and distributive justice; equality of opportunity; the economics of health care; positional goods and the moral foundations of capitalism; intergenerational equity and climate change; economic nationalism and new trade theory; behavioral economics; finance and financial crises; and rent-seeking. The combination of the historical focus of the early part of the course with discussion of modern policy issues and debates in the latter part of the course permits you to appreciate the ongoing dialogue between classical and contemporary views of political economy.

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

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

REQUIREMENTS AND GRADING

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

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

Most good essays address one of the “discussion questions” posed for that class on the syllabus below. (There are also some “check your understanding” questions for some classes – those are not intended to be essay topics, but you should be prepared to answer these questions in class, and figuring out the answers to these will help you write a better essay.) What makes a good short essay on material like this? The best ones have several things in common. A good essay should explicate what an author is saying in a certain passage, consider its logical and practical implications, and make some kind of critical commentary (about assumptions, or logic, consistency or inconsistency with evidence, or interesting open empirical questions that it suggests and how one might go about getting evidence on those questions, or practical implications for policy). It should go beyond just summarizing, and should offer some of your own insight and value-added along the lines just mentioned. In doing so, it should show an understanding of the author's position that is informed by the whole reading assignment and not just a few pages. A good approach is often to focus on answering a single discussion question. Don’t try to answer multiple discussion questions in one essay, as it is impossible to do a good job of that in just 650 words. Your paper should say clearly up front what thesis you intend to argue for. Acknowledging and responding to the strongest counter-arguments and counter-evidence to your position makes for a better paper.

Don’t shy away from the challenging but important concepts. Students who tackle a higher degree of difficulty successfully will be rewarded in the grading. There is a natural and understandable tendency to want to navigate around the more challenging, technical, or non-obvious insights and arguments in the readings, and to instead take the path of least resistance, but we notice that. In our evaluation of papers, a good, accurate, and accessible explanation of a challenging insight or argument counts very positively, while listing lots of conclusions without explaining the logic of the arguments that lead to those conclusions counts negatively. If you use technical jargon or even a common technical-sounding phrase (e.g., “economic efficiency”), explain what it means. This demonstrates that you understand what you are talking about, and makes your writing clearer.

Do not make strong empirical claims without backing them up with some empirical evidence. If you address empirical evidence, it is much better to briefly explain the nature of the evidence and why we should be convinced by it than to just appeal to authority. Think critically about evidence. For instance, how do we know the correlation you are describing is not caused by some other explanation than the one you are emphasizing? Given that you only have 650 words, you should avoid lengthy introductory and concluding paragraphs that reiterate what you say in more detail in the body of the essay – instead, state your point clearly and briefly up front and then get to your full explanations and arguments quickly.

Observe the **Honor Code** guidelines for independent work (which can be found in the *Student Handbook* at http://sites.williams.edu/honor-system/avoiding-violations/#general). Enclose direct quotations within quote marks and cite sources for these and for paraphrases. For purposes of this class, we ask that you put citations in footnotes. For course readings, short citations in a footnote, (e.g., Smith *WN*, 567) are fine; any outside sources (not encouraged) should include full reference information in a footnote. Citations in footnotes do not count against your 650 word limit (in Word, when you do your word count, you can uncheck the box for “Include textboxes, footnotes, and endnotes.”) Citations are important both to give appropriate credit, and to signal what part of the text you are talking about and to help back up your claims regarding your interpretation of what the author means. Use quotations sparingly, as you only have 650 words and you need to demonstrate that you understand the ideas well enough that you can explain them clearly and accurately without at the same time looking at the text. A paper that strings together lots of quotations just demonstrates that you can type, not that you can think. Quotations can be appropriate when you need evidence to support a particular interpretation of what you think the author means, though.

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 reason for not writing a paper some particular week. This will happen to everyone, on average, over a twelve-week period. If you can’t write a paper one particular week, you do not need to let us know, since we expect that students will typically skip one or more of the twelve opportunities. If you submit a paper late, the paper will be penalized one full letter grade (e.g., A- changes to B-) for each day or portion of a day that the paper is late; one rationale for this is that handing in a paper after you’ve heard the class discussion on a topic provides an unfair advantage.

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

On class participation, the quality and succinctness of your interventions are most important. Think before you speak and avoid repeating yourself. The course works best with discussions that are informed, vigorous, civil, and widely shared. You should come to class prepared to answer the “check your understanding” and “discussion” questions listed on the syllabus below. Attendance, voluntary contributions to class discussion, and answers to questions we pose to you when we call on you in class will all be taken into account in computing the class participation grade. We will sometimes quiz you on the “check your understanding questions.” When we compute your class participation grade, one correct answer to a "check your understanding" question is roughly equivalent to one high-quality comment made in class discussion. We mainly intend this as a little incentive to encourage you to grapple with technical material before class, in cases where failing to grapple with that technical material will be an obstacle to understanding the discussion questions that we're focused on in that class. It's also an opportunity for people who don't speak up much in class to show what they know. There may also be one or more short homework assignments which would count for no more than 5 percent of your overall grade, to be included in the 20 percent mentioned above.

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

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

READINGS

The following required books should be available 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*;
- Arthur Okun, *Equality and Efficiency: The Big Tradeoff*;
- Richard Thaler and Cass Sunstein, *Nudge* (revised and expanded edition); and
- Adam Smith, *The Wealth of Nations, Volumes I and II* (Glasgow edition, Liberty Press). Note that the publisher just notified us that it has temporarily run out of copies of *The Wealth of Nations*, so we have made a reading packet that includes the assigned pages of reading from it, which is available in the reading packet room now, in case the book does not arrive on time.

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

DIVISION OF LABOR

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

GLOW COURSE WEB SITE

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

SCHEDULE

(* denotes a reading from the packet)

Thu 9/8 Introduction and Organization

I. CLASSICAL THEORIES OF POLITICAL ECONOMY

A. Free-Market Liberalism: Adam Smith

Mon 9/12 Adam Smith: Principles of a Free Market Economy

- *The Wealth of Nations* (henceforth *WN*), read the "Introduction and Plan of the Work" plus [referring to book (I-V), chapter (i, ii, iii, etc.), then section or paragraph (1, 2, 3, etc)]: I. i-iii; iv 1-5, 11-18; v 1-10; vi 1-10, 18-24; vii 1-32. (In the Glasgow/Liberty Press edition, the pages are 10-39; 44-51; 65-68, 69-80).* [Here is some guidance on interpreting section and page references above. The references that are *not* in parentheses give you the book number, chapter number, and section number following Adam Smith's original numbering scheme. That's what you're required to read. The page numbers listed in parentheses at the end are particular to the specific edition we're reading. We provide the page numbers to make it easier for you to find what you are looking for. So for example, the part of the assignment above that says "I. iv 1-5" means you should read Book I, Chapter iv, sections 1-5. That starts on p. 37 of the text (not of the "General Introduction"), and ends in the middle of p. 39. You do not have to read all of page 39, just the part of p. 39 through the end of section 5.]

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

<u>Discussion questions:</u>

1. Why is it, according to Smith, that some nations are rich while others are poor (i.)?
2. Do people really have a natural "propensity to truck, barter, and exchange one thing for another" (ii 1, p. 25)? How would Smith's argument differ if he had begun from Hobbesian premises—say, with a "propensity to steal"?
3. Compare the division of labor in Chapter i (the pin factory) with the examples given in Chapter ii. Are they the same? In which are people working harder? In which are people more autonomous?
4. For Smith, how should we properly regard profit? How does he distinguish it from rent—economically and (it seems) ethically (vi.)?
5. What is the difference between "absolute demand" and "effectual demand" (vii 8, p. 73)? How do Smith's definitions compare with those of modern economics? Why is the distinction important?

