

The Role of Government in Market Economies (RoGME)

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Module 1. Market failures and an efficiency argument for government intervention

1. Command and control vs. the market

- *The USSR 1988: The Search for Growth*

Prof. Dyck, HBS No. 795-060

- Summary: The dramatic story of the Soviet Union in the second half of the twentieth century was an experiment on a grand scale, testing what happens when a government attempts to replace the market with centralized control.
- Assignment questions
 - Why did the Soviet Union's economy fail? Why did the Soviet Union's leaders think it would succeed?
 - Under what circumstances does centralized command improve on the market mechanism?

- Core concepts

- The first fundamental theorem of welfare economics
- Pareto efficiency and transfers

- Mind-bender

- Equality as a luxury good for society

- Supplementary readings

- *Inquiry into the Nature and Causes of the Wealth of Nations*, Chapters 1 and 2, A. Smith, 1776.
- "The Use of Knowledge in Society," F. A. Hayek, *American Economic Review*, 1945.

2. Public education

- *Reform in the Chicago Public Schools*

Prof. Weinzierl and K. Flanagan, HBS No. 714-027

- Summary: In 2012, the Chicago Teacher's Union went on strike over proposed reforms by the city's mayor, Rahm Emanuel. At the heart of the reforms, and the strike, was frustration over many decades of underperformance in the Chicago Public Schools (CPS) and a surge of controversial, largely market-based, experimentation in public education in many U.S. cities.
- Assignment questions
 - What market failures does public education intend to address?
 - What are the arguments against having the CPS system?

- Core concepts

- Public goods; Samuelson rule
- Tiebout sorting and efficiency

- Mind-bender

- Limits to government and constrained policy choice

- Supplementary readings

- "Diagrammatic Exposition of a Theory of Public Expenditure," P.A. Samuelson, *Review of Economics and Statistics*, 37, 1955.
- *The Economics of Taxation*, chapter 7, B. Salanié, MIT Press, 2011
- "A Pure Theory of Local Expenditures," C.M. Tiebout, *Journal of Political Economy*, 1956.
- *The American Dream and the Public Schools*, J. Hochschild and N. Scovronick, 2003.

3. Global cooperation and sustainability

- *Astroscale, Space Debris, and Earth's Orbital Commons*

Prof. Weinzierl and A. Acocella, HBS No. 716-037

- Summary: Low Earth Orbit was becoming increasingly crowded in the 2010s, with a booming satellite business contending with thousands, even millions of pieces of potentially destructive debris from prior missions, spent rockets, and exploded equipment. Space agencies and major space companies lamented the problem but had made little progress toward a solution. Would Astroscale, a small startup in Singapore, and its founder Nobu Okada lead the world to a solution by developing a key component of debris removal technology?
- Assignment questions
 - Why aren't space agencies or big contractors solving the space debris problem? Why doesn't Coase's solution apply here?
 - Do you expect Astroscale's strategy to work?

- Core concepts

- Tragedy of the Commons
- Coase Theorem and Ostromian Polycentric Governance
- Bargaining costs as a limit to Coase theorem

- Mind-bender

- How should property rights work in Space?

- Supplemental readings:

- "The Tragedy of the Commons," G. Hardin, *Science*, 1968.
- "Beyond Markets and States: Polycentric Governance of Complex Economic Systems," E. Ostrom, *American Economic Review*, 2010.
- "Information and the Coase Theorem," *Journal of Economic Perspectives*, J. Farrell, 1987.
- "The Problem of Social Cost," R.H. Coase, *Journal of Law and Economics*, 1960.

4. Universal health insurance

- *Obamacare*

Prof. Weinzierl and K. Flanagan, HBS No. 714-029

- Summary: One vote in June, 2012 decided the fate of President Barack Obama's crowning first-term achievement: universal health insurance. Chief Justice John Roberts of the U.S. Supreme Court cast the deciding vote to uphold the keystone of the reform: the mandate to purchase insurance. That mandate had a convoluted history. Though born in a conservative think-tank and originally adopted by Republican leaders as a necessary component of reform, it was rejected by Republicans when taken on board by the President and Democrats. Roberts' decision rested on an interpretation of the mandate as a tax.
- Assignment questions
 - What market failures was the ACA intended to address?
 - What are the arguments against the ACA?

