

Grinnell College
Economics 370
Fall 2005

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Office Hours: Tues.: 10 – 12:00; Thurs. 1:30 – 3:30

SEMINAR IN POLITICAL ECONOMY

Economic and political processes are intricately intertwined not only for the obvious reasons that political institutions and actions frame and constrain economic activity, while economic conditions influence the sustainability of political institutions, but at a deeper level because economic activity contains its own political logic, and vice versa. This course begins with the premise that many economic interactions are “political” in the sense that coalitions of participants, whose interest may differ, can influence important economic, or market, outcomes. In this regard, the course will explore tendencies toward competition, cooperation, and conflict, and their relationship to economic constraints imposed by the forces of supply and demand in addition to constraints imposed by norms concerning fairness, as they operate in various market and institutional arenas, such as labor markets or a national economy. The course will examine relevant theories of incomplete contracting under conditions of imperfect information with some attention to imperfect and asymmetric information, transactions costs, reciprocity relationships and game theory. It will proceed to apply these concepts to contemporary problems concerning employment, economic growth, and the distribution of income and wealth.

Now at last we are setting ourselves seriously to inquire whether there should be any so-called “lower classes” at all: that is, whether there need be large numbers of people doomed from their birth to hard work in order to provide for others the requisites of a refined and cultured life; while they themselves are prevented by their poverty and toil from having any share or part in that life. . . The question cannot be fully answered by economic science. For the answer depends partly on the moral and political capabilities of human nature . . . But the answer depends in a great measure upon facts and inferences, which are within the province of economics; and this it is which gives to economic studies their chief and their highest interest.

-- Alfred Marshall, *Principles of Economics*, first published in 1890.

There is a large arbitrary element in the relative rates of remuneration, and the factors of production get what they do, not because in any strict sense they precisely earn it, but because past events have led to these rates being customary and usual.

-- John Maynard Keynes

[No system of wages] ... when it is called into question, will ever be found to be fair . . . the system of wages should be well established, so that it has the sanction of custom. It then becomes what is expected; and (admittedly on a low level of fairness) what is expected is fair.”

-- John Hicks

Readings:

At Book Store:

Basu, Kaushik, *Prelude to Political Economy: A Study of the Social and Political Foundations of Economics*, Oxford U.K.: Oxford University Press, 2000.

(To the degree that this course has a central text, Basu is it.)

Hirschman, Albert O., *Exit, Voice and Loyalty*, Cambridge, MA: Harvard University Press, 1970.

North, Douglas, *Institutions, Institutional Change and Economic Performance*, Cambridge, U.K.: Cambridge University Press, 1990.

Schelling, Thomas, *Micromotives and Macrobehavior*, New York, N.Y.: W.W. Norton, 1978.

Placed on Library Reserve (* = e-reserve)

- Acemoglu, Daron, Simon Johnson and James Robinson, *Institutions as the Fundamental Cause of Long-Run Growth*, National Bureau of Economic Research Working Paper 10481.
- Akerlof, George, "On Making Economics Realistic," Interview, *Challenge*, Vol. 45, No. 6, Nov. – Dec. 2002, pp. 6-20.*
- Akerlof, George and Rachel Kranton, "Identity and the Economics of Organization," *Journal of Economic Perspectives*, 19 (1), Winter 2005, pp. 9-32.*
- Bewley, Truman, *Why Wages Don't Fall During a Recession*, Harvard University Press, 1999, Chapters 4, 20 and 21.
- Bowles, Samuel, *Microeconomics: Behavior, Institutions, and Evolution*, Princeton University Press, 2004.
- Bowles, Samuel, "What Markets Can and Cannot Do," *Challenge*, July/August 1991.*
- Dixit, Avinash and Susan Skeath, *Games of Strategy*, New York, NY: W.W. Norton, 2004.
- Kirchler, Erich, Ernst Fehr and Robert Evans, "Social exchange in the labor market: Reciprocity and trust versus egoistic money maximization," *Journal of Economic Psychology*, 17 (1996), 313-341.
- Knight, Jack, "The Primary Importance of Distributional Conflict," Chapter 2 of *Institutions and Social Conflict*, Cambridge, UK: Cambridge University Press, 1992.*
- Mansfield, Edwin, *Microeconomics: Theory/Applications*, New York: W.W. Norton, 2000, Chapter 13: "Game Theory and Strategic Behavior," pp. 410-444.
- Mankiw, N. Gregory, *Principles of Economics*, Chapters 10 and 11.*
- Milgrom, Paul and John Roberts, *Economics, Organization & Management*, Englewood Cliffs, N.J.: Prentice-Hall, 1992, Chapter 6, "Moral Hazard and Performance Incentives."
- Ostrom, Elinor, *Governing the Commons: The Evolution of Institutions for Collective Action*, Cambridge, UK: Cambridge University Press, 1990.
- Nelson, Richard R. and Paul M. Romer, "Science, Economic Growth and Public Policy," *Challenge*, March-April 1996.*
- Olson, Mancur, *The Rise and Decline of Nations*, New Haven CT: Yale University Press, 1982, chapter 2, "The Logic," pp. 17-35.*

