

PHIL 721 Section 001 - Advanced Seminar

Philosophy of Economics

Instructor: Mark Sagoff

Monday, 4:30-7:10pm

Robinson A246

This is a course in philosophy not economics. Philosophers are interested in economics for many reasons two of which will be studied here. First, economics claims as a science to represent, explain, predict, or help to manage facts about the world. Philosophers of science dig into such claims and question whether and how models, constructs, theories, laws, metaphors, useful fictions, and other concepts associated with economics help us to understand our experience. Economists disagree both in their theories and in the social prescriptions they base on them. This course does not ask which theories and which prescriptions are correct. It asks rather how one could tell – for example, if and how propositions economists defend can be tested.

Second, although many economists would deny it, economic research is chock-a-block with values such as “cost” “benefit,” “welfare,” “efficiency,” and “wealth.” Philosophers want to know how economists understand and measure these values and whether these values are related to broadly accepted social norms and goals. This course asks, in other words, whether and how economic science can tell us anything about facts or about values. Since these are philosophical questions, we shall approach them – as many economists themselves have done -- through philosophical analysis.

This course will follow a format of structured discussion; your participation is therefore essential. Everyone is expected to do all the readings before coming to class and to join in the class conversation about them. (**This will require you to print out and annotate the readings from Blackboard before each class; if this presents difficulties, please let me know.**) All of the readings have been (or will soon be) made available on Blackboard. For nearly all the readings, I have high-lighted some of the most important passages. (Remove these highlights if they annoy you). There are also recommended readings.

Assessment

There will be 2 midterm essay exams, each taking half a class period, on the readings and discussions up to that time. The midterm exams are scheduled for ---- and -----.

While these are closed-book exams, I will distribute a list of several questions at least a week in advance; some choice among these will appear as exam questions. There is a final paper but no final exam. It is crucial that your final paper go through at least two preliminary drafts. The first, which could be a prospectus, a paper proposal, or something more elaborate, is due ----. A substantial first draft of the paper is due ---. There is no limit on the number of drafts you can submit and thus the number of comments and suggestions you will receive as a result.

Students should consult <http://philosophy.gmu.edu/undergraduate/writing-standards>

Grading: 1. Midterm: 20% 2. Midterm: 20% 3. Course participation 10% 4. Essay 50%

PART I: ECONOMICS AND SCIENCE

Week 1: Introduction (January 28)

(These are very general readings which you should complete as soon as possible)

Backhouse, R. E. & S. G. Medema (2009) "On the definition of economics", *Journal of Economic Perspectives*, 23 (1): 221—33.

"Economics is what economists do." Statement attributed to Jacob Viner.

Buchanan, J.M. (1964) "What Should Economists Do?" *Southern Economic Journal* 30 (January): 213-22.

"I am also, you will note, rejecting the familiar proposition advanced by Jacob Viner that 'economics is what economists do.'" (p. 214).

Hausman, D. (2008), "Philosophy of Economics", in: *Stanford Encyclopedia of Philosophy* (on line).

"there is no way to do economics if one is not willing to simplify drastically and abstract from many complications. How much simplification, idealization, and abstraction is legitimate?" p. 7.

Week 2: John Stuart Mill and Lionel Robbins on confirmation in economics. (February 4)

John Stuart Mill, "On the Definition of Political Economy and the Method of Investigation Proper to It," 1836, in *Collected Works of John Stuart Mill*, vol. 4, Toronto: University of Toronto Press, 1967 (Essay V).

The science which traces the laws of such of the phenomena of society as arise from the combined operations of mankind for the production of wealth, in so far as those phenomena are not modified by the pursuit of any other object. (p. 6)

Lionel Robbins (1945), *Essay on the Nature and Significance of Economic Science*, excerpts from Chapters I, IV, V, and VI.

The propositions of economic theory, like all scientific theory, are obviously deductions from a series of postulates. ... The main postulate of the theory of value is the fact that individuals can arrange their preferences in an order, and in fact do so. The main postulate of the theory of production is the fact that there are [sic] more than one factor of production. The main postulate of the theory of dynamics is the fact that we are not certain regarding future scarcities. These are not postulates the existence of whose counterpart in reality admits of extensive dispute once their nature is fully realised. We do not need controlled experiments to establish their validity: they are so much the stuff of our everyday experience that they have only to be stated to be recognized as obvious. (p. 79 in 1945 edition)

Recommended: J. N. Keynes, "The Scope and Method of Political Economy" (1917). Excerpts from Chapter 2.

we ought at least to recognise as fundamental a positive science of political economy which is concerned purely with what is, and which seeks to determine economic laws.