- Core concepts

- Adverse selection
- Leviathan

- Mind-bender

- The possibility of benevolent obfuscation

- Supplemental readings:

- "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism," G. Akerlof, *Quarterly Journal of Economics*, 84, 1970.
- *Your Money or Your Life: Strong Medicine for America's Health Care System*, D. Cutler 2004
- "Selection in Insurance Markets: Theory and Empirics in Pictures," L. Einav and A. Finkelstein, *Journal of Economic Perspectives*, 2011.
- *Conscience of a Conservative*, B. Goldwater, 1960

5. Financial sector regulation

- **Subprime Meltdown**
Prof. Rotemberg, HBS No. 708-042
- Summary: The financial crisis of 2008-2009 had roots in a rapid rise of housing prices and credit, including for subprime mortgages. Who was to blame for the vulnerability of the housing finance system? What role should government play in strengthening it?
- Assignment questions
 - What market failures characterized the U.S. housing finance system, both leading up to and including the crisis?
 - What were the arguments against the government trying to address these market failures?

- Core concepts
 - Moral hazard
 - Bounded rationality
- Mind-bender
 - Norm formation and forgetfulness across long horizons
- Supplemental readings:
 - "From Efficient Markets Theory to Behavioral Finance," R. Shiller, *Journal of Economic Perspectives*, 2003.
 - "Regulation for Conservatives: Behavioral Economics and the Case for 'Asymmetric Paternalism'," C. Camerer, S. Issacharoff, G. Lowenstein, T. O'Donoghue, M. Rabin, *University of Pennsylvania Law Review*, 2003.

6. Fiscal policy

- **Herbert Hoover (A)**
Prof. Wells, HBS No. 798-041.
- Summary: At the onset of the Great Depression, U.S. President Herbert Hoover faced steep challenges. He was skeptical of having the government try to prevent downturns and believed that the government running a balanced budget was "indispensable to the restoration of confidence." To his opponents, these were misguided and dangerous beliefs that ignored the true functioning of the macroeconomy.
- Assignment questions
 - What market failures is countercyclical fiscal policy intended to address?
 - Why is Hoover skeptical of fiscal stimulus?

- Core concepts
 - Paradox of thrift
 - Ricardian equivalence
- Mind-bender
 - Impossibility of commitment to laissez-faire through crises
- Supplemental readings:
 - "Mr. Keynes and the 'Classics': A Suggested Interpretation," J. Hicks, *Econometrica*, 1937.
 - "Are Government Bonds Net Wealth?" R.J. Barro, *Journal of Political Economy*, 1974.

7. Fiat money and monetary policy

- *The U.K. and the Gold Standard in 1925*

Prof. McCraw, HBS No. 9-383-081.

- Summary: Great Britain had prospered during the century prior to World War I, and both it and the world were impatient to see the pre-war order restored as quickly as possible in the 1920s. Many British political and business leaders believed that a key to that restoration was the return of all countries – especially Britain – to the gold standard rather than the fiat currencies that had been adopted during the war years. The eminent economist J.M. Keynes vehemently disagreed. Deciding would be Chancellor of the Exchequer Winston Churchill.
- Assignment questions
 - What is money? Why is its supply controlled by the government?
 - Why did Keynes have few allies in the debate over the Gold Standard in the U.K. in 1925?

- Core concepts

- Money
- Nominal rigidity and Aggregate Demand/Aggregate Supply
- Specie-flow mechanism

- Supplemental readings:

- “The Bretton Woods System of Exchange Rates,” L.T. Wells, HBS note 9-797-093.
- “The German Hyperinflation of 1923,” D. Moss and J. Rotemberg, HBS case No 9-798-048
- “On the Origins of Money,” C. Menger, *Economic Journal*, 1892.
- “The Gold Standard and the Great Depression,” B. Eichengreen and P. Temin, *NBER Working Paper 6060*, 1997.

Module II. Beyond efficiency: government policy and economic justice

8. The personal income tax

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| <ul style="list-style-type: none">• <u><i>Tax Preferences: A Survey</i></u>
Prof. Weinzierl• Summary: The assigned survey asks for your preferences across a range of potential tax policies. You will complete the survey, online, prior to class, and we will discuss the results interactively, highlighting their implications for tax policy.• Assignment questions<ul style="list-style-type: none">○ What policies did you prefer? Why? | <ul style="list-style-type: none">• Core concepts<ul style="list-style-type: none">○ Tagging and distortionary taxation○ Veil of Ignorance; Welfarism• Mind-bender<ul style="list-style-type: none">○ Normative diversity• Supplemental readings:<ul style="list-style-type: none">○ <i>A Theory of Justice</i>, J. Rawls, 1971, esp. pp. 136-142.○ <i>Anarchy, State, and Utopia</i>, R. Nozick, 1974, esp. Chapter 7.○ "Income Inequality in the United States, 1913-1998," T. Piketty and E. Saez, <i>Quarterly Journal of Economics</i>, 118, 2003.○ "The Optimal Taxation of Height," N.G. Mankiw and M. Weinzierl, <i>American Economic Journal: Economic Policy</i>, 2010.○ "The Promise of Positive Optimal Taxation," M. Weinzierl, <i>Journal of Public Economics</i> 118, 2014. |
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9. Equality of opportunity