Available though JSTOR:

- Agion, Phillippe, Eve Caroli and Cecilia Garcia-Penalosa, “Inequality and Economic Growth: The Perspective of the New Growth Theories,” *Journal of Economic Literature*, Dec. 1999, pp. 1615-1660
- Akerlof, George and Rachel Kranton, “Economics and Identity,” *Quarterly Journal of Economics*, Aug. 2000, pp. 715-752.
- Bowles and Gintis, “Power and Wealth in a Competitive Capitalist Economy,” *Philosophy and Public Affairs*, 41: 324-53.
- Camerer, Colin and Richard H. Thaler, “In Honor of Matthew Rabin: Winner of the John Bates Clark Award,” *Journal of Economic Perspectives*, Vol. 17, No. 3, Summer 2003, pp. 159-176.
- Elster, Jon, “Social Norms and Economic Theory,” *Journal of Economic Perspectives*, 3(4), Fall 1989, pp. 99-117.
- Fehr, Ernst and Simon Gächter, “Fairness and Retaliation: the Economics of Reciprocity,” *Journal of Economic Perspectives*, Vol. 14, No. 3, Summer 2000, pp. 159-181.
- Fortin, Nicole and Thomas Lemieux, “Institutional Change and Rising Wage Inequality: Is There a Linkage,” *Journal of Economic Perspectives*, Spring 1997, pp. 75-96.
- Gottschalk, Peter, “Inequality, Income Growth, and Mobility: The Basic Facts,” *Journal of Economic Perspectives*, Spring 1997, pp. 21-40.
- Ostrom, Elinor, “Collective Action and the Evolution of Social Norms,” *Journal of Economic Perspectives*, Vol. 14, No. 3, summer 2000, pp. 137-158.
- Romer, Paul J., “The origins of endogenous growth,” *Journal of Economic Perspectives*, 1994, 8, Winter, pp. 3-22
- Young, H. Peyton, “The Economics of Convention,” *Journal of Economic Perspectives*, Spring, 1996, pp. 105-122.

EVALUATION AND ASSIGNMENTS: Students will be evaluated on written work, formal oral presentations and general classroom discussion.

Written assignments will include two group discussion papers (two pages), two short papers (4-5 pages each), one initial research project thesis statement and outline (two pages), one “long” research project thesis and outline (3-5 pages), and a research paper (15-20 pages). Papers must be written clearly and concisely and must be drafted at least twice before turning in. Students will be evaluated on clarity of written presentation as well as on content.

Formal oral assignments on specific course readings will consist of various panel presentations and debates. Students will also present their research projects orally.

Attendance is *required*. Students are expected to actively participate in class discussion. Students will receive a midterm oral evaluation as well as evaluations on many of the formal oral projects.

