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POLITICAL ECONOMY 250
Fall 2010
ECONOMIC LIBERALISM AND ITS CRITICS

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

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

Requirements. 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 (2-page) papers commenting on the readings assigned for the day the paper is due. Papers are due at the start of class. 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). The class will divide into two groups, with one group turning in its papers on Mondays and the other on Thursdays. There will also be a regular final examination that requires the identification of key concepts as well as the writing of integrative essays.

Grading. Of the twelve short papers, only the eight best count, together for 50 percent of your grade; the final exam counts for 30 percent; your class attendance and participation count for the remaining 20 percent. On the last, 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.

Observe the Honor Code guidelines for independent work (pp. 136-37 in the *Student Handbook*). Enclose direct quotations within quote marks and cite sources for these and for paraphrases. For course readings, short internal citations (Smith *WN*, 567) are fine; any outside sources (not encouraged) deserve a full footnote.

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

Papers. What makes a good short paper on material like this? The best ones have several things in common. They explicate what an author is saying in a certain passage, consider its logical and practical implications, and make some kind of critical commentary (about assumptions, or logic, or implications). In doing so, they show an understanding of the author's position that is informed by the whole reading assignment and not just a few pages. Many papers use study questions or portions of study questions for topics; all should say clearly up front what their focus is. Brevity is rewarded in the grade, so please stick to the two-page (500-word) limit.

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

Milton Friedman, *Capitalism and Freedom*;
Friedrich Hayek, *The Road to Serfdom*;
Albert Hirschman, *Exit, Voice and Loyalty*;
Arthur Okun, *Equality and Efficiency: The Big Tradeoff*;
Adam Smith, *The Wealth of Nations* (Glasgow edition, Liberty Press), and
Richard Thaler and Cass Sunstein, *Nudge*.

The other readings are in a packet. Its first part is available immediately, from Hollander Hall (NAB), room 026. Parts Two and Three will be made up after the enrollment is settled.

SCHEDULE (* denotes a reading from the packet):

Wed 9/8 (Thursday schedule) Introduction and Organization

I. CLASSICAL THEORIES OF POLITICAL ECONOMY

A. Free-Market Liberalism: Adam Smith

Mon 9/13 Principles of a Free Market Economy

- *The Wealth of Nations* (henceforth *WN*), Introduction through [referring to book.chap.sec.] I.iii.,8; I.iv.1-5, 11-18; I.v.1-10; vi-vii (pp.--text not general introduction--10-36; 37-39; 44-46; 47-52; 65-81).

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.

Study Questions:

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

Thu 9/16 Prices, the Distribution of Income, and Economic Growth

- *WN* I.viii.1-33, 36-48; I.ix.1-4, 11-24; I.x.a., I.x.b.1-34; I.x.c.1-32, 60-63; I.xi.a.1-9; I.xi.p.1-10; II.iii.1-9, 13-22, 28-32; (pp. 82-93, 96-102; 105-06; 109-15; 116-28; 135-46;157-59; 160-62; 264-67; 330-34, 337-39, 341-44).

The readings for this class focus on Adam Smith's views of the determinants of prices, income distribution, and economic growth. Here you can find some of his most trenchant critiques of the guild system along with a view of markets that places labor (and the laborer) front and center. You'll also find a great deal of attention to politics. Note: in Chapters x.a.2 and x.c, the "policy of Europe" refers to the mercantile system (which involved national economic strategy and had an important role for guild regulations) and "corporations" to guilds.

Study Questions:

1. What is Smith's rather complicated view of the relationship between high wages and general prosperity (pp. 91-93, 96-99)? Does it still apply in the international market of today? What do you think about Smith's (related) arguments about population and slavery (pp. 98-99)?
2. In chapter x., Smith discusses the perceived 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? (Or between a housepainter and a housewife?)
3. On pp. 73, 79 and 116, Smith refers to a situation of "perfect liberty." What does he mean by this term? Do you think he would favor modern labor unions?
 4. In your opinion, is Smith right about his assessment (pp. 264-67) of the degree of confluence between the particular interests of each of the three fundamental social groups (those who receive rent, profits, or wages, respectively) and the general interest?
 5. How does Smith distinguish between productive and unproductive labor (Book II, chap. iii)? (We will see a similar distinction at work in the tale of the profligate landlords at III. iv.) How does his argument relate to the discussion of the general interest on 264-67?

