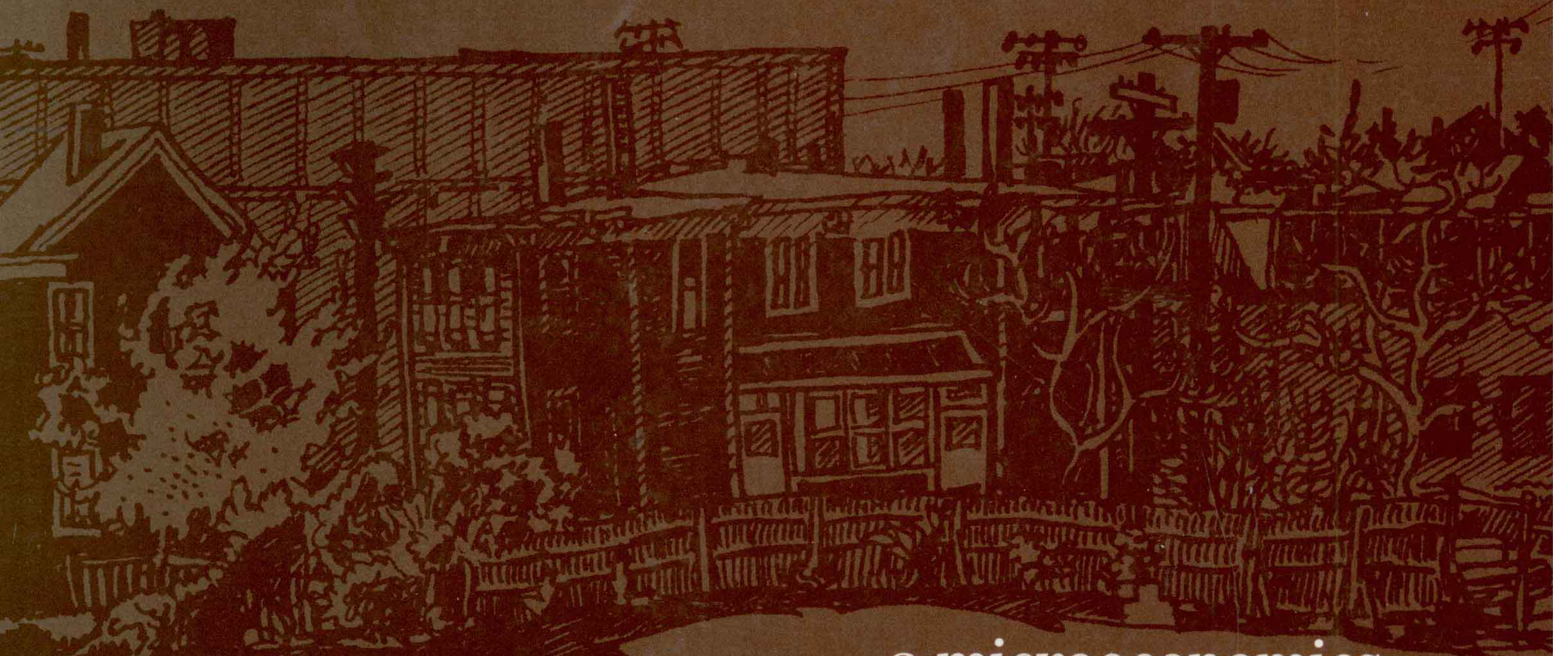
real world micro

twelfth edition



a microeconomics reader from

dollars & sense

real world micro

twelfth edition

edited by

Daniel Fireside,
Chris Tilly, and the
Dollars & Sense
Collective

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TWELFTH EDITION

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INTRODUCTION

THE TWO ECONOMIES

It sometimes seems that the United States has not one, but two economies. The first economy exists in economics textbooks and in the minds of many elected officials. It is a free-market economy, a system of promise and plenty, a cornucopia of consumer goods. In this economy, people are free and roughly equal, and each individual carefully looks after him- or herself, making uncoerced choices to advance his or her own economic interests. Government is but an afterthought in this world, since almost everything people need can be provided by the free market, itself guided by the reassuring "invisible hand."

The second economy is described in the writings of progressives, environmentalists, union supporters, and consumer advocates—as well as honest business writers who recognize that real-world markets do not always conform to textbook models. This second economy features vast disparities of income, wealth, and power. It is an economy where employers have power over employees, where large firms have the power to shape markets, and where large corporate lobbies have the power to shape public policies. In this second economy, government sometimes adopts policies that ameliorate the abuses of capitalism, and other times does just the opposite, but it is always an active and essential participant in economic life.