Thu 9/15 Adam Smith: Prices, the Distribution of Income, and Economic Growth

- *WN* Book I. chapter vii, paragraphs 33-37; I. viii 1-33, 36-48; I. ix 1-4, 11-24; I. x.a 1-3; I. x.b 1-34; I. x.c 1-32, 60-63; I. xi.a 1-9; I. xi.p 1-10; II. Introduction 1-6 (Glasgow/ Liberty Press pp. 80-93, 96-102; 105-06, 109-15; 116-28; 135-46, 157-62; 264-67; 276-78).*
- Mankiw, N. Gregory. 2008. "Chapter 18: The Markets for the Factors of Production" from *Principles of Microeconomics*, 6th edition. Mason, OH: South-Western Cengage Learning.*
- [OPTIONAL FURTHER READING; AVAILABLE ONLY ON GLOW] Robert C. Allen, *The British*

Industrial Revolution in Historical Perspective (Cambridge University Press, 2009), pp. 33-42.

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

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

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

Check your understanding:

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

Discussion questions:

1. Smith argues that the *level* of wages in a country will only rise above subsistence level if the *rate* of economic growth is continuously high. What are his arguments and evidence for this? What roles do fertility, mortality, and population growth play in his argument? Can you make sense of Smith's rather complex argument regarding these issues in terms of our modern economic understanding of the determinants of wages, as explained by Mankiw?
2. Smith contrasts living standards of typical people in the Britain and China of his day. (Note that Smith's impressions about relative economic conditions in Britain and China in the late 1700s stand up rather well when modern economic historians scrutinize the best available historical data, as suggested in the optional reading by Allen on Glow). Smith attributes the differences in living standards in Britain and China to Britain's newly emerging economic growth, and China's economic stagnation. Considering the full range of readings from today and from the previous class, what do you think Smith would say was causing the divergence in economic growth between Britain and China? Do you think he offers a compelling diagnosis?
3. In chapter x.b., Smith discusses the sources of inequality among wage laborers. What are the real sources of these differences, according to Smith? Do they suffice to explain wage differences today—say, between an NBA star and a housepainter? Thinking about this in the framework of the supply and demand for different types of labor, is Smith leaving out any important determinants of differences in wages between occupations?
4. At I. vii 6, vii 30, and x.a. 1, (Glasgow pp. 73, 79 and 116), Smith refers to a situation of "perfect liberty." What does he mean by this term? Do you think he would favor modern labor unions?
5. In your opinion, is Smith right about his assessment (I. xi.p. 1-10, Glasgow 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?

Mon 9/19 Adam Smith: Progress and Policy

- *WN* Book III. Chapter iv, paragraphs 1-7, 10-18; Book IV. ii 1-15, 23-45; IV. ix. 48-52; Book V. i.b. 1-2, 14-21, 25; V. i.c. 1-2; V. i.d. 1-8, 18-19; V. i.f. 1-7, 14-16, 47-61; V. ii.b. 1-6; V. ii.e. 1-3, 6, 9-11 (Glasgow pp. 411-15, 418-22; 452-59, 463-72; 686-88; 708-10, 716-21, 722; 723-26, 730-31; 758-60, 763-64; 781-88; 825-27; 840-41, 842, 843-44).*

Here is Smith on how good government can result from the spread of markets—and how, in turn, government can foster market expansion and national wealth. In both cases he uses an argument that forms the bedrock of liberal optimism—that freedom has non-obvious, usually unintended, but highly beneficial consequences. Book III gives a quick historical sketch of how state power was tamed by capitalism—an account that, in broad terms, was anticipated by Montesquieu and the physiocrats, and has been repeated by many others since Smith's time. Books IV and V give us some of Smith's best arguments for laissez-faire--and for government. The former begins with the "invisible hand" passage, which occurs at the conclusion his argument about how to maximize national product (IV. ii. 5-9, pp. 455-57). Because of its importance, both to Smith's purpose (here is a formula that directly involves the wealth of nations) and to liberal optimism generally, the argument deserves close attention. Book V (introduced and summarized at the end of chapter ix, Book IV) is on fiscal policy, but it contains lots of philosophical and sociological asides. Its careful discussion of appropriate revenue sources—especially the four maxims on taxes (V. ii.b., pp. 825-28)--is still relevant today. Also revealing is Smith's honest statement of his misgivings (V.i.f.) about the same division of labor he praised so highly at the outset. Note: the Law of Settlements (Iv. ii. 42-43, pp. 470-71) prohibited workers from moving from one parish to another.

Discussion questions:

1. Consider Smith's tale of the merchants, landlords, and "civil government" in Book III. Is the argument plausible? How do the relations between lords and farmers (those who lease land from the lords) change? How about the relations between lords and merchants? What happens to the lord's retainers?
2. Everyone's heard of the "invisible hand" but few realize, even when reading it, that it illustrates the conclusion of a classical syllogism or formal logical argument. Can you find this argument—three premises plus conclusion? Do you find it persuasive? That is (assuming it is logically valid), are the premises realistic?
3. What do you think of Smith's exception for national defense (IV. ii. 24-30, pp. 463-65)? If the Acts of Navigation fall under it, what would not? (Would, say, a Chinese firm's purchase of a US avionics company?)
4. Thinking of Smith's discussion of justice and revenue (I. i.b. 13-23, pp. 715-22), and his discussions of human dispositions elsewhere, does he answer a critic who alleges that auctioning judges' decisions to the party offering the greater bribe would be more "natural"?
5. Consider Smith's discussion of "publick works" V. i.c. 1-3 and d. 1-8, 18-19 (pp. 723-26 and 730-31). What examples does he give here of roles government should perform, and things that should be left to the private market? Why doesn't the "invisible hand" work well for the former kinds of things?
6. Smith indicts the division of labor for its effects on the minds of workers (V. i.f. 50-57, pp. 781-86). Is his proposed remedy adequate? (Compare these passages also to his description of dissolute soldiers at IV. ii. 42, pp. 469-71.) Does the increase in wealth from the division of labor make this sacrifice worthwhile in Smith's view, or in yours?

Thu 9/22 Adam Smith: The Moral Context of a Capitalist Society

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

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

Discussion questions:

1. For Smith, how are our moral rules derived? What are the roles of reason, sentiment, and public life? Does Smith help us understand the stories about traffic in Bogotá and diplomatic parking tickets in Manhattan?
2. Do you think Smith (especially *TMS* 123) romanticizes the poor? How does the passage at 122-23 square with his observation that we tend to despise the poor (78-79, 86-87)?

3. 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?
4. Does *The Theory of Moral Sentiments* solve the problems of *The Wealth of Nations*? In particular, does it suggest a) why our self-interest does not lead to a war of all against all, and b) where honest judges come from? How might the examples from Fisman and Miguel relate to these issues?

B. The Radical Critique of Economic Liberalism

Mon 9/26 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 try to find out what he and Engels think it means to be genuinely free. The first reading refers to different kinds of division of labor—one in which independent producers exchange goods in a market and another in which a factory manager assigns jobs to workers. While it's easy to expect Marx's antipathy toward the second, note his pejorative description of the first. The next reading is about how *any* settled division of labor restricts freedom and has as its political counterpart an "illusory form of communal life." The passages about division of labor in *The German Ideology* do sound utopian, even though Marx and Engels always contrasted themselves as "scientific" against the utopian thinkers of their day. It is interesting that in the passage about Robert Owen from *Socialism: Utopian and Scientific,* Engels clearly put him in the utopian camp—but it is also evident that Owen's ventures represented for Marx and Engels a demonstration that there were actual, practical alternatives to capitalism as it was.

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

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

<u>Discussion 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 9/29 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, 277-281, 287-291; and Vol. II (1877), pp. 396-402.*
- Robert Frank and Ben Bernanke, *Principles of Macroeconomics*, 3rd ed., pp. 301-304 (on finance).*
- John Maynard Keynes, “The State of Long-Term Expectation,” from *The General Theory of Employment, Interest, and Money* (1936), Chapter 12 (pp. 191-201 in the University of Adelaide e-book edition).*
- Burton Malkiel, “The Efficient Market Hypothesis and the Financial Crisis,” from Alan S. Blinder, Andrew W. Lo, and Robert M. Solow, eds., *Rethinking the Financial Crisis* (2012), Russell Sage Foundation and Century Foundation, [Excerpt, pp. 75-77 and 84-94].*

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 seven editions in his lifetime (the readings come from the fifth of these). Through his father he was influenced heavily by Bentham's utilitarian thought, turning these principles in a reforming direction and staking out then-radical positions on free speech and women's rights. In these readings you see a lover of liberty with a relentlessly logical mind seeking to justify private property and limitations on it, even as his valued principles come into conflict.