Mon 9/20 Progress and Policy

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

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

Study Questions:

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

Thu 9/23 Moral Foundations of 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. The Fisman and Miguel excerpt talks about the importance of culture in economic life in ways that link up nicely with Smith.

Study Questions:

1. What does Smith mean by “sympathy” and what role does it play in the *TMS*?
2. What distinction does Smith make between beneficence and justice? What is the significance of each to the proper ordering of economic life?
3. What is the role of public life—through human vanity and the sentiment of shame—in sustaining morality? Do traffic behavior in Bogotá and diplomatic parking tickets in Manhattan adequately illustrate this?
4. Does Smith muddle the distinction between shame and conscience?
5. 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)?
6. Can you reconcile the arguments in *The Theory of Moral Sentiments* with those in *The Wealth of Nations*? In particular, on the relationship between sympathy and the pursuit of self-interest? Is personal morality necessary for markets to do a good job of channeling the pursuit of self-interest in such a way that it promotes social good? Or do markets solve the problem of conflict between self-interest and morality? How are the examples in Fisman and Miguel relevant to that question?
7. Considering again the book’s opening sentence in light of everything else we have read from *TMS* and *The Wealth of Nations*, is this doggerel (from the Canadian writer Stephen Leacock) on target?
 Adam, Adam, Adam Smith
 Listen what I charge you with!
 Didn't you say
 In class one day
 That selfishness was bound to pay?
 Of all of the doctrines that was the Pith,
 Wasn't it, wasn't it, wasn't it, Smith?

B. The Radical Critique of Economic Liberalism

Mon 9/27 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.

¹From Stephen Leacock, *Hellements of Hickonomics* (1936), p. 75, quoted by Amartya Sen, *On Ethics and Economics*, p. 21.

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

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

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

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

Study Questions:

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

C. Reformist Liberalism and Social Democracy

Thu 9/30 Rethinking Property

- John Stuart Mill, *Principles of Political Economy* (1871), pp. 201-09, 215-27, 230-33; 806-09.*
- R.H. Tawney, *The Acquisitive Society* (1927), pp. 9-22, 36-43, and 55-69.*

In the nineteenth century, John Stuart Mill (1806-73) was just as famous for his political economy as for his other philosophical works. The *Principles* went through six editions in his lifetime (the readings come from the last 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. Note that where 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. Note also that “intestate” refers to people who die without having made out a will, and “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).

World War One shattered the fundamental assumptions of the long nineteenth century (1815-1914), including the belief that rising economic interdependence, via trade and capital flows, would lead to international peace. Then, in 1917, the Russian Revolution (and smaller communist revolutionary outbreaks in central Europe in 1918-19) presented a new menace to the established order. Finally, the war itself saw ambitious expansions of government power even among the most liberal combatants, the UK and US. The old free-market orthodoxy was questioned from several directions at once. In response, like Mill but more pointedly, the generation of reformers after 1918 argued that some forms of private property unfortunately put the whole idea of private property into question. For Mill and Henry George (American proponent of the “single tax,” world famous in the late 19th century), the most important offender had been land. R. H. Tawney generalized the argument to what he called “functionless property.”

Born in India to an eminent family, Tawney (1880-1962) later came into sympathetic contact with the poor people of London’s East End. Like T. H. Green before him, he sought to ground rights to different forms of property in the societal functions they performed.

Study Questions:

1. Does Mill’s attitude to what he calls “communistic” schemes (201-09) 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” (207). What does he mean by this, and how does he propose to remedy the problem?
3. Mill’s long section on inheritance and bequest (218-26) underlies his position on death duties or estate taxes later in the book (806-09). What do you think of his position?
4. Why does Tawney think that human beings cannot dispense with an idea of social purpose for property? What does social purpose have to do with job satisfaction?
5. What is functionless property, for Tawney? Do you agree with his classification? How does the array of property rights in the contemporary USA measure up in terms of functionality?
6. Is Tawney a conservative or a radical? Why?