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| <ul style="list-style-type: none">• <u><i>Equality of Opportunity and Outcome in the U.S.</i></u>
Prof. Weinzierl and A. Su, HBS No. 715-028• Summary: After his 2012 reelection, President Barack Obama shifted his rhetoric on inequality from a focus on incomes to opportunities, disappointing many of his supporters. Equality of opportunity is endorsed universally even though, or more likely because, it can mean such different things to different people. What definition of equality of opportunity ought to figure into policy decisions? What definition did Obama have in mind?• Assignment questions<ul style="list-style-type: none">○ What do you mean by equal opportunity?○ Was Obama right to shift his rhetoric? | <ul style="list-style-type: none">• Core concepts<ul style="list-style-type: none">○ Nondiscrimination○ Level playing field• Mind-bender<ul style="list-style-type: none">○ The family as an obstacle to equal opportunity• Supplemental readings:<ul style="list-style-type: none">○ "Four conceptions of equal opportunity," R. Arneson, 2014.○ "Equality of opportunity, and beyond," J.H. Schaar, in <i>Equality: Selected Readings</i>, L.P. Pojman and R. Westmoreland, eds., Oxford, 1997.○ <i>Justice, Equal Opportunity, and the Family</i>. J.S. Fishkin, Yale: 1983. |
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10. Wealth taxes and society

- **The Estate Tax Debate**

Prof. Weinzierl, K. Flanagan, and V. Galinskaya (MBA 2012), HBS No. 714-032

- Summary: Per dollar of revenue, no tax policy generates more sound and fury than the taxation of estates. To supporters, the tax is a brake on the concentration of wealth and power and an easy way to fund redistribution. To opponents, the tax is an unjust punishment of the frugal that sacrifices economic growth for short-term interests.
- Assignment questions
 - What is the right rate and exemption level for the estate tax?
 - Why is support for the estate tax not greater among the middle class?

- Core concepts
 - Atkinson-Stiglitz and optimal capital taxation
 - Bequest motives
- Mind-bender
 - Moral entitlements and economic justice
- Supplemental readings:
 - “Complementarity and the Excess Burden of Taxation,” W.J. Corlett and D.C. Hague, *Review of Economic Studies* 21, 1953.
 - “De Gustibus non est Taxandum,” B.B. Lockwood and M. Weinzierl, *Journal of Public Economics* 124, 2015.
 - “The Role of Intergenerational Transfers in Aggregate Capital Accumulation,” L.J. Kotlikoff and L.H. Summers, *Journal of Political Economy*, 89, 1981.
 - “Top Wealth Shares in the United States, 1916-2000: Evidence from Estate Tax Returns” W. Kopczuk and E. Saez, *National Tax Journal*, 57(2), 2004.

11. The corporate income tax

- **Should Corporate Profits be Taxed?**

Prof. Weinzierl and K. Flanagan, HBS No. 714-033

- Summary: Corporations do not bear the burden of taxes, people do, and the incidence of the corporate income tax burden falls on workers and consumers as well as capitalists. Nevertheless, popular support is high for greater taxation of corporate profits, and popular anger is high in response to (legal) tax avoidance by corporations.
- Assignment questions
 - What is the most convincing argument for taxing corporate income?

- Core concepts
 - Economic versus statutory incidence
 - Economic rents vs. returns to capital
- Mind-bender
 - Benefit-based taxation
- Supplemental readings:
 - “The Incidence of the Corporate Income Tax,” A.C. Harberger, *Journal of Political Economy*, 1962
 - “The Corporation as a Moral Person,” P.A. French, *American Philosophical Quarterly*, 16(3). 1979.
 - “Who Bears the Corporate Tax? A Review of What We Know,” A. J. Auerbach, *Tax Policy and the Economy*, 20, 2006
 - “A Modern Corporate Tax,” A. J. Auerbach, Brookings 2010.