If you are reading this introduction, you are probably a student in an introductory college course in microeconomics. Your textbook will introduce you to the first economy, the harmonious world of free markets. *Real World Micro* will introduce you to the second.

WHY "REAL WORLD" MICRO?

A standard economics textbook is full of powerful concepts. It is also, by its nature, a limited window on the economy. What is taught in most introductory economics courses today is in fact just one strand of economic thought—neoclassical economics. Fifty years ago, many more strands were part of the introductory economics curriculum, and the contraction of the field has imposed limits on the study of economics that can confuse and frustrate students. This is particularly true in the study of microeconomics, which looks at markets for individual goods or services.

Real World Micro is designed as a supplement to a standard neoclassical textbook. Its articles provide vivid, real-world illustrations of economic concepts. But beyond that, our mission is to address two major sources of confusion in the study of economics at the introductory level.

The first source of confusion is the striking simplification of the world found in orthodox microeconomics. Standard textbooks describe stylized economic interactions that bear scant resemblance to the messy realities of buying, selling, producing, and consuming that we see around us. There is nothing wrong with simplifying. In fact, every social science *must* develop simplified models—precisely because reality is so complex, we must look at it a little bit at a time in order to understand it. Still, much mainstream economic analysis calls to mind the story of the tipsy party-goer whose friend finds him on his hands and knees under a streetlight. "What are you doing?" asks the friend. "I dropped my car keys across the street, and I'm looking for them," the man replies. "But if you lost them across the street, how come you're looking over here?" "Well, the light's better here." In the interest of greater clarity, economics often imposes similar limits on its areas of inquiry.

As the title *Real World Micro* implies, one of our goals is to rub mainstream microeconomic theory up against reality—to direct attention to the areas not illuminated by the streetlight, and particularly to examine how inequality, power, and environmental imbalance change the picture. The idea is not to prove the standard theory "wrong," but to challenge you to think about *where* the theory is more and less useful, and *why* markets may not act as expected.

This focus on real-world counterpoints to economic theory connects to the second issue we aim to clarify. Most economics texts uncritically present key assumptions and propositions that form the core of standard economic theory. They offer much less exploration of a set of related questions: What are alternative propositions about the economy? Under what circumstances will these alternatives more accurately describe the economy? What difference do such propositions make? Our approach is not to spell out an alternative theory in detail, but to raise questions and present real-life examples that bring these questions to life. For example, textbooks carefully lay out "consumer sovereignty"—the notion that consumers' wishes ultimately determine what the economy will produce. But can we reconcile consumer sovereignty with an economy one of whose main products—in industries such as soft drinks, autos, and music—is consumer desire itself? We think it is valuable to see ideas like consumer sovereignty as debatable propositions—which require hearing other views in the debate.

In short, our goal in this book is to use real-world examples from today's economy to raise questions, stimulate debate, and dare you to think critically about the models in your textbook.

WHAT'S IN THIS BOOK

Real World Micro is organized to follow the outline of a standard economics text. We have specifically keyed our table of contents to David Colander's *Economics* (6th edition) and its *Microeconomics* "split," but since the topics covered by all major texts are similar, this reader is a good fit with other textbooks as well. Each chapter leads off with a brief introduction, including study questions for the entire chapter, and then provides several short articles from *Dollars & Sense* magazine that illustrate the chapter's key concepts—42 articles in all. In many cases, the articles have been updated or otherwise edited to heighten their relevance.

Here is a quick walk through the chapters.

Chapter 1, Markets: Ideology and Reality, starts off the volume by taking a hard look at the strengths and weaknesses of markets, with special attention to weaknesses that standard textbooks tend to underemphasize.

Chapter 2, Supply and Demand, presents real-world examples of supply, demand, and taxation in action. *Dollars & Sense* authors question the conventional wisdom on topics such as rent control and tax fairness.

Chapter 3, Consumers, raises provocative questions about utility theory and individual consumer choice. What happens when marketers shape buyers' tastes? What happens when important information is hidden from consumers? Does consumer society threaten environmental sustainability?

Chapter 4, Firms, Production, and Profit Maximization, illustrates how business strategies often squeeze workers to boost profits—and challenges students to think about other ways of organizing work.