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

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

For today, our section on Keynes starts with a brief reading by Frank and Bernanke which reviews basic economic principles regarding the determination of prices of stocks (shares of ownership in corporations) which you should have learned in introductory economics. Reviewing this material will be extremely helpful for understanding some of what Keynes is talking about. Then, we’ll read Chapter 12 from Keynes’s *General Theory*, a particularly notable chapter where he memorably lays out his views on the role of “uncertainty” in finance and investment, and its consequences for the economy. The final reading is by Burton Malkiel, a present-day economist at Princeton University. Malkiel is the author of the best-selling investment guide *A Random Walk Down Wall Street*, and one of the leading defenders of the “efficient markets hypothesis,” which some have viewed as a refutation of the kinds of arguments Keynes made in the chapter we’re reading for today. Malkiel, however, is an adherent to a “weak” form of the efficient markets hypothesis, and he attempts to reconcile it with the sorts of things Keynes is talking about. Malkiel contends that while financial markets are not necessarily always "rational," they are almost always "unbeatable." He offers his own views on modern financial theory and evidence, and how it has evolved since Keynes's day.

Guide to jargon: When Mill speaks of "communism" in the first pages of this selection, he is not referring to Leninist state socialism (which did not yet exist) but to factories, farms, and stores owned by workers or members of the community, like those of the Rochdale Pioneers. "Estate" is the total wealth that a person leaves behind when he or she dies. A "bequest" is the wealth that a person leaves to his or her heirs at death. An "inheritance" is the amount of bequest that a particular heir receives (so every bequest is an inheritance). "Intestate" (or in Latin, *ab intestado*) refers to people who die without having made out a will. Note that Mill advocates completely different policies for people who die intestate and people who leave a will. 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. For this reason, we've cut out most of the discussion relating to people who die intestate, but there are still some mentions of what to do in that case, so pay attention and don't assume that a policy he recommends for the case where someone dies *ab intestado* is meant to apply to all bequests. "Collateral inheritances" are those received by distant relatives or non-relatives – that is, people other than direct descendants (e.g., the decedent's own children or grandchildren) or direct ancestors (e.g., the decedent's parents). In his discussion of income taxation, note that a "proportional" tax means a tax that is the same percentage of income for people of all income levels, whereas a "progressive" tax is a tax that is a larger percentage of income for people with higher income levels.

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

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

Check your understanding:

1. What specific public policies towards inheritance does Mill actually advocate?
2. What income tax policy does Mill favor?
3. Consider an asset that you expect will pay you a $10 dividend per year forever, with no risk, and no expected capital gains or losses. Suppose the risk-free interest rate available in the economy is 10 percent, and is expected to stay there. What is the maximum price should you be willing to pay today for the asset that pays a $10 dividend per year forever risk free? Why?

4. Continuing the example above, now suppose there is a 30 percent chance the asset will pay $20 per year, a 40 percent chance it will pay $10 per year, and a 30 percent chance it will pay nothing. If you are risk-averse, should the maximum price you are willing to pay for this asset be higher, lower, or the same as in question 3? Why?

Discussion questions:

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

Mon 10/3 The Keynesian Explanation of Recessions and Depressions

- John Maynard Keynes, "The General Theory of Employment," *Quarterly Journal of Economics*, Vol. 51, No. 2 (Feb., 1937), excerpt, pp. 212-223.*
- Joel Slemrod and Jon Bakija, *Taxing Ourselves* (2017), excerpt on "Recessions, Monetary and Fiscal Policy, and the Government Budget"*
- 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.*
- Paul Krugman, *End This Depression Now*. (2012). Chapters 3 and 9.*
- Paul Krugman, "The Expansionary Austerity Zombie." *New York Times*, November 20, 2015.*
- Lawrence H. Summers. "The Age of Secular Stagnation: What It Is and What to Do About It." *Foreign Affairs*, March / April 2016, pp. 2-9.*
- Christina D. Romer. "Dear Ben: It's Time for Your Volcker Moment." *New York Times*, October 29, 2011.*
- Lars Christensen. "Krugman Finally Acknowledges That It Is All About Monetary Policy." *The Market Monetarist Blog*. May 1, 2016.*

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. 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 logic behind Say's Law is that when people supply goods and services to the market, they receive income for doing so, and this income always turns into demand for *something*. When people spend their income on consumption, they create demand for consumption goods and services. When people save their income, that saving flows through banks or other financial intermediaries and is turned into investment, which in turn creates demand for investment goods. So for example, if there is a drop in consumption, Say's Law suggests there is no reason for that to cause a recession, because a drop in consumption necessarily means an increase in saving, and the increase in saving will push down interest rates enough to induce firms to use the saving to finance investments in physical capital. Thus aggregate demand never drops – any fall in consumption is matched by an equal and opposite rise in investment, and *vice versa*, with interest rates being the key mechanism that maintains equilibrium at full employment.

In 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. Before doing this reading, make sure to remind yourself of exactly what economists mean by "money" by reading the "guide to jargon" for the previous class -- otherwise you are sure to confuse yourself. Moreover, in thinking about the first discussion question below, be mindful that Keynes's explanation for how money causes Say's law to break down is *not* primarily about the effects of an increase in the quantity of money that is hoarded – in other words, Keynes's key insight is *not* about how cash hidden under mattresses is saving that does not turn into investment. That might be part of what is going on, but is empirically only a small part – Keynes's main insight is considerably more sophisticated than that. Keynes's use of the term "hoarding" is a bit confusing and misleading. He sends many signals that he is not mainly talking about the effects of an increase in the quantity of money that is hoarded -- consider for example this quote from p. 199 of the Keynes reading from our previous class: "Those who have emphasised the social dangers of the hoarding of money have, of course, had something similar to the above in mind. But they have overlooked the possibility that the phenomenon can occur without any change, or at least any commensurate change, in the hoarding of money."

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

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

The next five readings are by economist Paul Krugman (the first of these readings is co-authored with his wife, economist Robin Wells). Krugman is a Nobel laureate and *New York Times* columnist, and is probably the closest approximation we've got to having Keynes alive today. The first two of these readings present diagrams that can help you understand the economic logic behind the arguments laid out in the previous two readings. "Reconciling the Two Models of the Interest Rate," by Krugman and 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"). The next Krugman reading, "Zero Bounds and Butter Mountains," uses the latter of those two diagrams to help explain the Keynesian idea of a "liquidity trap." The remaining readings by Krugman discuss the insights of economists Hyman Minsky and Irving Fisher and how they complement the Keynesian analysis of economic crises, consider how inflation fits into the story, and provide a bit of modern cross-country evidence that seems consistent with Keynes's claims about fiscal policy.

The next reading is by Larry Summers, a leading modern economist who has also served as Treasury Secretary (under Bill Clinton) and President of Harvard. Summers discusses the Keynesian-inspired theory of "secular stagnation," and explains why he is increasingly convinced that it explains our current economic predicament. Summers argues for aggressive policy actions to boost demand in the economy, including major and sustained deficit-financed expansionary fiscal policy, even as others (including many on the U.S. Federal Reserve Board) are currently arguing that the U.S. economy has nearly returned to normal so that we should turn our attention again to keeping inflation at or below a 2 percent target and to cutting the government budget deficit.