Week 3: Milton Friedman and Critics: Positivism in Economics (February 11)

Milton Friedman, "The Methodology of Positive Economics" (University of Chicago Press (1953), 1970, pp. 3-43.

Positive economics is in principle independent of any particular ethical position or normative judgments. As Keynes says, it deals with "what is," not with "what ought to be." Its task is to provide a system of generalizations that can be used to make correct predictions about the consequences of any change in circumstances. Its performance is to be judged by the precision, scope, and conformity with experience of the predictions it yields. In short, positive economics is, or can be, an "objective" science, in precisely the same sense as any of the physical sciences.

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An obvious and not unimportant example is minimum-wage legislation.

"[The academic economist] must for instance analyse the methods which people are tempted to take for securing a high minimum wage . . . and must show which of them will have indirect effects that will cause workingmen as a whole a loss greater than the benefit. . . . ordinary people do not see that the means most commonly advocated . . . would impoverish all" (Alfred Marshall, "The Old Generation of Economists and the New." *Quarterly Journal of Economics* 11.2:115-35 (1897), p. 128).

"If law or opinion succeeds in fixing wages above this [competitive] rate, some laborers are kept out of employment; as it is not the intentions of the philanthropists that these should starve, they must be provided for." (John Stuart Mill, *Principles of Political Economy with Some of Their Applications to Social Philosophy*. Boston: Little & Brown 1848, p. 432)

Richard Freeman, "Comment: Review Symposium on Myth and Measurement: The New Economics of the Minimum Wage." *Industrial and Labor Relations Review* 48, no. 4 (July 1995).

there is little evidence . . . that minimum wage increases reduce employment.

Herbert A. Simon, Comment on Methodology, *The American Economic Review*, Vol. 53, No. 2 (May, 1963), pp. 229-231.

It is far more important to know whether they [deviations of observation from theory] are significant in the sense that the approximation of theory to reality is beyond the limits of our tolerance.

Look at case summary *Lochner v. New York*, 198 U.S. 45, 25 S. Ct. 539, 49 L. Ed. 937 (1905).

the freedom of master and employee to contract with each other in relation to their employment cannot be prohibited or interfered with without violating the Constitution.

Recommended: Thomas C. Leonard, "The Very Idea of Applying Economics: The Modern Minimum-Wage Controversy and its Antecedents." In Roger Backhouse and Jeff Biddle (eds), *Toward a History of Applied Economics, History of Political Economy, Supplement to Vol. 32* (2000), pp. 117-144.

In particular, minimum wage research has come to be seen as a test of the applicability of neoclassical price theory to the determination of wages and employment.

Recommended: David Autor, "Lectures 1 and 2 -Introduction and a First Application: The Minimum Wage Debate and Causal Inference in Economics," MIT Department of Economics Open Courseware. (Proposing ways to fit the Card and Krueger to standard theory.)

Minimum wages: A venerable topic in economics and area of ongoing controversy

Week 4: Falsification in Economics (February 18)

Note: In his syllabus for the Philosophy of Economics course taught at the University of Wisconsin, Dan Hausman states: "Warning! Philosophy challenges complacency. It is hard to know what the truth is concerning hard questions like the ones we will be addressing this semester." This is especially true of understanding the conditions under which the qualifier "all else being equal" turns a general statement into a vacuity.

Karl Popper, *Conjectures and Refutations*, London: Routledge and Keagan Paul, 1963, pp. 33-39 [Science as Falsification"].

I wished to distinguish between science and pseudo-science; knowing very well that science often errs, and that pseudoscience may happen to stumble on the truth.

"the fact is that falsification is seldom if ever practiced in economics. . . [The question is whether it should be practiced]" – D. Wade Hands "Popper and Lakatos in Economic Methodology" (1993).