Chapter 5, Market Structure and Monopoly, spotlights monopoly power, just one example of the unequal power relationships that pervade our economic system. The chapter critiques monopoly power in pharmaceutical and agribusiness companies, but also questions whether small business dominance would be an improvement.

Chapter 6, Labor Markets and Income Distribution, examines problems of workforce discrimination and inequality, and discusses policy solutions.

Chapter 7, Market Failure, debates when and how public policy should address both particular and systemic failures of markets, with particular attention to environmental issues.

Chapter 8, Policy Spotlight: Is Privatization the Answer? Social Security and Beyond, continues the discussion of public policy, offering alternative views on the current hot-button issue of privatization.

WHAT'S NEW IN THIS EDITION

We have updated this edition of *Real World Micro* to reflect current controversies. Each of the chapters contains new articles written in the last two years (except for Chapter 2 on Supply and Demand—we found the examples in the previous edition to still be timely!). The Policy Spotlight in Chapter 8 is completely new, inspired by the debate about the future of the Social Security program.

KEY TO COLANDER

In each chapter introduction, we provide a key that links our text to David Colander's *Economics*, 6th edition. The chapters in that book's microeconomics "split," *Microeconomics*, 6th edition, are numbered identically, so these keys should work with either version of Colander's book. Professors and students using other textbooks should, of course, feel free to ignore these keys. Here is the summary key for the entire table of contents.

Chapter 1 – Colander chapters 1-3
Chapter 2 – Colander chapters 4-7
Chapter 3 – Colander chapter 8
Chapter 4 – Colander chapters 9-11
Chapter 5 – Colander chapters 12-15
Chapter 6 – Colander chapters 16-17
Chapter 7 – Colander chapters 18 and 20
Chapter 8 – Colander chapters 19 and 21

CHAPTER 1

Markets: Ideology and Reality

INTRODUCTION

Economics is all about tradeoffs. The concept of opportunity cost reminds us that in order to make a purchase, or even to make use of a resource that you control (such as your time), you must give up other possible purchases, other possible uses. Markets broaden the range of possible tradeoffs by facilitating exchange between people who do not know each other, and in many cases never meet at all—think of buying a pair of athletic shoes in Atlanta from a company based in Los Angeles that manufactures shoes in Malaysia and has stockholders all over the world. As the idea of gains from trade suggests, markets allow many exchanges that make all parties better off.

But markets have severe limitations as well. The articles in this chapter probe some of them. Markets ration goods to those most able to pay (Article 1.2). More generally, if we rely on markets to distribute goods that we think of as basic needs or even rights—health care, housing, education, and so on—lower-income people will get "rationed out," receiving fewer or poorer-quality goods (Article 1.4). What's more, markets are built around *private* decisions to produce or consume. When society needs to make some basic investment that will benefit *the public* (such as vaccinations, a mass transit system, or the infrastructure of the Internet), markets often fall down on the job (Article 1.3). However, lots of bestselling economics texts, like the one by Gregory Mankiw, overlook many of the ways that markets fail and governments succeed in making the economy fairer and more efficient (Article 1.1).

KEY TO COLANDER

This chapter is designed to be used with Chapters 1-3.

Most of these articles are keyed to ideas in Chapter 3, "The Evolving U.S. Economy in Perspective." They also anticipate some of the arguments put forward in Chapter 7, "Taxation and Government Intervention."

DISCUSSION QUESTIONS

1) (General) What things should *not* be for sale? Beyond everyday goods and services, think about human bodies, votes, small countries, and other things that might be bought and sold. How do you draw the line between what should be for sale and what should not be?
2) (General) Advocates of unregulated markets often argue that deregulating markets doesn't just promote mutually beneficial exchanges, but also fundamentally expands freedom. Explain the logic of their argument, the logic of the opposing view, and evaluate the two points of view.
3) (General) If not markets, what? What are other ways to organize economic activity? Which are best equipped to solve the problems raised in this chapter?
4) (Article 1.2) Ellen Frank claims that markets erode democracy. Explain her perspective. Do you agree? Do *all* markets undermine democracy?
5) (Article 1.3) Many argue that open markets are needed to unleash the potential of information technology. Phineas Baxandall says that just the opposite is true. Explain the two opposing viewpoints. Where do you come down in this debate?
6) (Article 1.4) Boosters of educational management organizations (EMOs) say that privatization, by bringing competition to education, will result in innovation and improved efficiency. Amy Gluckman counters that for the most part this has not happened, and that EMOs have resorted to socially destructive ways to cut costs. Explain. If Gluckman is correct that EMOs have not increased efficiency, why do you think they are spreading?
7) (Article 1.1) Mark Maier criticizes Gregory Mankiw's textbook for distorting the way the economy works. When economists disagree, why can't we just tell who's right by seeing who provides a better description of economic reality? Why do you suppose Mankiw's text has become a bestseller?

