

Ricardo, Alfred Marshall, Institutionalists, Public Choice

Buchholz IV: David Ricardo

Ricardo was a self-made man who came to economics after a very successful career in the financial markets. This was a productive change from the usual crowd of academics that had dominated the field so far. He wrote a lot on economics but also applied its lessons when he gained a seat in England's House of Commons.

Ricardo's main pursuit in government was to advocate for free trade, particularly for food. (He worked against the "Corn Laws" that limited English imports of a many types of grains.) Ricardo saw English society broken into three groups: workers, entrepreneurs, and landowners. Landowners thought they would benefit from keeping out foreign grown food, so that they could get better prices in England for the crops they grew. Further, the landowners tended to dominate the English government, so they got what they wanted.

Ricardo's reply to them was his "Theory of Comparative Advantage." Essentially, this says that we should use each resource to what it is relatively best at, and that this allows us the largest PPF and most total production. Further, that this would lower food prices, to the benefit of English entrepreneurs who need to pay their workers enough to eat, and that it was the success of this business class upon which England's future depended. Furthermore, Ricardo did not think that higher compensation for landowners was particularly deserved. They were going to rent their land out anyway, so paying them more didn't get them to do anything they weren't going to do anyway; all it did was make food expensive for workers and increased the wages that entrepreneurs would have to pay workers. Ricardo referred to these excess payments for landowners as "rents", that is, a payment that has no real incentive effect to increase output.

Many people could not see the wisdom of freeing trade and giving any business to foreigners, even if it there were domestic interests that could benefit from cheaper food. The quote from Abraham Lincoln is a great example of this failure of understanding, and the quotes from the delightful Frederic Bastiat are a great rejoinder.

Ricardo also did interesting work on both the long run growth of the economy, and its short run fluctuations. In this latter work, he debated Malthus's theory of the economy falling into recessions because of General Gluts, due to under-consumption of what was produced. While Malthus pointed out that leakages such as savings (and we would add taxes and imports) would reduce demand below what was produced, Ricardo pointed out that demand is pushed back up by injections such as investment (and we would add government spending on goods and services and exports). Following Say's Law that "Supply creates its own demand," as long as total leakages equal total injections, then the economy should be in equilibrium. Malthus would ask, "But then why do we see 'General Gluts' where there is insufficient demand in the economy to buy up everything

produced?” Ricardo’s response would be that sometimes things mess up the injections, such as a financial panic messing up investment.

Buchholz VII: Alfred Marshall

Alfred Marshall, (1842-1924, English), Professor of Economics at Cambridge, Keynes was his student. Formalized three of the great tools of economics: supply and demand, marginal analysis, and the use of *ceteris paribus*.

- Interesting but not for this class:
 - Short versus long run in microeconomics.
 - Economies of scale.
 - Internal and external economies.
 - Less interesting: Marshall on the “Big Picture.”

Note: On page 170 Buchholz gets wrong the definition of inelastic, confusing it with perfectly inelastic.

Buchholz VIII: Old and New Institutionalists

Marshall tried to describe social behavior as being a matter of people trying to maximize utility (happiness) and businesses trying to maximize profit. An alternative approach is to think about how social institutions affect social behavior.

Thorstein Veblen, (1857-1929, American). People do things to impress others, so they may buy flashy goods that they don’t like very much to try to show off how rich they are (“conspicuous consumption” and conspicuous leisure). He also worried that the push of engineers to improve how goods are produced and make them cheaper and better may run at odds with the management of firms that would want to limit production to keep prices high.

John Kenneth Galbraith, (1908-2006, Canadian). In an affluent society, people can pretty much afford everything they need (“needs”), so how will they spend the rest of their income (“wants”)? Did people buy things because they really liked them, or because advertising convinced people to buy things that weren’t really very useful or good? Galbraith’s “dependence effect” suggests that advertising creates “wants”, that advertising is very powerful, and that firms need this as production becomes increasingly complex. If this is true, Galbraith fears that society will end up devoting too many resources to market goods that are heavily advertised, and too few resources to things for which there is little incentive to advertise, particularly government provided goods like mass transportation and public schools.

Supreme Court Justice Louis Brandeis (1856-1941, American). Not really an economist, but he did have a great line: A “lawyer who has not studied economics...is very apt to become a public enemy.”

Very interesting for this class:

- Judge Learned Hand (1872-1961, American) on negligence (Buchholz pp. 193-194).
- Nobel Prize winner Gary Becker (1930- , American). Economics and Sociology. Does

increasing the opportunity cost of crime (probability and severity of punishment) reduce how many people break the law and the badness of what they do?

- Economics and Law: Should we focus on justice, or efficiency?

Interesting, but NOT for this class:

- Nobel Prize winner Ronald Coase (1910- , English). Can private markets handle problems of externalities? Maybe, if property rights are clear and the transactions costs of negotiations are low enough.
- Leveraged Buy-Outs (LBOs)

Buchholz XI: Public Choice

We think of private people and businesses as being out for personal gain, so why not people in government as well? Sure, the people who run the EPA care about the environment, but they also like having a big organization and nice furniture.

The most famous example of this is Mancur Olsen's theory of special interest groups who are able to manipulate government into imposing policies that gather gains for the special interest groups through imposing much larger costs on the rest of society. This will work if the costs of the policy per person are low enough that it's not in anyone's interest to get organized to fight back. A key part of this process is that the special interest groups are willing to share their gains through generous political contributions. Classic examples of this come from policies that restrict imports, at a great cost to consumers, but to the benefit of domestic producers.

Similarly, economist George Stigler figured out that many regulated industries actually favor costly regulations, because these rules can make it hard for new businesses to open up and compete in the market. So, costly regulations can actually reduce economic competition and make the regulated firms able to charge higher prices and get more profits, which harm consumers and create dead weight loss.

Economist James Buchanan explains the reason that governments are prone toward deficit spending (voters hate taxes but love benefits, and don't seem to pay much attention to the future).

Also of interest: William Niskanen on the incentives of bureaucrats to try to expand their power and pay.

However, the discussion of whether Keynes was wrong to ignore these issues is silly. Keynes was worrying about much larger issues. This Niskanen critique won't be on any tests.