Imre Lakatos, "The Methodology of Scientific Research Programmes," excerpt from *Philosophical Papers of Imre Lakatos*, volume I, edited by John Worrall and Gregory Currie, Cambridge University Press, 1995.

Popper replaced the central problem of classical rationality, *the old problem of foundations*, with *the new problem of fallible-critical growth*, and started to elaborate objective standards of this growth.

Robert Sugden, "Credible Worlds: The Status of Theoretical Models in Economics", *Journal of Economic Methodology* 7 (2000), 1-31.

The gap between model world and real world can be filled only by inductive inference, and we can have more confidence in such inferences, the more credible the model is as an account of what could have been true.

Nancy Cartwright, "If No capacities then No Credible Worlds", *Erkenntnis*, 70 (1), 45-58.

Economics has very few uncontroversial principles at its disposal. Its models must do a lot with a little.

Week 5. *Ceteris Paribus* (February 25)

Daniel M. Hausman, "Ceteris Paribus Clauses and Causality in Economics," PSA: Proceedings of the Biennial Meeting of the Philosophy of Science Association, (1988), pp. 308-316.

When Mill enunciates the "psychological law" "that a greater gain is preferred to a smaller", he is not claiming that people always prefer greater gains, but that this is one motivational "force" that often predominates. Economists tell us how agents behave in the absence of various complications.

[Note: The following readings are very difficult. Have a go at them. Part of the purpose is to illustrate the difficulty of understanding how models, theories, and assumptions in economics are justified.]

John Earman, John Roberts, and Sheldon Smith, "*Ceteris Paribus* Lost," *Erkenntnis* 57(2002): 281-301. [It helps to start with the tobacco example at the end of the paper]

In order for a hypothesis to be testable, it must lead us to some prediction. The prediction may be statistical in character, and in general it will depend on a set of auxiliary hypotheses. Even when these important qualifications have been added, CP law statements still fail to make any testable predictions.

Nancy Cartwright, "Causal Powers: What Are They? Why Do We Need Them? What Can Be Done with Them and What Cannot?" London School of Economics, Centre for Philosophy of Natural and Social Science. Contingency and Dissent in Science Technical Report 04/07. Pages 31-42; recommended pp. 1-5.

Here's what I think happens. We have seen a vast number of cases of forces at work to which we have tried to fit Newton's second law and over time we have established very strong rules of thumb about what can make trouble for it. That is, we have learned from a lot of experience what kinds of things might *interfere* with the operation of the force. That's what we control for.

Week 6. Economics in Crisis (March 04)

J. Bradford DeLong, "Economics in Crisis," *The Economists' Voice*, May 2011, pp. 1-2.

Or perhaps economics will remain a discipline that forgets most of what it once knew and allows itself to be continually distracted, confused, and in denial.

James M. Buchanan, "Economists Have No Clothes," *Perspectives in Moral Science*, ed. M. Baurmann & B. Lahno, 2009, 151-156.

The fundamental misconception here lies in the understanding of what 'the economy' is.

F. A. Hayek, "The Use Of Knowledge In Society" *American Economic Review*, XXXV, No. 4; September, 1945, Pp. 519–30.

The peculiar character of the problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess.

Recommended:

Peter Boettke "Teaching economics, appreciating spontaneous order, and economics as a public science," *Journal of Economic Behavior & Organization* 80 (2011) 265– 274

The economist looking out into the world of a commercial society is immediately struck with two primordial facts: individuals pursue their self-interest, and modern commercial society with its vast division of labor is orderly. ... the first task of the economist is to explain how these two facts of commercial life – self-interest, and social order – are consistent with one another. P. 267

Friedrich A Hayek, "Economics and Knowledge" in *Individualism and Economic Order*, Chicago: Chicago University Press (1937 [1948]) pp. 33-56. Find this at: <http://www.virtualschool.edu/mon/Economics/HayekEconomicsAndKnowledge.html>

The statement that, if people know everything, they are in equilibrium is true simply because that is how we define equilibrium.

PART II -- LAW, ECONOMICS, AND ETHICS

Week 7. **First Midterm Exam (first half of class period).** (March 18)

Reading for second half of class:

Nicholas Kaldor, "Welfare Propositions of Economics and Interpersonal Comparisons of Utility," *The Economic Journal*, Vol. 49, No. 195 (Sep., 1939), pp. 549-552.