FROM THE CLASSROOM TO THE WHITE HOUSE

ECONOMICS ACCORDING TO N. GREGORY MANKIW

BY MARK MAIER

"Let those who will, write the nation's laws if I can write its textbooks," Paul Samuelson, author of the one-time leading economics textbook, once boasted. Now N. Gregory Mankiw (pronounced "Man-kew") is about to do both. He's the newly confirmed chair of President Bush's Council of Economic Advisers, the three-member group that gives direct economic advice to the president. And he is author of a best-selling college economics text. Thus, Mankiw is powerfully positioned, bringing his highly regarded academic credentials to the Bush economic plan, while his new-found political prominence will likely fan sales of his book.

Press coverage of Mankiw's May 2003 nomination focused narrowly on the ways his work appeared inconsistent with some of the more patently absurd tenets of Bush economic policy—like the idea that cutting taxes will increase government revenue. The Associated Press reported that Maryland Senator Paul Sarbanes accused Mankiw of "twisting like a pretzel" during his confirmation hearing to reconcile his prior writing with administration policies. The coverage cast Mankiw as a reasonable critic and a moderate.

Less often recognized is the fact that Mankiw's writing consistently supports nearly all of the Bush conservative agenda, including tax cuts for the rich, deregulation, and reduced government spending. Mankiw's textbook, hailed as a breakthrough for its slimmed-down, high-tech approach, tilts so much toward the right that college professors interviewed for this article fear that students learn a particularly biased view of modern economics—far more so even than students who use other mainstream texts.

THE BIG MONEY

Known in the economics community as a rising star—Harvard tenure at age twenty-nine—Mankiw gained national recognition and raised eyebrows when he was paid a $1.4 million advance for a new introductory textbook, *Principles of Economics,* in 1997. Favorably reviewed in *USA Today* and the *Wall Street Journal,* the book is among today's best-selling college economics texts.

With over one million students taking an introductory course every year, the market is highly profitable. Actual textbook sales numbers are a closely guarded secret. Mankiw's publisher, Thomson South-Western, puts the book at the top, a claim disputed by competing publisher McGraw-Hill/Irwin. Whether the text is number one or two, it has unquestionably done well, far better than another entry ten years ago by Nobel Prize winner and Clinton advisor Joseph Stiglitz, and ahead of texts by other Bush appointees John Taylor (undersecretary of the Treasury) and Ben Bernanke (Federal Reserve governor). Paul Krugman, sharp critic of the Bush administration in his *New York Times* editorials, will go head-to-head with Mankiw when Krugman's new textbook hits the market next year.

The success of *Principles of Economics* is attributed to its clear writing style, its high-tech ancillary support materials, and most of all its slimmed-down presentation. Unlike bulky texts such as Mankiw's main competitor, the 800-page, double-column textbook by Campbell McConnell and Stanley Brue, Mankiw chose to emphasize a limited set of key ideas. Such brevity is welcome news to economics students required to buy hefty, expensive books that include more arcane mathematical theory than could possibly be learned in a one-year course. But Mankiw's choices about what content to leave *in* skew the book in a conservative direction, a bias that is reinforced by his selective use of examples, all of which support policy recommendations put forward by his new White House employer.

WHAT'S IN, WHAT'S OUT

Mankiw proudly claims that his Harvard students couldn't guess his political viewpoint. Obviously, they weren't keeping up with his *Fortune* magazine opinion pieces supporting school vouchers, privatization of Social Security, and an end to inheritance taxes. But more troubling, this attitude suggests that Mankiw believes his book to be politically neutral when in fact his textbook goes even further than most mainstream competitors in singling out conservative policies for study and selectively choosing illustrations that support a conservative agenda. By contrast, textbooks usually labeled "liberal" in their orientation by and large go out of their way to present a balance of arguments and to reveal the author's own point of view.

In his discussion of the 2002 Microsoft settlement, under which the company agreed to minor restrictions on its business practice, Mankiw fails to disclose that he was a paid consultant for Microsoft. Political transparency is not only honest, it also models for students how a social scientist can take a stand while still recognizing the need to understand opposing arguments.