The final two readings provide a brief introduction to a possible alternative (or perhaps complement) to expansionary fiscal policy that has garnered some support among libertarians (and which also has some support from Democratic economists such as Krugman). In the first of these readings, Christine Romer, a Berkeley economist and former Chair of President Obama's Council of Economic Advisers, makes a case for adopting "nominal GDP targeting," which basically involves having the central bank setting monetary policy so as to maintain a target rate of nominal GDP growth over time, instead of the current practice of targeting a fixed inflation rate. In the second of these readings, economist Lars Christensen presents a bit of cross-country evidence that he interprets as supporting the effectiveness of expansionary monetary policy at the zero lower bound (which would be a necessary condition for nominal GDP targeting to be an effective response to our recent economic predicament). A number of libertarian-leaning economists such as Christensen and Scott Sumner, collectively known as the "market monetarists," have led the way in promoting nominal GDP targeting as a solution to the kinds of problems Keynes pointed out. Nominal GDP targeting appeals to some (but certainly not all) libertarians for a number of reasons. First, libertarians tend to be suspicious of fiscal policy (given that it often involves an increase in government spending), and nominal GDP targeting provides an alternative that they argue can be effective even at the zero lower bound, obviating the need for expansionary fiscal policy. Second, there is a libertarian tradition of opposing discretionary government policies, due to distrust of the wisdom and/or public-spiritedness of government officials. Libertarians such as Friedrich Hayek and Milton Friedman often sought to constrain government action with simple, predictable enforceable rules, and sometimes advocated using such rules to guide monetary policy. Nominal GDP targeting can be thought of as a continuation of this tradition, but one which arguably gets around serious shortcomings of earlier rules in this tradition, such as the gold standard, a rule requiring steady growth in the money supply, or an inflation target. An important difference between the libertarian market monetarists and the Democratic economists who are friendly to nominal GDP targeting is that the former favor exclusive reliance on nominal GDP targeting and oppose expansionary fiscal policy, whereas the latter favor using both to complement each other.

<u>Check your understanding:</u>

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

<u>Discussion questions:</u>

1. The key to Keynes's explanation for why Say's law breaks down, and thus why recessions can happen, is *money*. Explain Keynes's argument about the central role of *money* in causing Say's Law to break down, and why the peculiar social institution of money is critical to understanding how an economy can spiral into a persistent recession or depression. Is there convincing empirical evidence to suggest that he is right about this?
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 do uncertainty, and the associated fluctuations in business confidence and "animal spirits," play in exacerbating the problems identified in the first discussion question for today? What, if anything, does this imply for policy, and for how we should interpret the empirical evidence presented in the readings?
3. What do Hyman Minsky and Irving Fisher contribute to our understanding of why financial crises and recessions happen? What, if anything, do you think the practical for implications for policy are?
4. Considering arguments and evidence from the full set of readings, make your own argument for one of the following propositions:
    a. Larry Summers is right, and we should follow his policy recommendations.
    b. The market monetarists are right. We should use nominal GDP targeting to stabilize the economy, and we should avoid expansionary fiscal policy.
    c. It is time to for the U.S. government to undertake reforms that would significantly reduce current and future budget deficits, or for the central bank to raise interest rates to prevent inflation from getting out of hand.

III. MID-20th-CENTURY ARGUMENTS

A. Defenses of the Market

Thu 10/6 The Case Against Central Planning

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

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

Discussion questions:

1. What does Hayek mean by "planning"? For Hayek, is all "planning" bad? What is Hayek's argument for why "*central* planning" will not work well economically?
2. For Hayek, just because a state formally codifies its decisions as laws, this does not necessarily mean that it practices "the rule of law." Why not? Why is this distinction important?
3. Hayek thinks socialism is likely to kill democracy. Why? Do you agree? Does the experience of Western Europe between the end of World War II and today shed any light on this?
4. Hayek describes democracy as one means for attaining the end of liberty. (Note that by "end," Hayek of course means "goal"). Just saying something is democratic doesn't mean it is good, because the democratically imposed will of the majority can be just as dangerous to freedom as the rule of the autocrat: "Democratic control *may* prevent power from becoming arbitrary, but it does not do so by its mere existence" (p. 111 in Caldwell edition). What do you think?
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 10/10 No class (Reading Period)

Thu 10/13 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 in a peacetime economy. He had won the argument by about 1955, but he did not stop there. These excerpts from the *Constitution of Liberty* (1960) are part of Hayek's attempt to demonstrate the continued relevance of his arguments in the era of the welfare state. Be sure you understand the difference between progressive and proportional (or flat) income taxation (in a progressive tax, the total tax burden is a larger percentage of income for higher-income people; for a proportional tax, the tax burden is the same percentage of income for everyone). In "Competition as a Discovery Procedure" (1968), Hayek returns to his theory of the market process, a theory which some have taken to be incompatible with and superior to the theory of the market in neoclassical economics.

Discussion questions:

1. According to Hayek, "the more civilized we become, the more relatively ignorant must each individual be of the facts on which the working of his civilization depends" (CoL, 26). What does he mean? Does he offer reasons why we should submit ourselves to "facts" we do not (or cannot) understand?

2. Hayek argues that inequality is a public good, in part because the rich act as consumption scouts, but that majorities would not vote for it. This proposition seems to rest on a key distinction: how much inequality is enough, in his opinion?
3. Early in his discussion of progressive taxation, Hayek says that the idea of the interpersonal comparability of utilities has been “generally abandoned” (*Constitution of Liberty*, 309). Yet many policymakers, economists, and ordinary people still think that a rich person gains less utility than does a poor one from income gains of the same magnitude. If we deny comparability, should we also abandon the Golden Rule because it enjoins us to consult our own preferences when we do unto others?
4. If raising revenue in a way that avoids unfair discrimination among taxpayers and avoids distorting incentives to engage in productive economic behavior are important goals of tax policy, then why should proportional taxation be the best approach? Why not use a lump-sum head tax, where everyone pays the same absolute dollar amount? So for example, take the total cost of government, divide it by the number of adults, and each adult is required to pay that same dollar amount in tax no matter what. *Parade* magazine columnist Marilyn vos Savant, who has been listed in the *Guinness Book of World Records* under “Highest IQ,” seems to the think the head tax would be the fairest approach, saying it is “clearly unfair” to require some persons to pay more taxes than others, just as it is unfair to ask one person to pay more for a hamburger than another. And a lump-sum head tax would involve no deadweight loss, because there’s nothing you can do to avoid it, so it does not affect your incentives. A critic of Hayek might argue that once we go beyond lump-sum head taxes, we’ve admitted that our conception of fairness suggests that taxes should be related to ability-to-pay, and it seems kind of arbitrary to assume the optimal tradeoff between addressing that concern and meeting other goals like efficiency is necessarily achieved through proportional taxation. Or as Hayek puts the objection, “It is sometimes contended that proportional taxation is as arbitrary a principle as progressive taxation and that, apart from an apparently greater mathematical neatness, it has little to recommend it.” Does Hayek offer a compelling response?
5. According to Hayek, "Spontaneous order does not ensure that what general opinion regards as more important needs are always satisfied before the less important ones” (“Competition,” 257-58). What reasons does he give to defer to the market on this? Are they sufficient for us to accept, for example, a rich lady’s purchase of heart surgery for her cat taking precedence over the public provision of such surgery for another person?

Mon 10/17 Liberty, State, and Market

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

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

Discussion questions:

1. Friedman says that markets offer a kind of proportional representation (15). Proportional to what? Thinking of this passage and others (e.g., 23-25), would you say he is a democrat?
2. In his discussion of monopoly (28), Friedman says that exchanges are voluntary where both parties have alternative options that are nearly equivalent. Does he believe that market participants usually have such alternatives (13-14)? If so, is this a reasonable belief? If such alternatives do not exist, are we somehow unfree?
3. Friedman argues that minorities have wrongly blamed capitalism for the "residual restrictions" upon their lives when the market “has been the major factor enabling these restrictions to be as small as they are" (p. 109). 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 10/20 Economic Efficiency as a Normative Criterion, and Liberal Principles Applied

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

Here, we start by taking a brief interlude from reading Milton Friedman, in order to get a deeper understanding of the concept of "economic efficiency," which is lurking behind virtually all of the policy recommendations in *Capitalism and Freedom*. We start with a reading by David Friedman (son of Milton, and a physicist who teaches law at U. Santa Clara) which describes the problems with measuring the "welfare" (well-being) of people in a society, and defends the idea that the pursuit of *economic efficiency* is the "least bad solution" to improving it. He explains the idea of an "economic improvement," and correctly notes that this is colloquially what economists mean when they say that a policy change "improves economic efficiency" or is "more efficient." (An "economic improvement" is also known as a "Hicks-Kaldor Improvement," a "Marshall Improvement," an "Increase in Economic Surplus," and a "*Potential* Pareto Improvement" – these are all essentially synonyms except in some weird and rare special cases that we won't worry about). This is a fundamental normative concept in economics (despite the fact that nobody can agree on what to call it) and is frequently used to evaluate whether a policy change is "good" or "bad." So it is a critical concept to understand. As you do this reading, don't forget what you've already learned about these concepts so far this semester. For example, be cognizant of the fact that if you conclude that we should evaluate all policy questions based *solely* on whether or not they would be "economic improvements," that would imply that all taxes should be replaced with lump-sum taxes, where rich and poor pay the same dollar amount in tax, because that would eliminate the deadweight loss from taxation – see second class on Hayek. And remember that Hayek emphasized repeatedly that economic progress is *not* a Pareto improving process. It's easy to be lulled into a complacent and rosy view of the concept of economic improvement when you read Friedman, but as always, think critically here.