In all cases, therefore, where a certain policy leads to an increase in physical productivity, and thus of aggregate real income, the economist's case for the policy is quite unaffected by the question of the comparability of individual satisfactions; since in all such cases it is possible to make everybody better off than before, or at any rate to make some people better off without making anybody worse off.

Recommended – take a quick look at:

Harriet Friedmann, "International Political Economy of Food: A Global Crisis," *New Left Review* no. 197, Jan./Feb. 1993, pp. 29-57.

[In Third-World countries] US wheat surpluses made imports an attractive alternative to the modernization of the domestic food sector.

To see how far some economists have taken the “compensation test” as a measure of value, look at: Zerbe Jr., Richard O, Yoram Bauman, and Aaron Finkle, 2005. “An Aggregate Measure for Benefit–Cost Analysis,” *Ecological Economics* 58 (2006) 449–461.

A logical extension or clarification of KH requires including all goods for which there is a WTP.

Week 8. Should Preferences Count? (March 25)

Tyler Cowen, "The Scope and Limits of Preference Sovereignty," *Economics and Philosophy*, 9, 1993, 253-269.

Incoherence of the preference sovereignty norm implies the radical conclusion that welfare economics does not have a positive marginal product in judging welfare or making social decisions.

Amartya K. Sen, Rational Fools: A Critique of the Behavioral Foundations of Economic Theory *Philosophy & Public Affairs* Vol. 6, No. 4 (Summer, 1977), pp. 317-344.

Behavior, it appears, is to be explained in terms of preferences, which are in turn defined only by behavior. Not surprisingly, excursions into circularities have been frequent.

The characteristic of commitment with which I am most concerned here is the fact that it drives a wedge between personal choice and personal welfare, and much of traditional economic theory relies on the identity of the two.

Daniel M. Hausman and Michael S. McPherson, “Preference Satisfaction and Welfare Economics,” *Economics and Philosophy*, 25 (2009) 1–25.

Yet it is obvious that people’s preferences are not always self-interested and that false beliefs may lead people to prefer what is worse for them even when people are self-interested. So welfare is not preference satisfaction, and hence it appears that cost-benefit analysis and welfare economics in general rely on a mistaken theory of wellbeing.

Week 9. Social Costs and Property Rights (April 01)

R. H. Coase, The Problem of Social Cost, *Journal of Law and Economics*, Vol. 3. (Oct., 1960), pp. 1-44.

In a world in which there are costs of rearranging the rights established by the legal system, the courts, in cases relating to nuisance, are, in effect, making a decision on the economic problem and determining how resources are to be employed.

Guido Calabresi and A. Douglas Melamed “Property Rules, Liability Rules, and Inalienability: One View of the Cathedral” *Harvard Law Review* 85(6)(April 1972), pp. 1105-1111.

Whenever society chooses an initial entitlement it must also determine whether to protect the entitlement by property rules, by liability rules, or by rules of inalienability.

Boomer vs. Atlantic Cement Company 26 N.Y.2d 219, 309 N.Y.S.2d 312 (N.Y. 1970). To get the facts of the case, read the first 3 pages (pp. 674-676) of: E. F. Roberts, "The Right to a Decent Environment" *Cornell Law Review* (55) (1969-1970).

Why should the trial court have allowed the cement company, in empirical effect, to buy up its neighbors?

Week 10. Social Costs continued. (April 08)

Guido Calabresi, "The Pointlessness of Pareto," *The Yale Law Journal*, Vol. 100(5)(March 1991), 1211-1237.

Transaction costs (including problems of rationality and knowledge), no less than existing technology, define what is currently achievable in any society-the Pareto frontier.

Week 11. Cost-Benefit Analysis (I) (April 15)

[FIRST DRAFTS or at least a perspective of papers are due.]

John V Krutilla, "Conservation Reconsidered" *American Economic Review*, September 1967, pp. 777-786.

When the existence of a grand scenic wonder or a unique and fragile ecosystem is involved, its preservation and continued availability are a significant part of the real income of many individuals.