Occidental College professor Peter Dreier complains, "When students who have used the Mankiw text in Economics 101 show up in my urban policy seminar, many of them have a lot of misconceptions about the way the real world works. Mankiw's text presents the inefficiency of government regulation as a proven fact, not as one perspective subject to debate and verification with evidence." Perhaps Mankiw's favorite issue—he examines it four times in the book—is the income tax's alleged drag on work effort. Of course, rolling back tax rates for high earners is the Bush's administration's top priority—big cuts on top income tax rates passed in 2001 and were accelerated with this year's tax cut. As evidence in favor of the tax cut, Mankiw points to a study from Iceland showing that people worked more when marginal taxes temporarily were reduced to zero—hardly a strong empirical foundation for his support of the administration's plans to lower the income tax rate for the rich by 3.6 percentage points and reduce taxes on stock dividends.

Conveniently ignored by the book (and the Bush administration) is the payroll tax, although it is the number-one tax for many U.S. households and is extraordinarily regressive in its impact, hitting the poor and middle class much harder than the rich.

Mankiw's chapters on "Earnings and discrimination" and "Inequality and poverty" ignore the most important causes of pay disparities and poverty in the United States. For instance, they give practically no attention to gender bias, race discrimination, or businesses' anti-union activity. Yet the text finds space to analyze the trivial problem of bias that favors those with good physical looks and to present an argument for why employer discrimination against blondes would put some firms at a competitive disadvantage. No evidence is provided for this imagined discrimination scenario, while real race and ethnic relations merit only two brief case studies—one on segregated streetcar seating and another on sports star salaries. The message in both examples is that employers suffer at the hands of racist customers who demand that they discriminate, a conclusion that's at odds with overwhelming historical evidence of employers gaining from suppressed African-American pay and businesses manipulating racist attitudes for profit.

Mankiw's only analysis of gender inequality is to point out that women's rising pay causes greater income inequality among families because high-income women are likely to marry high-income men. This is only a relatively minor consequence of the women's movement, and far less important than its equalizing impact on *individual* male and female pay. Taken out of context, Mankiw's observation is a convenient excuse for growing inequality that discounts the women's movement and ignores far more important causes of inequity, including the tax cuts advanced by George W. Bush and his ideological predecessor, Ronald Reagan.

Mankiw omits discussion of the benefits of public spending whether for European-style social welfare programs or less ambitious programs such as Social Security and interstate highways, and he disregards positive examples of government intervention and regulation. By my count, the textbook uses 37 examples to underscore the dangers of government intervention while only 12 examples acknowledge any benefits of government spending or regulation.

Even seatbelt requirements come in for criticism on the grounds that riskier driving by less-vulnerable, buckled-up drivers offsets the higher number who survive auto accidents—never mind that several research studies dispute this claim. Mankiw also ignores the historical context in which automobile manufacturers fought against seat belt rules and even made seat belts difficult to use when they were first introduced.

Real-world cases where government intervention *has* worked—in areas like environmental improvement, workplace safety, and civil rights—have no place in the textbook. Discussing air and water pollution control, where economists can readily document environmental improvements from Environmental Protection Agency (EPA) intervention, Mankiw sidesteps current political debate over the Bush administration's rollback of environmental protection. Instead, he limits his analysis to the fictional case of "glop" dumped in a river, concluding that "market forces, properly redirected, are of the best remedy." Occidental College economics professor Jennifer Olmsted points out that "once again Mankiw's political view slips into the book. Students relying on the textbook cannot analyze the most pressing environmental concerns, global warming and ozone depletion, because Mankiw addresses neither the link between global income distribution and the environment nor the need for countries to work together." Not coincidentally, disregard for equality and international cooperation also are hallmarks of Bush administration environmental policy.

MINI-MACRO

Although macroeconomics is Mankiw's research specialty (see "Mankiw's Contribution to Macroeconomics," p. 10), in comparison with other textbooks, issues like employment and recessions receive relatively scant attention. The lengthy microeconomic preview on markets comprises nearly 40% of the macroeconomics version of the book. The pared-down macroeconomics chapters are far more in line with Bush administration thinking than press reports suggest. For example, the Laffer curve theory that cutting taxes increases tax revenue, relegated to a historical Reagan administration curiosity in many textbooks, receives a sympathetic three-page treatment by Mankiw.