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

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

<u>Check your understanding</u>:

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

<u>Discussion 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 would understand it? Given Reinhardt's critique of the concept, why should we care about achieving economic improvements (increasing economic efficiency) at all? What role, if any, do you think it should it play in policy analysis? Should it be our sole normative criterion for evaluating policy, should we consider it along with other ethical values too, or should we just ignore it? 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 10/24 Microeconomics and Renascent Liberalism: Ronald Coase

- Ronald Coase, "The Problem of Social Cost." *Journal of Law and Economics*, 1960, Vol. 3, excerpt, pp. 1-2, 8-10, 16-20, 27-35, and 39-44.*
- Steven Landsburg. 1993. "Of Medicine and Candy, Trains and Sparks." Excerpted from pp. 83-89 of *The Armchair Economist: Economics and Everyday Life*. New York: The Free Press.*
- Gary Becker and Julio Jorge Elias, "Introducing Incentives in the Market for Live and Cadaveric Organ Donations." *Journal of Economic Perspectives*, Summer 2007 (excerpts).*
- Ronald Coase, "The Nature of the Firm." 1937. *Economica*, New Series, Vol. 4, No. 16 (November 1937), excerpt, pp. 386-398.* [Read the footnotes too!]

The two readings for today by Ronald Coase (b. 1910) are largely responsible for his 1991 Nobel Prize in economics.

In "The Problem of Social Cost" (1960), Coase suggested that free markets were in fact able to correct many of the problems associated with externalities that conventional theory generally believed could only be addressed by government action. After attending a dinner party at which Coase presented these ideas before their publication, Milton Friedman commented that he had witnessed a revolution in economic thought. By the end of the twentieth century this had become the most often-cited article in economics. Landsburg's piece offers an accessible discussion of some key insights in "The Problem of Social Cost" and their practical implications.

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

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

When reading both pieces by Coase, be careful to distinguish between Coase's paraphrases of others' opinions (which he will reject) and his own arguments.

Discussion questions:

1. According to Coase's famous argument about social cost, if transaction costs involved in bargaining are low enough, and if property rights are clearly defined and enforced, then the economically efficient use of resources will be obtained regardless of the distribution of property rights. How does this work? Given the importance of tradable property rights as stressed by Coase, do you think we should we give people full property rights to their own kidneys, by making it legal for them to sell their kidneys? If we did have trade in human kidneys and if

transactions costs were lower than the gains from trade, would it "matter" whether people were initially assigned property rights to the kidneys in their own bodies? How do the David Friedman and Uwe Reinhardt articles from last time help us think about this question?
2. Coase recognizes that in many real-world legal disputes, transactions costs are often significant. In those cases, Coase argues that property rights should not be assigned based on who is deemed to be "at fault," but rather should be assigned so that the party who is in possession of the most economically efficient solution to the dispute will have the incentive to implement it. For example, Coase contends that assigning property rights to a polluter can sometimes be a more efficient solution than a Pigouvian tax, even in the high-transaction cost case (41-42). What are his arguments here? How would the decision about how to allocate the property rights in these cases be made? What would Hayek think of this implication?
3. Hayek made compelling arguments about the benefits of relying on the price system and competition to organize economic activity, and about the problems associated with central planning. As Coase emphasizes, when a firm brings economic activity "in house" instead of contracting it out, it is choosing to organize and direct that within-firm activity using methods similar to central planning, and is sacrificing some of the benefits of the competitive price system. Given this, why should firms exist at all? Moreover, if the reasons for the existence of firms that Coase emphasizes are important, then what, if anything, limits the size and scope of firms? Does Coase answer these questions adequately? Do you think Coase's arguments weaken Hayek's case for the price system and against central planning?
4. Following Coase, what effect might we expect, on the economically optimal size of firms, from recent advances in information technology?

B. Defenses of Politics, Equality, and Workplace Democracy

Thu 10/27 Equality and Rights

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

Arthur Okun (1928- 1980) did most of his empirical work on labor markets and price theory. However, as a former policymaker and a lucid writer, he was also capable of writing a book that describes as clearly as any some important areas of conflict between market distribution and democracy. He also offers us a nice review and commentary on authors we've read up to now, from Smith and Mill to Hayek and Friedman. The recent piece from the *Times* discusses a realm of criminal justice in which dollars really do make a difference to outcomes.

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

Mon 10/31 An Economist Defends Politics

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

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

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

Thu 11/3 Power and Autonomy at Work

- Daniel Pink, *Free Agent Nation* (2001), Chap. 1 (pp. 9-25) and pp. 179-181.*
- Lawrence Mishel, "Uber is Not the Future of Work," *The Atlantic* Nov. 2015.*
- Annie Lowrey, "Instacart and the On-demand Middle Class," *New York* Magazine, 8/17/15.*
- William C. Taylor, "These Workers Act Like Owners (Because They Are)," *NY Times* 5/21/06.*
- National Center for Employee Ownership, "ESOP Facts" (2014).*
- Richard Thaler and Cass Sunstein, *Nudge*, "Company Stock" section of chapter 7 (pp. 127-30 in the revised and expanded edition).
- Samuel Bowles and Herbert Gintis, *Democracy and Capitalism*, Chap. 3 (to p. 87 only).*

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

<u>Discussion questions:</u>
1. Thinking of Coase, does Pink give us good economic or technological reasons to believe that the firm is now passé? Could the "sharing economy" fulfill Pink's dream? Thinking especially of Lowrey's article, what limits might there be to the economic advantages of free agency and contracting?
2. What is the "labor commodity" proposition? Do you agree with Bowles and Gintis' critique of it? How does

their position differ from Coase's idea that authority, not the market, governs relationships inside the firm?
3. How about the "asset neutrality" proposition? Do we have to assume that all good ideas get funded in order to regard capitalism as fair? Efficient?
4. Referring to the readings on employee-owned firms and the bit from *Nudge*, what are the advantages and problems of such firms? Are these understandable in the terms articulated by Bowles and Gintis?

IV. CONTEMPORARY CHALLENGES TO AND REVISIONS OF ECONOMIC LIBERALISM

A. Social Insurance, Inequality, Distributive Justice, and the Case for Bigger Government

Mon 11/7 Social Insurance and Distributive Justice

- Jon Bakija, "Insurance and Asymmetric Information" (2016).*
- Richard Arneson. "Justice." in David Estlund, editor, *The Oxford Handbook of Political Philosophy*. Oxford: Oxford University Press, 2012, portions of pp. 58-75.*
- John Roemer, "Ideological and Political Roots of American Inequality." *Challenge*, September-October 2011 [Excerpt, portions of pp. 76-80 and 88].*
- Noah Smith, "I Get What You Get in Ten Years, In Two Days." *Noahpinion Blog*. 6/27/2013.*
- David Weisbach, "Redistribution," from "Should Legal Rules be used to Redistribute Income?" *University of Chicago Law Review*, 70 (2003), pp. 440-446 only.*

The readings for this class consider economic principles and philosophy relating to luck, risk, insurance, asymmetric information, and economic inequality. These concepts play big roles in justifications for, and critiques of, the modern welfare state.