Mon 10/4 Keynes

- Christina Romer. “Lessons from the Great Depression for Economic Recovery in 2009.” Speech presented at the Brookings Institution, Washington, D.C., March 9, 2009 (11 pages).*
- Robert Skidelsky, “Keynes’s Economics,” Chapter 4 from *Keynes: The Return of the Master*. (New York: Public Affairs, 2009, pp. 75-100).*
- J.M. Keynes, *The General Theory of Employment, Interest, and Money* (1936), sections IV, V and VI from chap. 12 on equity markets (pp. 152-61) and “Concluding Notes” (pp. 372-384)*
- Paul Krugman, “How Did Economists Get It So Wrong?” *NY Times Sunday Magazine*, Sept. 6, 2009.*
- Robert Skidelsky, “Efficient Market Theory” from Chapter 2 from *Keynes: The Return of the Master*. (New York: Public Affairs, 2009, pp. 38-44).*
- J. Bradford DeLong, “We Can Afford a Second Stimulus.” *The Week*, October 12, 2009.*
- Peter Coy, “Keynes vs. Alesina. Alesina Who?” *Bloomberg Business Week*, June 30, 2010.*

In the basic thrust of his philosophy, John Maynard Keynes (1883-1946) can be seen as the heir of reforming liberals such as Mill and Tawney. 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*, from which we will read some excerpts 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. Yet his position on finance, featuring such memorable phrases as the “euthanasia of the *rentier*,” might sound radical today. (By the way, here the word “*rentier*” means a person who lives off interest-bearing investments.) 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).

The first reading by Christina Romer (Professor of economics at UC Berkeley, a leading scholar on the economics of the Great Depression, and first chair of the Council of Economic Advisers under President Obama) provides some background on the economic and historical context in which Keynes wrote, supplying a brief review of what happened in the Great Depression and the role that government policy played in it. The next reading selection by Robert Skidelsky (Professor of Political Economy at Warwick and Keynes’s definitive biographer) provides an overview of Keynes’s economics and how it differed from the conventional economic theory that preceded it. In the next set of readings, Keynes himself presents his views on finance and investment, and then in the conclusion to the *General Theory* he muses on what “social philosophy” might be implied by the analysis in his book, and speculates on the future. The next readings by Krugman and Skidelsky discuss how large portions of modern academic macroeconomic and finance theorists came to reject Keynes’s insights, and argue that this rejection helps explain the development of the recent financial crisis and our difficulty getting out of it. The final two short readings, by DeLong and Coy, discuss leading alternative viewpoints on the wisdom of further fiscal stimulus to address the current recession.

Study Questions:

1. Jean Baptiste Say argued that recessions and depressions were impossible, because “supply creates its own demand.” The key mechanism that equilibrates aggregate supply and aggregate demand is the real interest rate. If people decide they want to save more and thus consume less, or if businesses decide they want to invest less, that leads, through supply and demand, to a drop in real interest rates that induces firms to invest any extra saving and induces consumers to consume more. As a result there’s no drop in aggregate demand, and thus no recession. What are the key problems that Keynes identified that prevented this economic self-correcting mechanism from working smoothly? Does his analysis make sense? How relevant do you think his diagnosis is to the current economy?
2. Keynes says that the stock market is like a beauty contest where we judge the contestants not on their beauty, but by how we think other people will judge their beauty. Is this right? If so, is it any way to allocate capital?
3. Skidelsky makes much of Keynes’s distinction between “uncertainty” and “risk.” What is the difference, and what is its significance? What is the argument for why ignoring this distinction contributed to the development of the recent financial crisis? Do you find this compelling, or is the argument missing something important?
4. As this syllabus is being written, the unemployment rate is near 10 percent and not improving, nominal interest rates and inflation are both very close to zero, and the \$800 billion stimulus package enacted in early 2009 has already mostly been spent. Currently, there is a debate over whether to adopt further fiscal and/or monetary stimulus, or whether we should instead start taking actions to reduce our arguably unsustainable budget deficits and perhaps start raising interest rates to prevent recurrence of inflation. Do you favor one of these approaches or some other? Why? Is Keynes’s analysis and prescription for fiscal stimulus on target and pertinent to the conditions of today, or not? Was Keynes missing something important that’s relevant to today?
5. What does Keynes mean by “the euthanasia of the rentier” (Concluding Thoughts, p. 376)? Why did he predict this would happen, and why does he think it would be a good thing? What do you think?

II. CONTEMPORARY WRITINGS ON POLITICAL ECONOMY

A. Contemporary Liberalism: the Defense of the Market

Thu 10/7 The Case against Central Planning

- F. A. Hayek, *The Road to Serfdom*, introduction by Friedman and Chaps. 3-7.

Perhaps the most important contribution of Hayek (1899-1992) to social theory is his insistence that knowledge—of talents, capacities, scarcities, and potential consumer demands—is dispersed among countless individuals, so central planners cannot coordinate all this knowledge as effectively as markets. Along with laying

the groundwork for this important point, *The Road to Serfdom* develops an argument that central planning not only produces poverty, but also destroys liberty and threatens democracy.