READINGS AND COURSE OUTLINE
(Please refer to lists above for full citations)

I. Micro, Social, and Political Foundations of Political Economy

“The main weakness of previous theories that stress the importance of distributive questions has been the lack of microfoundations, or the mechanisms by which institutions emerge and change.” – Jack Knight

“What is missing from the policy analyst’s tool kit – and from the set of accepted, well-developed theories of human organization – is an adequately specified theory of collective action whereby a group of principals can organize themselves voluntarily to retain the residuals of their own effort.” – Elinor Ostrom

A. Introduction – Political Economy, Institutional, and Neoclassical Economics: *Week 1*

- Akerlof, “On Making Economics Realistic,” Interview.*
- Bowles, “What Markets can and cannot do” Interview*;
- Basu, Chapter 1; North, Chapter 1; Schelling, Chapter 1; Worksheet on political economy

B. Individuals, Strategic Behavior, and Collective-Action Problems: *Weeks 2 - 3*

1. Elementary game theory and its relation to public goods, common pool resources, externalities and, more generally, collective-action problems

- Edwin Mansfield and Gary Yohe: Chapter 13 on Game Theory
- Basu, Chapter 2, “Games and Misdemeanors,”
- Review Mankiw, Chapters 10 and 11 on externalities, public goods and common pool resource problems.
- Application: Nelson, Richard R. and Paul M. Romer, “Science, Economic Growth and Public Policy,” *Challenge*, Mar./Apr. 1996.*

2. Individual Rationality and Behavior

- Basu, Chapter 3, “Individual Rationality,” through section 3.1. Remainder of chapter is optional.
- North, Chapter 3, “The behavioral assumptions in the theory of institutions,”

3. Interdependence, cooperation, and collective-action problems

- North, Chapter 2: “Cooperation: the theoretical problem,”
- Ostrom, Elinor, “Collective Action and the Evolution of Social Norms,”
- Olson, Chapter 2, “The Logic”*

Related Readings:

Dixit and Skeath, Chapter 11, “Collective-Action Games.”

C. Reciprocity, Social Norms and Coordination: *Weeks 3 - 5*

1. Reciprocity:

- Fehr and Gächter, “Fairness and Retaliation: The Economics of Reciprocity,”
- Camerer, Colin and Richard H. Thaler, “In Honor of Mathew Rabin: Winner of the John Bates Clark Medal” (through p. 164).

2. Conventions and social norms as solutions to coordination & collective action problems:

- Young, “The Economics of Convention.”
- Elster, Jon, “Social Norms and Economic Theory,”

3. Social norms and economic transactions

- Basu, Chapter 4, “Social Norms, Culture and Beliefs”
- Kirchler, Erich, Ernst Fehr and Robert Evans, “Social exchange in the labor market: Reciprocity and trust versus egoistic money maximization,”*
- Application: Bewley, Chapter 4, “Morale,”*

4. Coordination and Critical Mass

- Schelling, Chapter 3

****First Short Paper, Monday, Sept. 26****

5. Norms and identity

- Akerlof & Kranton, “Economics and Identity,”
- Akerlof & Kranton, “Identity and the Economics of Organization,”

****Research Paper Topic Paragraph Sept. 28****

D. Institutions and Economics: *Week 6*

1. Transactions costs, institutions -- informal and formal -- and problems of enforcement

- North, Chapters 4 - 7,

2. Law and economics

- Basu, Chapter 5, “Law and Economics”
- Milgrom and Roberts (selections) on principal-agent problems

E. Power and Redress in Political Economy: *Weeks 7-8*

1. Principal-agent Problems and Contested Exchange:

- Bowles and Gintis, “Power and Wealth in a Competitive Capitalist Economy,”
- Handout on effort models; Handout on principal-agent problems

2. Power, coercion and influence

- Basu, Chapter 6

3. Mechanisms for redress: exit and voice

- Albert O. Hirschman, *Exit, Voice and Loyalty*, chapters 1-4, 7, and Appendix A, B.

**Initial Thesis Statement, Outline and Bibliography for Research Paper
Due Wednesday, Oct. 12****

Related Readings:

Bowles, Samuel, *Microeconomics*, chapters 7 and 8

Bowles, Samuel and Herbert Gintis, "Contested Exchange: New Microfoundations for the Political Economy of Capitalism," *Politics and Society*, June 1990, pp. 165-222.

Dufwenberg, Martin and Georg Kirchsteiger, "Reciprocity and wage undercutting," *European Economic Review*, 44(4-6), May, 2000, 1069-78.