The Bakija reading explains why insurance against risk is economically efficient, and then discusses how insurance markets can fail or operate sub-optimally because of asymmetric information between buyer and seller, a category of market failure including the problems of "adverse selection" and "moral hazard."

The reading by Richard Arneson, a philosopher at UC San Diego, discusses philosophies of distributive justice, including for example utilitarianism, Rawlsianism, libertarianism, and "luck egalitarianism." Among other things, it highlights the central roles that luck and insurance play in modern political philosophy regarding the ethics of government policies intended to reduce inequality and help the less fortunate. John Roemer, a "luck egalitarian" philosopher and economist at Yale University best known for his work on the concept of equality of opportunity, offers a philosophical discussion of what kinds of economic inequality are morally justified and what kinds are not, and gives some examples of what the practical policy implications might be. Noah Smith, an economist and columnist for *Bloomberg*, offers a colorful defense of utilitarian reasoning and critique of the notion that all inequality arising from the market is "deserved." The final reading, by David Weisbach (a law professor at U. Chicago), explains in a bit more detail what the policy implications of utilitarianism and Rawlsianism might be for government policy towards taxes, transfers, and social insurance, once we take the efficiency costs of redistribution into account. In addition to its relevance to the topics of discussion for today's class, the Weisbach reading helps set the stage for our next class as well.

<u>Check your understanding:</u>
1. Suppose you face a risk that leaves you with a 10 percent chance of having bad luck, in which case your consumption is $0, and a 90 percent chance of having good luck, in which case your consumption is $40,000. Further assume that your utility function is $U = \sqrt{C}$. Suppose there are many people just like you, and firms in a competitive insurance market offer an insurance policy that pays a benefit of $40,000 in the event of bad luck. Each firm incurs an administrative cost of $100 per insured customer (regardless of their luck). How much consumer surplus do you get if you purchase the insurance?

<u>Discussion questions:</u>
1. As the science of genetic testing advances, it will become increasingly easy for insurance companies to adjust insurance premiums to more accurately reflect the risks of disease faced by each individual. Suppose we were starting from a hypothetical free market for insurance. If government enacted a regulation that prohibited

insurance companies from using genetic information to help set premiums, would this make the insurance market more efficient or less efficient? In light of the day's readings on distributive justice, would it be a good thing? What, if anything, do you think are the practical policy implications of your answer?
2. The day's readings discuss several different philosophies of distributive justice. Compare and contrast any two of them, and consider what their most important practical implications might be. Which one do you find most persuasive, and why? Or do you find some combination of them to be the best approach, and if so why?

Thu 11/10 Economic Inequality and Public Policy

- Jon Bakija, "Social Welfare, Distributive Justice, and Public Policy" (2016)*
- Lane Kenworthy, "America's Social Democratic Future." *Foreign Affairs*, January / February 2014.*
- Lane Kenworthy, *The Good Society* (2016), chapters on "Equality of Opportunity," "Early Education," and "Is Big Government Bad for the Economy?"*

The first reading by Bakija ties the rather abstract philosophical discussion from the previous class to practical implications for policy, discussing how concerns about economic efficiency and distributive justice can be integrated in the evaluation of policy changes, including for example changes in taxation and transfers intended to address economic inequality. The remaining readings, by Lane Kenworthy, a sociologist at UC San Diego, make a case U.S. public policy should do more to promote economic security, opportunity, and shared prosperity for more Americans, and should adopt policies that are more like those of a Nordic welfare state. He then provides an evidence-based response to many possible objections.

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

<u>Discussion questions:</u>
1. What are the leading explanations for why the share of pre-tax income going to the top of the income distribution has increased so much over time in the U.S.? Which explanations seem most consistent with the evidence? Consider how the implied optimal tax-and-transfer policy would differ depending on which of these explanations is empirically most important, drawing on one or more of the philosophies of distributive justice that we've considered in class.
2. Kenworthy argues that U.S. public policy should do more to promote opportunity for the disadvantaged, and advocates (among other things) a government-funded universal pre-school program. What are his best arguments and evidence for this? What is the most compelling counter-argument? How might Kenworthy would respond? How does this connect with our discussion of philosophies of distributive justice from the previous class?
3. Kenworthy presents several evidence-based arguments against various objections to his proposals, such as the concern that they would be harmful to the nation's economic performance. Explain at least one evidence-based argument, discuss its implications for policy, and consider the strengths and weaknesses of the evidence. What

further questions does it raise? On balance, do you find it persuasive or not? Why?

4. Consider how Hayek or Milton Friedman would critique any of Kenworthy's arguments, and how Kenworthy would respond. Who do you think wins the argument and why? Where, if anyplace, do you think they would share common ground?

Mon 11/14 Health Care

- David Cutler, *The Quality Cure*, Chapters 1-4. University of California Press (2014).*
- Austin Frakt, "Accountable Care Organizations: Like H.M.O.s, but Different." *New York Times*, January 19, 2015.*
- Katherine Baicker, Amitabh Chandra, and Jonathan S. Skinner, "Saving Money or Just Saving Lives? Improving the Productivity of US Health Care Spending." *Annual Review of Economics*. 2012. [Excerpt, portions of p. 34 and 47-51]*
- Council of Economic Advisers, *Economic Report of the President 2014*. [Excerpt, portions of pp. 162-170]*
- Eric D. Schansberg, "A Free Market for Health Care: The Possible Dream?" *Milken Institute Quarterly*, 3rd Quarter 2011, pp. 55-64.*

Health care is a hugely important and complex policy issue. The intensely controversial Affordable Care Act (ACA), the most significant health care reform since the 1960s, was enacted in 2010, and its main provisions for extending coverage to the uninsured began to roll out in 2014. Gallup poll data suggests the fraction of the population that lacks health insurance declined from 17.3 percent in 2013 to 11.0 percent by the second quarter of 2016.[1] After a long period of rapid growth, total U.S. health care expenditures only grew from 17.4 percent of GDP in 2009 to 17.5 percent of GDP in 2014,[2] although it is hard to say how much of the slowdown in health care expenditure growth is due to recession, health care reform, or other factors. Rising health care expenditures are the dominant budgetary challenge facing the U.S. -- the Congressional Budget Office predicts that if federal tax revenues remain constant as a percentage of GDP in the future, then federal spending on social security and healthcare will exceed that level of tax revenue by around 2040, meaning either that there will be nothing left for other government programs, or taxes will have to be raised significantly. Quality is also a big problem in the health care industry – while advances in health care have helped produce big increases in longevity over time, David Cutler (a Harvard health economist who helped advise the Obama administration during the development of the ACA) points out that "the death rate from medical errors… is the equivalent of a medium-sized jumbo jet crashing daily."

The first four chapters of *The Quality Cure* by Cutler concisely describe the current health care system in the U.S. and the rationale behind its design, summarize empirical evidence on what factors have been driving the rapid rise in health care expenditures and to what extent this reflects inefficiency, describe a variety of approaches to controlling costs that have been implemented or proposed here and in other countries, and then present examples of private health care systems in the U.S. that have succeeded in providing high-quality, efficient health care at low cost and consider what characteristics those systems have in common.

The remaining readings consider a variety of reforms that are all intended to improve the efficiency and reduce the cost of the U.S. health care system. Roughly speaking, most of the reforms can be thought of as broadly falling into three categories: (1) reforms to the system of paying health care providers, which are intended to incentivize the providers to behave more efficiently, and more like the examples in Chapter 4 of Cutler's book; (2) reforms that incentivize patients to economize on health care spending by requiring them to share more of the costs of the health care services they consume; and (3) reforms that attempt to facilitate or remove obstacles to competition in the markets for health care and health insurance. Health economist Austin Frakt introduces concepts such as "accountable care organization" and "capitation," which play a big role in discussions of how to reform the system of paying health care providers. Health economists Baicker, Chandra, and Skinner summarize theory and evidence on the major approaches to improving efficiency in the health care system. The excerpt from the 2014 *Economic Report of the President* explains some of the most significant cost-control measures that have been implemented in government health insurance programs so far as a result of the Affordable Care Act, including the leading theories for why these measures would work, and some evidence that they've helped. The final reading, by Schansberg, argues for several different "free market" reforms to the health care system, including for example

[1] http://www.gallup.com/opinion/thrive/193922/tracking-progress-affordable-care-act.aspx
[2] http://content.healthaffairs.org/content/early/2015/11/25/hlthaff.2015.1194

changing the tax code to create strong incentives for consumers to choose high-deductible "catastrophic" health insurance plans, deregulating health insurance, and hoping that the deregulated private insurance market adopts innovations such as "health status insurance" that would protect people against the risk of insurance premium increases when their health status changes (e.g., onset of an expensive chronic disease).