Larry Ruff, "The Economic Common Sense of Pollution," *The Public Interest*, 19 (Spring 1970); read excerpts at: <http://www.terry.uga.edu/~satkinso/2100/econcommonsense.doc>

Once the prices are set, polluters can adjust to them in any way they choose. Because they act on self-interest they will reduce pollution by every means possible up to the point where further reduction would cost more than the price.

Duncan Kennedy, "Cost-Benefit Analysis of Entitlement Problems: A Critique," 33 *Stanford Law Review* (1981). Parts I and II – pp. 387-400.

Externalities Run Wild

Richard O. Zerbe and Howard E. McCurdy, "The Failure of Market Failure," *Journal of Policy Analysis and Management* (18: 4) (Fall 1999) , pages 558–578.

A fundamental problem with the concept of market failure, as economists occasionally recognize, is that it describes a situation that exists everywhere

Recommended but difficult:

Duncan Kennedy, "Law and Economics from the Perspective of Critical Legal Studies" in *The New Palgrave Dictionary of Economics and the Law* 465 (P. Newman ed., Macmillan, 1998).

the rhetoric of Kaldor-Hicks is so thoroughly manipulable that liberals and conservatives can pursue agendas of these kinds within its strictures. . . . [The effect is] supportive of liberalism and conservatism together, seen as a bloc in opposition to more left and right wing positions. What the liberal and conservative members of the centrist bloc have in common is moderation, statism and rationalism.

If you want to see a summary of Buchanan's view of externalities. see:

Alain Marciano, "Buchanan on externalities: An exercise in applied subjectivism," *Journal of Economic Behavior & Organization* 80 (2011) 280–289.

Week 12. Cost-Benefit Analysis II (April 22)

[Second Midterm Exam (first half of class period)].

Reading for second half of class:

Robert H. Frank, "Why Is Cost-Benefit Analysis So Controversial?" *Journal of Legal Studies*, Vol. 29, No. 2, Pt. 2, June 2000; only pages 913-917 are assigned.

Rich and poor alike have an interest in making the economic pie as large as possible. Any policy that passes the cost-benefit test makes the economic pie larger. And when the pie is larger, everyone can have a larger slice.

[Question: What does "the economic pie" refer to in this context?]

Please look at or skim (to get the general idea – no need to print this):

Robert W. Hahn, "An Evaluation of Government Efforts to Improve Regulatory Decision Making," *International Review of Environmental and Resource Economics*, 2009, 3: 245–298.

There is little evidence that economic analysis of regulatory decisions has had a substantial positive impact,

Week 13. Paternalism (April 29)

First full draft of final paper due. Papers will be returned with comments and suggestions next week.

Cass Sunstein and Richard Thaler, "Libertarian Paternalism Is Not an Oxymoron," *University of Chicago Law Review*, 70(4)(2003), 1159–1202. Read "Introduction" (pp. 1159-1167) and skim the rest. Also downloadable in legible text at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=405940

We propose a form of paternalism, libertarian in spirit, that should be acceptable to those who are firmly committed to freedom of choice on grounds of either autonomy or welfare.

Glen Whitman, "Against the New Paternalism: Internalities and the Economics of Self-Control," Policy Analysis No. 563 (Feb. 22, 2006) 15pp. Issued by the Cato Institute.

The theory of internalities is explicitly modeled on the theory of externalities.

Recommended but difficult, J. David Velleman, "Persons in Prospect," *Philosophy & Public Affairs* 36, no. 3, pp. 221-243.

self-concern does not extend to other possible worlds

Week 14. Happiness Research and Economics (May 6)

Matthew Adler & Eric A. Posner, "Happiness Research and Cost-Benefit Analysis," *Journal of Legal Studies*, vol. 37 (June 2008), pp. S253-S292. Read pages S253-S69 and skim the rest.

we argue that the happiness literature does not undermine CBA and similar conventional methods of project evaluation that rely on a money metric.

Erik Angner, "The Politics of Happiness: Subjective vs. Economic Measures as Measures of Social Well-being," in Lisa Bortolotti (Ed.) *Philosophy and Happiness* (New York: Palgrave), pp. 149-166.

My main thesis is that economic and subjective measures – although they differ with respect to the underlying account of individual welfare – in fact are based on the very same account of social welfare: both are applications of the utilitarian social welfare function.

Final Papers due – [Date TBA] No final exam.