Study Questions:

1. 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?
2. Hayek describes democracy as one means for attaining the end of liberty. 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 (pp. 70-71 old edition, p. 111 new): "Democratic control *may* prevent power from becoming arbitrary, but it does not do so by its mere existence." What do you think?
3. Hayek thinks planning is likely to kill democracy. Why? Do you agree? Does the experience of postwar Europe shed light on this?
4. Hayek argues that the term "privilege" should not apply to the ownership of property: "to call private property as such, which all can acquire under the same rules, a privilege, because only some succeed in acquiring it, is depriving the word privilege of its meaning" (p. 89 old edition, p. 118 new). What do you think? If I am born rich, am I privileged or not?
5. Is Hayek inconsistent when, in the middle of Chapter 3, he allows that “the preservation of competition” is compatible with “an extensive system of social services” (p. 43 old edition, p. 87 in the new edition)?

Mon 10/11 No class (Reading Period)

Thu 10/14 Hayek's Critique of the Welfare State

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

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

Study Questions:

1. According to Hayek, "the more civilized we become, the more relatively ignorant must each individual be of the facts on which the working of his civilization depends" (CoL, 26). What does he mean? Assuming he is civilized, how does he know this? Does he give us, here or elsewhere, good reasons to submit to these unintelligible but critically important facts?
2. Hayek argues that although inequality is a public good, in part because the rich act as consumption scouts, majorities would not vote for it. But this proposition seems to rest on a key distinction: how much inequality is enough, in his opinion?
3. Early in his discussion of progressive taxation, Hayek says that the idea of the interpersonal comparability of utilities has been “generally abandoned” (309). Yet many policymakers and ordinary people continue to believe 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?
4. Why should proportional taxation be the best way to avoid unfair discrimination among taxpayers? Why not a poll or head tax, where everyone pays the same absolute amount?
5. According to Hayek, "What is required [in the field of taxation] ... is a rule which, while still leaving open the possibility of a majority's taxing itself to assist a minority, does not sanction a majority imposing upon a minority whatever burden it regards as right" (CoL, p. 314). Is this a good argument for a "flat tax"?

Mon 10/18 Liberty, State, and Market

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

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

Study Questions:

1. In his discussion of monopoly (28), Friedman says that exchanges are voluntary where both parties have alternative options that are nearly equivalent. Does he believe that market participants usually have such alternatives? If so, is this a reasonable belief? If such alternatives do not exist, are we somehow unfree?
2. Friedman says that markets offer a kind of proportional representation (15). Proportional to what? Thinking of this passage and others, would you say he is a democrat?
3. Friedman argues that minorities have wrongly blamed capitalism for the "residual restrictions" upon their lives when the market "has been the major factor enabling these restrictions to be as small as they are" (p. 109). He offers an example of two singers whose incomes depend on the public's musical tastes. What do you think?
4. Friedman (pp. 164-66) argues that we should make no ethical distinctions between inequalities derived from inherited property and inherited talent, and he even suggests including those arising from effort and thrift. 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 10/21 Liberal Principles Applied

- Friedman, *Capitalism and Freedom*, Chaps. 6, 11-13.

Here 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 Earned Income Tax Credit). They share a conviction that government social programs should be narrowly tailored to leave the greatest possible sphere of choice to the recipient.

Study Questions:

1. How would you evaluate Friedman's proposal for school vouchers?
2. When it comes to old age pensions (Chap. 11), Friedman argues that it is unjustifiable to make people save more than they would on their own, and to do so through a government program. What do you think?
3. Friedman's proposal for a negative income tax stands in stark contrast to the conservative welfare reform enacted in the mid-1990's, which was more paternalistic and intrusive—and less generous. In your opinion, is the difference a result of Friedman's being too liberal (in the classical sense)—that is, loving liberty too much?