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

<u>Check your understanding</u>:

1. What does each of the following mean in the context of the markets for health care and health insurance, and what is the theory for why each one would help improve the efficiency of these markets.
    - Capitation
    - Accountable care organization
    - Bundled payment
    - Value-based insurance plan
    - Health status insurance
    - Health savings accounts

<u>Discussion questions</u>:

1. According to Cutler, what are the most important reasons why health care is so much more expensive in the U.S. than it is in other rich countries? What evidence does he supply to support these conclusions? What do you think this implies for the politics and economics of health care reform in the U.S.?
2. Despite the regulations that Schansberg highlights, there is still a reasonable amount of competition in the markets for health insurance and health care provision in the U.S. In most industries, competition leads to provision of the economically efficient quantity and quality of the product. It's plausible this could work in health care too – for example, one might expect that competition should reward insurers that develop innovative managed care schemes which give health care providers optimal incentives to provide efficient, low-cost, high-quality care, because then demand for that insurance company's product by individuals and employers would increase. What evidence do we have that this is not working well in the health care industry? What are the most compelling explanations for why competition has not solved our health care inefficiency problems? What are the practical implications for policy?
3. The readings discuss a wide variety of possible reforms that could improve the efficiency of the U.S. health care system. Which ones seem most promising to you, and why? How much would you rely on each of the different approaches?

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

Thu 11/17 Is "More of the Same" Feasible? Positional Goods and the Norms of Capitalism

- David Brooks, "The Power of Altruism," *NY Times*, 7/8/16.*
- Jonathan Kaufman, "Striking it Richer: Amid Economic Boom, the 'Haves' Envy the 'Have-Mores'," *WSJ* 8/3/98.*
- Fred Hirsch, *Social Limits to Growth* (1976), Chaps. 1, 3, 8, and 10 (pp. 1-12, 27-54, 77-82, 117-18, and 137-43 and 150-51).*

Conventional economics focuses on the policies most conducive to rapid and sustainable economic growth, since it is commonly held that economic growth promotes human happiness and well-being. Writing in 1976, Fred Hirsch asked if, over time, growth might instead result in more disappointment and strife. His key step was a focus on relative rather than absolute gains or satisfactions, coining the term "positional goods." He foresaw a conflict between the pursuit of such goods and the maintenance of the norms that sustain liberal capitalism. The first article, a recent David Brooks column, complains about our selfishness, while offering a summary of recent research on altruism as an inborn trait. The next one vividly depicts paycheck envy during the 1998-2000 dot-com boom; similar things were written around 2006 about the attitudes of merely rich Wall Streeters toward hedge-fund managers.

Discussion questions:

1. What are positional goods, and why does Hirsch think they have important implications for our thinking about the political economy of affluent societies? For example, do they contradict Hayek's argument about the rich as society's consumption scouts (*CoL* 43-44)?
2. How does Hirsch mean by the "tyranny of small decisions" (40, 53-54)? Is it really a "tyranny"? What are its consequences? (Contrast him to Hayek, *Constitution of Liberty* pp. 50-51.)
3. Hirsch believes that "education"..."is a filter as well as a factory" (p. 48). What does he mean by this? Would we all be better off if Williams College were reduced to an Office of Admissions that handed out certificates of virtue to five hundred people a year, leaving them to learn relevant skills immediately in actual jobs?
4. For Hirsch, why do a society's moral resources inevitably get depleted? What consequences does he see for capitalism? What does Brooks add to this argument?

Mon 11/21 Climate Change

- Brad Plumer, "Conservatives are Now Debating Carbon Taxes. Here's Why They're Still Skeptical." *Vox*. June 12, 2015.*
- Gernot Wagner and Martin L. Weitzman, "Pop Quiz" and "911," Preface and Chapter 1 of *Climate Shock: The Economic Consequences of a Hotter Planet*, Princeton University Press (2015).*
- Jon Bakija, "A Primer on Discounting, Climate Change, and Intergenerational Equity" (2016).*
- David Weisbach, "Climate Change Blinders," from Stephen M. Gardiner and David A. Weisbach, *Debating Climate Ethics* (2016), pp. 205-208.*
- Gernot Wagner and Martin L. Weitzman, *Climate Shock: The Economic Consequences of a Hotter Planet*, Chapter 3, Princeton University Press (2015).*
- Cass Sunstein, "U.S. Should Act Unilaterally on Climate Change." *Bloomberg*. January 23, 2013.*
- David Roberts, "The Political Hurdles Facing a Carbon Tax – And How to Overcome Them." *Vox*, April 26, 2016.*
- K. William Watson. "Green Industrial Policy: Taxes, Subsidies, and Privilege." Cato @ Liberty Blog. December 21, 2012.*

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

The first article by journalist Brad Plumer discusses a carbon tax proposal intended to garner conservative political support, and conservative reactions to it. It makes clear why it is so hard to reach a compromise that would lead to progress, and what some of the key points of contention are. The next reading is from the book *Climate Shock* by Gernot Wagner (lead economist of the Environmental Defense Fund) and Martin Weitzman (an environmental economist at Harvard). The first excerpt from their book provides background information on key issues, and makes an economic case for putting a high price on carbon emissions, either through a tax or a cap-and-trade scheme. The Bakija reading clarifies what "discounting" is and why it plays such a central role in the debate over what to do about climate change. It clarifies that the "market discount rate" and the "social discount rate" are answers to two different questions, and summarizes why some other economists (including Wagner and Weitzman) argue that market discount rates are the ones to use when setting a price on carbon. The Weisbach reading introduces the "climate change blinders" argument, which is part of his case for setting carbon taxes based on efficiency rather than equity considerations. Then we return to Chapter 3 of *Climate Shock*, where Wagner and

Weitzman argue that if we take risk into account appropriately, we should discount future climate damages at a very low or even negative rate, implying a very high carbon tax.

The final three readings turn to some questions of positive political economy related to climate change. The reading by Cass Sunstein, a Harvard law professor, makes a case for unilateral action by the U.S. to fight climate change. Since Sunstein wrote, many countries around the world, including the U.S. and China, committed to the Paris Climate Accord. Each country agreeing to the accord pledged to voluntarily meet certain targets for reductions in carbon emissions by certain future dates. However, there are no sanctions for failing to follow through. Making significant progress towards meeting the targets will require adoption of policies that may face significant political opposition back home, so there's plenty of worry that countries might not follow through on their commitments, making Sunstein's arguments still quite relevant. In the next reading, journalist David Roberts presents an evidence-based political strategy that he thinks will help us make progress on enacting policies that would help fight climate change in the U.S. The final reading by Watson discusses reasons why some people are skeptical of "Green Industrial Policy" (i.e., government subsidies for clean energy) of the sort advocated by Roberts.

Check your understanding:

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

Discussion questions:

1. David Roberts has said (accurately) that among economists, the seemingly technical issue of what discount rate to use when computing the "optimal" price of carbon emissions is "the difference between apathy and panic" about climate change. What are the issues here? What is the gist of Wagner and Weitzman's argument on this topic? Roughly what discount rate do you think should be used for pricing carbon, and why?
2. The article by Plumer summarizes a Senate proposal designed to garner conservative support for a carbon tax. What do you think of that proposal? Pick any one of the objections to the proposal. (Or offer your own objection). Do you think other readings from today (or from elsewhere in the course) offer compelling responses to the objection? Why or why not? What else would you want to know?
3. Many of the readings discuss strategies for addressing the political obstacles to policy action on climate change. Which strategies do you find most promising or problematic, and why?