Elster, Jon, *The cement of society: A study of social order*, Cambridge, U.K.: Cambridge University Press, 1989.

Fehr, Ernst and Klaus M. Schmidt, "A Theory of Fairness, Competition, and Cooperation," *Quarterly Journal of Economics*, Aug. 1999, pp. 817-868.

Milgrom and Roberts, chapters 6-8

Solow, Robert M, *The Labor Market as a Social Institution*, Basil Blackwell, 1990.

II. The Political Economy of Growth and Distribution: Weeks 9 - 11

A. Distribution, Institutional Evolution and Economic Growth

- Knight, Chapter 2, "The primary importance of distributional conflict."**
- Acemoglu, Johnson and Robinson, "Institutions and the Fundamental Cause of Long-Run Growth," NBER Working Paper 10481

****Long Outline, Thesis & Bibliography due Wednesday, Nov. 2**
(Meet with me at least a week in advance of this date)**

B. Income Inequality and Economic Growth

- Review: Dornbusch, Fisher and Startz, *Macroeconomics*, Chapters 3 and 4.
- Phillipe Aghion, Eve Caroli and Cecilia Garcia-Penalosa, "Inequality and Economic Growth: The Perspective of the New Growth Theories."**

Related Readings:

Abramovitz, Moses (interview) "What Economists Don't Know about Growth," *Challenge*, Jan.-Feb. 1999.

Grossman, Gene M. and Elhanan Helpman, "Endogenous Innovation in the Theory of Growth," *Journal of Economic Perspectives*, 8 (1), Winter 1994, pp. 3 - 23.*

- Hoff, Karla, "Market Failures and the Distribution of Wealth," *Politics and Society*, 24(4), Dec. 1996, pp. 411-432.
- Mankiw, N. Gregory, "The Growth of Nations," *Brookings Papers on Economic Activity*, 1995, pp. 407-37.
- Nelson, Richard, "How New is New Growth Theory?" *Challenge*, Sept.-Oct. 1997.
- Rodrik, Dani, "Democracies Pay Higher Wages," *Quarterly Journal of Economics*, CXIV (3), Aug. 1999, pp. 707-738.
- Snowdon & Vane, *A Macroeconomic Reader*, Part VI, "The renaissance of economic growth analysis."
- Solow, Robert M., "Perspectives on endogenous growth theory," *Journal of Economic Perspectives*, 1994, 8, Winter, pp. 48-54.*
- Ziera, Joseph, "Machines and Economic Growth," *Quarterly Journal of Economics*, Nov. 1998, pp. 1091-1117. (This article is difficult.)

C. Trends in Inequality in the Income Distribution in the U.S.

- Peter Gottschalk, "Inequality, Income Growth, and Mobility: The Basic Facts," *Journal of Economic Perspectives*, spring, 1997.*
- Nicole Fortin and Thomas Lemieux, "Institutional Changes and Rising Wage Inequality: Is There a Linkage?" *Journal of Economic Perspectives*, spring, 1997.*

****Second Short Paper due Monday, Nov. 14****

D. Policy and distribution:

- Basu, Chapter 7, "On Advising Government"
- Bowles, Samuel and Herbert Gintis, "Asset Redistribution"*
- Hausman, Daniel, "Problems with Supply-Side Egalitarianism,"

Related Readings:

- Galbraith, James K. "A Two-Track Growth Program," *Challenge*, Jan./Feb. 1993.
- Gintis, Herbert, "New Economic Rules of the Game," *Challenge*, Sept./Oct. 1992.
- Krugman, Paul, *The Age of Diminished Expectations*, Chapters 15-17
- Phelps, Edmund, "The Case for Subsidizing Wages," *Challenge*, Jul.-Aug. 1997.
- Vickery, William, "Today's Task for Economists," *Challenge*, Mar./Apr. 1993.

VI. Student Presentations of Research Papers – Nov. 21 – Dec. 5.

*****Draft of Research Paper due Monday, Nov. 21*****

Concluding Session, Wednesday, Dec. 7

****** FINAL PAPER DUE at Noon, FRIDAY, Dec. 9******

(You know this now and you know the end of the semester will be busy. This is true for everyone; I expect the papers on time.)