Mon 10/25 Microeconomics and Renascent Liberalism: Ronald Coase

- Ronald Coase, "The Nature of the Firm."*
- Ronald Coase, "The Problem of Social Cost."* [skip sections III and IV]
- "The Gap between Supply and Demand," *The Economist* 9 Oct. 2008.*

The two articles we discuss today are largely responsible for Coase's 1991 Nobel Prize in economics. In "The Nature of the Firm" (1937), Coase (b. 1910) introduces the fertile concept of transactions costs, a concept whose implications are still being explored by economists. It has political-economic implications, too. In "The

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

Study Questions:

1. The central puzzle of "The Nature of the Firm" occurred to Coase when he was an undergraduate and a socialist (he changed his mind later), after visiting Ford and GM: how could liberal economists fault the USSR for being run like a big factory when some very large firms are run efficiently? Does he answer this question adequately?
2. Following Coase, what effect might we expect, on the economically optimal size of firms, from recent advances in information technology?
3. According to Coase's famous argument about social cost, in the absence of transaction costs, the socially efficient use of resources will be obtained if property rights are clearly defined--regardless of their distribution. Are there any reasons to doubt this? If we had trade in human kidneys—see the *Economist* article--would it make any difference whether people were initially assigned property rights to the kidneys in their own bodies?
4. Given that in the real world, transaction costs are often significant, Coase maintains that the socially efficient use of a disputed resource would be obtained if the property rights to it were assigned to the party who would pay the most for them. How would the decision be made? What would Hayek think of this implication?

B. Defenses of Politics, the State, and Democracy

Thu 10/28 Equality and the Welfare State

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

Arthur Okun (1928- 1980) did most of his empirical work on labor markets and price theory. However, as a former policymaker and a lucid writer, he was also capable of writing a book that describes as clearly as any the areas of conflict between market distribution and political rules.

Study Questions:

1. Why, for Okun, must a clear line be drawn between dollars and rights? Do you agree with his reasoning?
2. Here might be one implication from Okun's placement of the line between dollars and rights. In the provision of counsel to criminal defendants, today the rich get the best defense money can buy and the poor often get an underprepared public defender. This vitiates equality before the law. We should make all defendants draw from the same pool by lot, paying all defense lawyers publicly (like we do prosecutors). What do you think?
3. Okun thought the link between private property and personal freedom was not so clear-cut. He claimed that "To evaluate the net gain in freedom provided by private ownership (rather than public access) for any asset requires a balancing of pluses and minuses. The plus is the enhanced scope of the owner through exclusive powers over the asset; the minus is the restriction the keep-off sign imposes on non-owners" (37). What do you think? Does one person's property restrict the freedom of everyone else?
4. According to Okun, "the issue of government versus private ownership of industry has little to do with freedom, but much to do with efficiency" (p. 61). Friedman and Hayek might disagree. Who's right?
5. Where, for Okun, might equality and efficiency *not* trade off? Do you agree?

Mon 11/1 An Economist Defends Politics

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

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

lately become a whole new field called "the new institutional economics."

Study Questions:

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

Thu 11/4 Power and Autonomy at Work

- Samuel Bowles and Herbert Gintis, *Democracy and Capitalism*, Chap. 3 (to p. 87 only).*
- Farhad Manjoo, "United's ESOP Fable," *Salon.com* 12/12/02.*
- William C. Taylor, "These Workers Act Like Owners (Because They Are)," *NY Times* 5/21/06.*
- Richard Thaler and Cass Sunstein, *Nudge*, "Company Stock" section (pp. 127-30 in the revised and expanded edition).
- Daniel Pink, *Free Agent Nation* (2001), chap1(pp. 9-2) and pp. 178-181.*

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. 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 trade off.) The next three 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. The excerpt that follows is from a book that heralds 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).

Study Questions:

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

Mon 11/8 Economic Efficiency, Social Welfare, and Redistribution

- David Friedman, *Hidden Order: The Economics of Everyday Life* (1997), Chap. 15.*
- David Weisbach, "Redistribution," from "Should Legal Rules be used to Redistribute Income?" *University of Chicago Law Review*, 70 (2003), pp. 440-446 only.*.

- Brad DeLong, “A Non-Socratic Dialogue on Social Welfare Functions,” blog post 4/13/09.*
- Jon Bakija and Brad Heim, “Jobs and Income Growth of Top Earners and the Causes of Changing Income Inequality: Evidence from U.S. Tax Return Data” (2009).*

David Friedman (son of Milton, and a physicist who teaches law at U. Santa Clara) describes the problems with measuring a society’s welfare and defends the idea that the pursuit of efficiency is the “least bad solution” to improving it. Weisbach (a law professor at U. Chicago) disagrees, arguing that we can do better: government can and should attempt to improve social welfare by addressing income inequality, for example through the use of progressive taxation. Weisbach emphasizes, however, that that redistribution is costly in terms of economic efficiency, and he considers how one might find the “optimal” balance between the benefits and costs of redistribution. In a whimsical parody of a Platonic dialogue, DeLong takes on the question of whether using economic efficiency as a normative criterion really avoids interpersonal comparisons of utility, and considers what kinds of social welfare functions the free market is maximizing.