On the issue of unemployment, Mankiw departs from the traditional textbook approach, looking not at the economy's ups and downs, but instead blaming unions and the minimum wage (for the fourth time in the book) for unemployment. The chapter is titled "Unemployment

MANKIW'S CONTRIBUTION TO MACROECONOMICS

Ironically, Mankiw gained his reputation as a "New Keynesian." (The New Keynesian school of thought aims to provide microeconomic foundations for traditional Keynesian theories.) Mankiw's most famous research looked at the idea of "small menu costs"—the costs of adjusting prices, such as printing new menus and informing suppliers, when demand rises or falls. Classical theory argues that the economy will gravitate naturally toward full employment and that government spending is not an effective tool for stabilizing the economy because higher prices offset the impact of additional government spending. New Keynesian theory raises the possibility that business firms will not respond to every change in demand by adjusting prices. According to New Keynesians, prices (including wages) are "sticky"—they adjust slowly. This "microfoundation" is one explanation for the economy's inability to maintain full employment as well as a rationale for government intervention because, contrary to theory put forward by conservatives, prices will not rise to offset additional demand when government spending is used to stimulate a stagnant economy. As Colgate University macroeconomist Tom Michl points out: "The downside of the New Keynesian approach is that by putting all that emphasis on micro underpinnings, you reinforce the naive belief that a complex whole is just the sum of its parts. Some of the most important insights in macroeconomics require thinking about the structure of the whole economy."

and its natural rate," and leaves students with the notion that substantial—5.5%—unemployment is normal and non-controversial within economics.

Not only is the existence of a natural rate of unemployment subject to debate, but Mankiw's presentation is even more at odds with the mainstream view in assuming an *unchanging* rate for the last 45 years. As economist Tom Michl, author of a textbook on macroeconomic theory explains: "There is strong evidence that *if* there is a natural rate, it must have declined substantially in the 1990s. Mankiw's text says that some of the unemployment at the natural rate exists because unions and minimum wage laws raise wages too high. Union membership as a percentage of the workforce and the real value of the minimum wage have both declined a lot since the 1960s. Why hasn't Mankiw's natural rate declined along with them?"

Unemployment caused by the economy's overall rise and fall is dismissed until the end of the book as a "short run" problem. In chapter 20 (out of 23 chapters) Mankiw celebrates President Bush's tax cuts for ending the 2001 recession, but later invokes the natural rate of unemployment as a limit on the impact of government intervention. Supposedly, conservative economists Milton Friedman and Edmund Phelps proved that there is no long-term trade-off between inflation and unemployment. As a result, Mankiw argues that the economy will return to its "natural" unemployment rate even if the government attempts to nudge the growth rate upward with fiscal or monetary policy.

Mankiw is adamant on the point: "By 1973, policymakers had learned that Friedman and Phelps were right." However, Michl counters, "Mankiw's treatment of the Friedman-Phelps hypothesis is one-sided. In the 1990s, the unemployment rate fell well below 5.5% and inflation did not rise. From a pedagogical point of view, a much sounder approach would emphasize the enormous difficulty of using historical data to prove or disprove economic hypotheses." But this would require that the textbook author take seriously the idea that there exist different and competing economic hypotheses. Mankiw does not.

The concluding chapter on "Debates over macroeconomic policy" is limited to a narrow wish list of conservative recommendations like "Should the tax laws be reformed to encourage saving?" and "Should the central bank aim for zero inflation?" It leaves out the progressive policy options implied by long-established and widely accepted Keynesian economic theories.

Keynesians and other liberal and progressive economists are concerned about the rising inequality of income, opportunity, and wealth over the last two decades, and would like to see more attention paid to crafting policies that level the playing field in our society. By omitting these perspectives, Mankiw's book does not prepare students very well for the current debates about changing the tax system, labor laws, or social welfare programs, or even for debates over economic stability, which you'd expect from a textbook by the new chair of the Council of Economic Advisors.

Former Harvard College student Ben McKean looks back on the Mankiw textbook as "not one of the livelier intellectual encounters of my college career. It was an indoctrination tool that didn't help me to think critically." Over the past year, more than three hundred Harvard undergraduates petitioned the economics department to offer a course with more diverse readings and opinions. (See "Harvard Students Demand Alternative Economics Course," p. 11.)