12. Immigration

- ***Immigration Policy in Germany (A) and (B)***
Prof. Weinzierl and A. Su, HBS No. 715-029
Prof. Weinzierl and R. Scherf, TBD
- Summary: In the early 2010s, Germany's Chancellor Angela Merkel faced economic and moral pressure to encourage greater immigration from struggling European, and especially Eurozone, countries. In fact, it was possible that both the euro currency union and the European political union depended on it. But domestic politics made Merkel's decision a difficult one. By 2019, as Merkel prepared to leave office, her decisions' implications loomed large.
- Assignment questions
 - Should all Europeans, or all citizens of Eurozone countries, be allowed to immigrate into Germany? If not, why?

- Core concepts
 - Optimal currency unions
 - Trilemma
- Mind-bender
 - Citizenship and geographic limits to moral responsibility
- Supplemental readings:
 - "The Economic Benefits from Immigration," G. J. Borjas, *Journal of Economic Perspectives*, 1995
 - "Global Redistribution and the Equality-Openness Trade-Off," G.E. Weyl, 2014
 - "The Euro: Monetary Unity to Political Disunity?" M. Friedman, Project Syndicate, 1997
 - *Spheres of Justice*, (esp. chapter 2) M. Walzer, 1983

13. The safety net and political economy

- ***1996 Welfare Reform in the United States***
Prof. Weinzierl, K. Flanagan, and A. Su, HBS No. 715-030
- Summary: U.S. President Bill Clinton took office in 1992 promising, among other things, to "end welfare as we know it." Near the end of his first term, after suffering bruising political defeats and frustrating policy battles, he fulfilled that pledge when he signed the Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA). Viewed by Clinton and many others as a model of centrist, common-sense policymaking, PRWORA was to others a sign of capitulation to an outdated, unjust, even racist view of welfare and welfare recipients.
- Assignment questions
 - What market failures are the institutions of the modern welfare state intended to address?
 - Did Clinton do the right thing by signing PRWORA?

- Core concepts
 - Median voter theorem
 - Moral hazard
- Mind-bender
 - The fuzzy concept of desert
- Supplemental readings:
 - *Social Choice and Individual Values*, K.J. Arrow, 1951.
 - "On the Rationale of Group Decision-Making," D. Black, *J. of Political Economy*, 1948.
 - "A Rational Theory of the Size of Government," A.H. Meltzer and S.F. Richard, *Journal of Political Economy*, 1981.
 - *Public Finance and Public Choice: Two Contrasting Visions of the State*, J.M. Buchanan and R.A. Musgrave, 1999
 - "'Race Coding' and White Opposition to Welfare," M. Gilens, *American Political Science Review*, 90(3), 1996.

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14. The objective and measurement of government

- *Space, the Final Frontier*

Prof. Weinzierl, article to be distributed

- Summary: A new era in how humans interact with space had begun with the end of the US Space Shuttle program in the 2000s. As private visions of space once again took center stage, how should the development of space be managed? What role should the public sector play? And why were humans so interested in developing space, after all?
- Assignment questions
 - How would you design your ideal space colony?
 - Should humans develop a space-based society? Why?

- Core concepts
 - Public-private partnerships
 - Stag Hunt game
- Mind-bender
 - Utopia
- Supplemental readings:
 - *Anarchy, State, and Utopia*, R. Nozick, 1974, esp. chapter 10.
 - *The High Frontier*, G. O'Neill, 1977.
 - *Red Mars; Green Mars; Blue Mars*, Kim Stanley Robinson

Underlying Conceptual Framework¹

The following summarizes the conceptual framework around which the course is structured:

- I. Market failures and an efficiency argument for government
 1. Market vs. state control
 2. Price and quantity corrections, given missing markets
 - Public goods, local taxes, and compulsory taxes
 - Agglomeration externalities and private coordination
 - Externalities and corrective subsidies and taxes
 3. Social insurance and regulation, given incomplete information
 - Moral hazard and paternalism
 - Adverse selection and tax-like mandates
 4. Innovation policy and antitrust regulation, given imperfect competition
 5. Demand management, given nominal rigidities
 - Countercyclical fiscal and monetary policies
 - Fiscal-monetary connections
 6. Intellectual property, market power, and the profit motive
 7. Trade and industrial policy, given learning by doing
- II. Beyond efficiency: government policy and economic justice
 8. Social welfare beyond the Pareto criterion
 - Income redistribution
 - Equality of opportunity
 - Wealth taxation and preference heterogeneity
 9. Scope of social welfare
 - Tax competition
 - Corporate taxation
 - Intergenerational equity
 10. Implementation
 - Safety net and political economy
 - The objectives and measurement of government

¹ In the half-course version of RoGME to which this document refers, not all of the topics named here will be addressed directly in case discussions. Cases from the full-course version of RoGME, summarized in HBS Course Overview Note 714-035, that are omitted from the half-course version may be provided upon student request.