Since the late 1970s in the U.S., income inequality has increased substantially, especially at the very top of the distribution. Yet at the same time, income taxation has been made less progressive, and other methods of redistribution such as welfare benefits for the poor were made more restrictive. The reading by Bakija and Heim summarizes various theories for why income inequality has been increasing, and presents some “stylized facts” and new data that are helpful for evaluating the different theories. Among other things, it discusses why the different explanations for rising income inequality have widely varying implications for how much economic efficiency is sacrificed when we redistribute.

Study Questions:

1. Is economic efficiency really the “least bad” normative criterion for public policy, as Friedman contends? Or would it be better to pursue policies which, at least in an approximate fashion, move us closer to maximizing some other metric of social welfare, as Weisbach suggests? Or are both authors leaving out something important?
2. How would you explain economic efficiency to that a typical voter (say, your grandmother) would understand it? Why should we care about efficiency at all? If a policy is chosen on the grounds of efficiency as David Friedman defines it, what would you say to someone who loses out because of the policy?
3. According to Weisbach, exactly where and how would a utilitarian strike the optimal balance between efficiency and equity? What factors affect where the optimal balance lies? Do you agree with Hayek that lack of relevant information about these factors renders this approach close to useless as a way of thinking about the issue?
4. Why does Weisbach conclude that even a Rawlsian, whose goal is to maximize the well-being of the poorest members of society, would stop redistribution well short of reaching complete income equality? (In the made-up example he presents in the article, for example, the optimal Rawlsian tax rate is 60 percent and no higher.)
5. What do the different explanations for rising income inequality imply about the cost of redistribution in terms of economic efficiency? Which explanations do you find most compelling and why?
6. All things considered, do you think we should have a progressive or a proportional tax system? Why?

C. Community, Sustainability, and the Market

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

- Jonathan Kaufman, “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, 117-22, and 137-51).*

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

Study Questions:

1. What are positional goods, and why does Hirsch think they have important implications for our thinking about the political economy of affluent societies?
2. One possible response to the increased competition for leadership positions is for the compensation attached to them to fall. Hirsch provides a list of reasons for expecting this *not* to occur. Do you find his list persuasive?
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. How does Hirsch differ from Hayek on the "tyranny of small decisions"? (See Hayek, *Constitution of Liberty* pp. 50-51.)
5. For Hirsch, why do a society's moral resources inevitably get depleted? What consequences does he see for capitalism?
6. How do Hirsch and Marx differ—and agree--on the role of religion in capitalist society?

Mon 11/15 Market and Place: Suburban Sprawl

- Andres Duany, Elizabeth Plater-Zyberk, and Jeff Speck, *Suburban Nation: The Rise of Sprawl and the Decline of the American Dream* (2000), Chaps. 1, 2, 7, and conclusion.*

This book represents a good summary of what is now called the "New Urbanism" in architecture and city planning. It contends that suburban sprawl damages our quality of life not only by contributing to the obvious problems of lost open space, abandoned city poor, and congested freeways, but also more deeply, in ways relating to community and aesthetics. It ties in with themes articulated by Hirsch.

Study Questions:

1. What, according to the authors, have been the main public policies responsible for suburban sprawl? Do you agree, or might there be other factors?
2. Why do they think sprawl makes us unhappy? Do you agree? Would you prefer to live in one of their projects, or in a gated subdivision of conventional design?
3. John Tierney has asserted that the New Urbanists are just what they claim not to be, "the heirs of Le Corbusier, the architect who dreamed of cramming millions of urbanites into an array of huge towers in a meticulously planned community"...the enthusiasts for smart growth want regional or statewide authorities to regulate land use" ("The Way We Drive Now," *NYT* 9/26/04). Are the authors really "traditionalists," as they claim, or merely big-government, interventionist radicals? In particular, what might Hayek think about their position?
4. So would we be better off—and would you prefer to live in a place--with no zoning at all?