Thu 11/24 No class (Thanksgiving)

D. Psychology and Finance

Mon 11/28 Psychology, Irrationality, and Economics

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

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

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

Discussion questions:

1. What does "rationality" mean to an economist? What is the most compelling evidence that people behave in irrational ways? Can we really be so sure that this evidence of irrationality can't actually be explained as plausibly rational if you think about it a different way?
2. 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? What if a teen-ager or young adult decides the personal benefits of smoking outweigh the personal costs because of a strong preference for current utility over future utility, but his or her older self disagrees when diagnosed with cancer? What if the question were about heroin?

Thu 12/1 What Is Finance For?

- 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.*
- "The Housing Boom and Bust Was Global" (*McKinsey Quarterly*, via Barry Ritholtz, 2011).*
- Nelson D. Schwartz, "How Wall Street Bent Steel," *NY Times*, 12/4/14.*
- Thomas Philippon, "Finance vs. Wal-mart: Why Are Financial Services So Expensive?" (2012).*
- Noah Smith, "How Finance Took Over the Economy," *Bloomberg View*, 4/20/16.*
- John Cochrane, "Finance: Function Matters, Not Size," *Journal of Economic Perspectives* 27:2 (Spring 2013).*
- John Kay, *Other People's Money* (2015), Chap. 10.*

The first reading, by Kwak and Johnson, concisely explains a few financial concepts that are helpful for understanding what is going on in the remaining articles. The second 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*). After a bit of data on the 2008 crisis, we turn to a story reminding us that, crisis or not, our capital-market-based financial system often puts financial firms in a position to decide whether industrial firms stay together or break into pieces. Philippon and Smith then introduce a macroeconomic issue often heard from critics: the financial sector has grown too big, it is not efficient, and this has hurt the real economy. Cochrane rebuts this argument, getting into the weeds about price discovery and financial markets. His main target is the assertion that the growth of the financial sector in recent decades has taken place in parallel with an increasing overall cost of asset management (as in mutual funds, etc.), due in large part to proportional fees on expanding asset bases. (This happened despite the fact that it is extraordinarily rare for a money manager to outperform major indexes over anything but the short run, especially if we calculate the return net of fees.) We conclude with John Kay, writing from a British perspective, who prescribes not more regulation but a new structure of finance.

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

Additional background: for obvious reasons, lurking in the background of these readings is a difference of opinion on the most important cause of crises such as the one the world experienced in 2007-09. Critics of finance often cite the instability thesis of Hyman Minsky. He posited that borrowing for asset purchases could be of three types: hedging (in which the borrower can expect to pay back both interest and principal from earnings on the invested capital); speculative (in which the borrower can pay back only interest, so must roll over the principal portion of the loan); and Ponzi (in which the borrower cannot fully pay even the interest due, and can only remain solvent as long as appreciation of the asset allows renegotiation of loan terms or its sale can pay off the loan). Minsky thought that financial instability was born out of financial stability: long periods of stable asset markets and low risk premia would breed confidence among agents about the likelihood of stable or rising prices in the future; in this environment, as market participants sought greater yield, their borrowing would move from hedging to the speculative and Ponzi types. Once the last two come to dominate the universe of borrowers, the stage is set for a meltdown. Therefore, crises happen because of how asset markets behave when left to themselves. Defenders of free financial markets generally point to moral hazard created by government. This arises, so the argument goes, when private lenders expect a bailout, perhaps because these agents regard themselves as too big and interconnected for the government to let them fail, or because they've seen it happen in the past, or because their loans are serving some other politically popular purpose (like promoting mortgages to poor or first-time home buyers). Expecting to have their losses covered, they lend recklessly. Hence (the argument goes) markets are not at fault, politicians are.

Discussion questions:

1. Is Lewis saying the crisis was caused by a systemic or institutional problem on Wall Street, or is his story just about greed and other human failings? Stepping back and considering the graph with housing prices across the Atlantic, is his argument for its origins persuasive?
2. Critics often begin from the idea that while some financial firms and exceptional performers might make outsized profits, a sector that mostly trades with itself should roughly break even (because every shift of assets that creates a profit for one agent creates a corresponding loss for another). If so, the fact that financial profits and salaries are still very high must therefore mean either that the sector is producing unusual value or that it is hurting other sectors. Do you agree with this premise? Does the story of Timken support it? In accounting terms (profits and losses), how do you come to your conclusion?
3. Citing Hayek, Cochrane argues that we should not even be in the business of judging the right size for the financial sector. How might Kay or Philippon respond? What do you think?
4. Lewis and (in several passages) Kay seem to argue that the problem with finance boils down to immorality among its practitioners. Is this fair? Or are there more systematic structural causes for the issues they describe? How do you think Hirsch would answer this question?
5. Based on his assessment of the last financial crisis, Kay recommends (among other things) separation of deposit-taking and investment banking, simplicity in financial intermediation, and strict liability for corporate officers of financial firms. What do you think of his diagnosis—and his prescription?

C. Economic Nationalism and New Trade Theory

Mon 12/5 The Return of the Repressed? Economic Nationalism and New Trade Theory

- Peter Dizikes, "When (and Where) Work Disappears," MIT News Office, 2/24/12.*
- Noah Smith, "There's Great News on Inequality and Poverty," *Bloomberg View*, 6/20/16.*
- Patrick Buchanan, *The Great Betrayal* (Little, Brown, 1998), first part of Chap. 3 ("How Free Trade Is Killing America"), pp. 44-58.*
- Lester Thurow, *Head to Head* (Morrow, 1992), middle section of Chap. 4 (pp. 117-24).*
- Ha-Joon Chang, *Bad Samaritans* (Bloomsbury, 2008), first part of Chap. 1, two excerpts from Chap. 3.*
- Dani Rodrik, *The Globalization Paradox* (Norton, 2011), Chap. 4.*

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

The first reading is a quick summary of what was then a working paper by Autor, Dorn, and Hanson, to be published in 2013 in the *American Economic Review*, detailing the impact of the "China shock" on manufacturing employment in the US. The second is an overview of recent work and data regarding world poverty and inequality. We then turn to a polemic by the man who preceded Donald Trump in introducing an ethnonationalist-inflected critique of trade into recent US politics, Patrick Buchanan. Thurow (Williams '60) shows the divergence from liberalism in key philosophical assumptions, while the excerpts from Chang present a perspective from developing countries. The next reading by Dani Rodrik, a Harvard economist, is from a book with a foot in each camp, in order to remind us of the case for free trade and how its complications might relate to the nationalists' worries.

<u>Discussion questions</u>:

1. Is Smith's exception for defense (recall his discussion of the Acts of Navigation in *WN*) large enough to warrant Buchanan's position?
2. How might a convinced nationalist like Buchanan or Trump respond to Noah Smith? Who has the better argument, in your opinion?
3. "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? Can we count on them to tell us?
6. Do Rodrik's arguments offer any insight into the complaints of Buchanan?

IV. CONCLUSION: BACK TO POLITICS AND MARKETS

Thu 12/8 Failures of Government

- James Buchanan, "Rent Seeking and Profit Seeking." Chap. 1 from James M. Buchanan, Robert Tollison, and Gordon Tullock, eds., *Toward a Theory of the Rent-Seeking Society* (Texas A&M University Press, 1980).*
- Rosen, Harvey. 2005. "Rent-Seeking" excerpted from *Public Finance*, 7th ed., New York: McGraw-Hill, pp. 129-132.
- Greg Rushford, "Don't Bother to Compete; Hire a Lawyer," *WSJ* 9/21/95.*

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

For the concluding class, we have assigned a short piece by another Nobel Prize-winning economist, James Buchanan, a short excerpt from a *Public Finance* textbook by economist Harvey Rosen that elaborates on the rent-seeking idea with a diagram, and a snippet from the *WSJ* that shares Buchanan's ideas.

Discussion question:

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