Thu 11/18 Does the Market Disadvantage Future Generations? Exhaustible Natural Resources, Climate Change, and Sustainability

- Herman E. Daly. "Economics in a Full World." *Scientific American*, Sept 2005, pp. 100-105 and 107.*
- Partha Dasgupta. "Counterpoint." *Scientific American*, Sept 2005, p. 106.*
- Robert Solow, "The Economics of Resources or the Resources of Economics," *American Economic Review*. Vol. 64, No. 2, 1974 [Excerpt, pp. 1-5 and portions of 6 and 8].*
- David Weisbach and Cass R. Sunstein, "Climate Change and Discounting the Future: A Guide for the Perplexed." *Yale Law & Policy Review*, Vol. 27, 2009, pp. 433-457.*
- J. Bradford DeLong. "The Stern Review on Global Climate Change Once Again." Blog post, 12/ 30/06.*
- Paul Collier, "I Don't Buy the Economists' Case for Fighting Climate Change." *The Guardian*, 2/ 26/09.*

Some of the most pressing issues facing political economists relate to the appropriate relationship between humanity and the environment, and the question of how we ought to treat future generations. While Hirsch asked us to look at the social limits to growth, limits that have implications about how we should deal with environmental problems, Herman Daly (an economist at the University of Maryland) argues that there are the biological and geophysical limits to growth, and that we have already started to push too close to those limits. Robert Solow (a

Nobel Prize winning economist at MIT) provides an accessible non-technical explanation of the conventional economic theory for how market prices allocate exhaustible natural resources over time. David Weisbach and Cass Sunstein (both U. Chicago law professors; the latter is currently President Obama's "regulation czar") discuss the economics and ethics of discounting the future, lay out the utilitarian approach to thinking about these issues, and consider the implications for policy towards climate change. DeLong discusses how risk factors into the calculation, and offers his best guess at whether we ought to be doing something about climate change once we take discounting into account. Finally, Paul Collier, a development economist at Oxford, questions whether the utilitarian framework is the right one for thinking about climate change.

Study Questions:

1. Daly claims there is an "optimal scale" to a market economy, and that we are already close to or beyond that optimal scale. What does he mean by this, and why does he think the market will tend to push us well beyond the optimal scale? Do you agree that we are close to or beyond the optimal scale, and / or that the market will tend to push us well beyond it?
2. According to Solow, how do market prices allocate exhaustible natural resources over time? Do the arguments in Solow give us reason to stop worrying about Daly's concerns? Why or why not?
3. It has been joked that at prevailing discount rates, today the net present value of Armageddon in 2200 would be about the price of a six-pack. Do the discounted cost-benefit calculations inherent in the market's method for allocating resources over time systematically disadvantage future generations? Why or why not? If so, can government effectively fix the problem?
4. How would a utilitarian think about the problems of exhaustible natural resources and climate change? What factors would affect the optimal utilitarian response? How would the optimal balance be struck? Do you think a utilitarian analysis would suggest we should undertake expensive actions now in order to combat climate change in the future? Is the utilitarian framework a good way to think about this, or does it miss something important about the ethics of the situation?
5. Were past generations too generous to us, or not generous enough? Why? What, if any, implications might this have for thinking about climate change and exhaustible natural resources?

D. The Economics of Information, Behavioral Economics, and their Policy Implications

Mon 11/22 Insurance, Asymmetric Information, and Equality of Opportunity

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

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

Study questions:

1. Why should anybody buy insurance? How could it be that transactions between an individual and insurance

- company that would make both sides better off would fail to occur in the market?
2. As the science of genetic testing advances, it will become increasingly easy for insurance companies to adjust insurance premiums to more accurately reflect the risks of disease faced by each individual. Would this make the insurance market more efficient or less efficient? Would it be a good thing?
 3. Varian argues that the optimal amount of tax progressivity and redistribution depends on the degree to which income arises from random chance. Part of the logic behind this argument, not spelled out in the article, is that policies that are commonly viewed as “redistributive” are to some extent playing a social insurance role, so that their negative effects on efficiency due to distorting incentives (which can be thought of as moral hazard), are offset to some degree by positive effects on efficiency, because they cure insurance market failures. Do you think this is an important consideration? How much of income do you think is due to luck, and how much is due to effort?
 4. Roemer argues that redistributive policies are only ethically justified when the redistribution is based on factors that are beyond the individual’s control. Do you agree? Why or why not? Do you think there are ways of designing policy to make the amount of redistribution / social insurance depend more on luck and less on effort?

Thu 11/25 No class (Thanksgiving)

Mon 11/29 Psychology, Irrationality, and Economics

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

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

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

Study Questions:

1. According to Thaler and Sunstein, what are the situations in which nudges are most needed or justifiable? Why? Can you think of any examples from your own experience?
2. What is the difference between the psychological properties cited by Thaler and Sunstein (say, inertia), and Coase’s widely used, now mainstream-economics concept of transaction costs?
3. Thaler and Sunstein claim that the good choices resulting from their “nudges” are in fact what the people making them really want. How do they know this? Why shouldn’t we take what people actually do as the best indicator of what they really want?
4. 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 their arguments?
5. Thaler and Sunstein emphasize that they are only arguing for *libertarian* paternalism, which leaves open a lot of freedom of choice for active choosers. They are careful to avoid advocating “plain old paternalism,” which would involve the government making choices for people directly, without the chance to opt out. Yet our democracy has produced a lot of public policy that is arguably “plain old paternalism.” One example is public policy towards addictive drugs. Another would be policy towards poverty. Most federal and state government assistance to the poor often takes the form of in-kind transfers such as food stamps, housing subsidies or public

housing, free health insurance (Medicaid), etc. A libertarian like Milton Friedman would say that if government is going to help the poor, it would be better to just give the poor cash, and let them decide how to spend it. Given the evidence of human irrationality discussed in Thaler and Sunstein's book, do you think more far-reaching paternalism of the sort we see in actual government policies is justified?

Thu 12/2 The Current Financial Crisis: A Failure of Capitalism?

- Michael Lewis, "The End," *Portfolio*, December 2008.*
- Robert Solow, "How to Understand the Disaster," review of Richard Posner, *A Failure of Capitalism*, *NY Times* 5/14/09.*
- Lawrence White, "What Really Happened?" 12/2/08 and
- Brad DeLong, "Liquidity, Default, Risk" (Reply to Larry White), 12/8/08, *Cato Unbound* blog.*
- Barry Ritholtz, "Global Housing Boom," *Big Picture* blog, 7/20/10.*
- Edward Glaeser, "Did Low Interest Rates Cause the Great Housing Convulsion?" *NYTimes* 8/3/10.*
- Janet Yellen, "A Minsky Meltdown: Lessons for Central Bankers," 4/16/09.*
- Simon Johnson, "The Quiet Coup," *Atlantic Monthly*, May 2009.*

The first reading is an engaging story about what was happening on Wall Street in the years leading up to the financial crisis, told by Michael Lewis (author of best-sellers such as *Liar's Poker* and *Moneyball*). The next readings engage in a back-and-forth about the recent financial crisis, beginning with Solow's review that gives context and explanation of important concepts for the lay reader. Yellen considers the relevance and implications of the financial cycle theories of Hyman Minsky in the wake of the crisis, and Johnson considers the role of the political power of finance.

Study Questions:

The different writers emphasize different problems that contributed to the severity of the crisis and the likelihood of it happening again, each of which may suggest different policy responses. Considering the readings for this and the previous class, what do you find problematic or compelling about any of these arguments, and what do you think should be done?

1. The incentives of market participants were distorted by the government.
2. The incentives of market participants were distorted by failures of the market, not so much by the government.
3. People behaved irrationally.
4. The financial sector has grown too powerful. This is preventing us from taking steps that would resolve the crisis more quickly and make it less likely that another would occur.

Mon 12/6 Health Care

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

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

Study Questions:

1. Gawande presents an argument that market competition has destructive and inefficient effects in an environment where patients and doctors have extremely asymmetric information. What evidence does he present in support of this view? What if anything might policy do to address this? Does this seem compelling to you?
2. Goldhill considers many problems with the health care system, but concludes that the critical problem is that people have “too much” insurance. He proposes replacing the current system with a system of insurance that only pays for catastrophic health expenses (say, those above \$50,000), and that requires individuals to pay for anything less than a catastrophic expense out of their own pockets. What is the rationale for this? What do you think of this approach?
3. Glied and Remler argue that recent advances in health care economics suggest that the nature of inefficiencies in the health care market are more subtle and complicated than even many experts recognize, and that these subtleties may have important implications for the best policy approach. What examples do they give? Do you agree with their reasoning?
4. Do you agree with Krugman and Wells’s prescription for the U.S. health care system? Do you think any of the other authors offer compelling reasons not to go the route the authors recommend?
5. The authors for today all engage, to varying degrees, with moral hazard in health insurance. What makes moral hazard a problem in this area? Is it the most serious problem with the system in the US, or just another minor problem? Which of the authors has the best solution to dealing with it, in your opinion?

E. Conclusion

Thu 12/9 Failures of Government

- James Buchanan, "Rent Seeking and Profit Seeking."*
- Greg Rushford, "Don't Bother to Compete; Hire a Lawyer," *WSJ* 9/21/95.*

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

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

Study 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.)