Even though many instructors supplement the Mankiw textbook with additional readings so that students gain a broader view of economics, as Peter Dreier points out, "the fact that Mankiw's big, expensive book is 'the text' gives it the ring of authority." Mankiw's new-found political prominence will drive book sales and legitimize the text's one-sided content. And, as chair of the Council of Economic Advisors, Mankiw brings to the Bush administration a narrow view of economics that is wholly consistent with his new employers' *laissez-faire*, anti-environment, tax-slashing agenda.

Alternative Texts: While few textbooks provide truly balanced introductions to economics that include critical perspectives along with mainstream economic theory, there are exceptions. Alternatives to Mankiw include a new entry by Goodwin, Nelson, Ackerman, and Weisskopf called *Microeconomics in Context* (Houghton Mifflin) and *Economics: A Tool for Critically Understanding Society* by Riddell, Shackelford, Stamos, and Schneider (Addison Wesley Longman).

HARVARD STUDENTS DEMAND ALTERNATIVE ECONOMICS COURSE

At Harvard, the economics department has long offered just one introductory economics course. The class, known as "Ec10," is a prerequisite for economics and social studies majors and the only basic primer on economics available on campus. Since 1984, the course has been taught exclusively by tenured professor Martin Feldstein, a former economic adviser to Ronald Reagan and current head of the National Bureau of Economic Research.

Feldstein's course is centered around N. Gregory Mankiw's textbook and a supplementary sourcebook of articles from newspapers and magazines. The articles are heavily biased to the right, with over 15% of them penned by Feldstein himself. The section on "Income Distribution" features articles titled, "A Welfare-to-Work Success Story" and "Guess What? Welfare Reform Works!"

Over the past year, a group of about 10 undergraduates at Harvard organized for an alternative economics course. The students, members of the campus organization Students for a Humane and Responsible Economics (SHARE), demanded a more diverse introduction to economics than is provided by Feldstein's "Ec10."

They argued that Feldstein's approach to economics reflects and reinforces a right-wing political agenda. His readings support tax cuts for the rich, the privatization of Social Security, and the notion of a "natural" rate of unemployment, and they blame the poor for their poverty. Given that "Ec10" is the largest course at Harvard—about 750 students take it each year, and nearly half of Harvard undergraduates will have taken the class before they graduate—it has a particularly powerful influence on campus debates and beyond.

During a three-week student living wage sit-in in 2001—when students took over an administrative building to demand a living wage for all Harvard workers—Mankiw was a public opponent of the campaign. In the wake of the sit-in, he wrote a Boston Globe article arguing that a living wage would hurt workers. (In reality, the living wage has only improved the living standards and bargaining power of Harvard workers.) Feldstein still assigns the article. In fact, Mankiw's is the only article on the topic included in the sourcebook, even though the Globe had run a pro-living wage editorial opposite Mankiw's. When students confronted him about this at a SHARE forum earlier this year, Feldstein claimed that he didn't realize his course presented only one side of the issue.

SHARE's petition for an alternative course garnered over 700 signatures in only a few weeks. Despite this, the economics department refused to approve the alternative class proposed by radical economist and tenured professor Stephen A. Marglin. In May, Harvard's core curriculum office granted Marglin permission to teach the class next year, but the credits will not count as a replacement for "Ec10" for economics majors. Nevertheless, the launch of this new course represents a victory for SHARE.

The conservative ascendancy within economics serves to indoctrinate undergraduates politically. Critical perspectives on economics are key to countering the rise of political conservatism on campuses—and to informing radical, anti-corporate, and anti-capitalist student movements. Hopefully, the push for alternative economics education will continue at Harvard and at campuses across the country.

—Dan DiMaggio

THE IDEOLOGY OF THE FREE MARKET

BY ELLEN FRANK

When the County Commissioner for Lake County, Florida, proposed last year that the fire department be turned over to a private, for-profit company, he unleashed a torrent of opposition and the idea was dropped. Throughout the United States, similar proposals to "privatize" public schools, education, and health services face strong resistance from taxpayers and state workers. Yet the overall trend in U.S. public policy for at least 20 years has been toward greater reliance on market forces and the profit motive to provide what used to be considered public goods and services.

In liberal Massachusetts, substantial portions of the public bus system are now run by private businesses; in New York City, private security forces patrol sections of Manhattan. Nationwide, some 15% of hospital beds are now owned and operated by for-profit corporations. Privately run prisons, trash disposal companies, social service providers are growing in importance everywhere.

"The era of big government," President Clinton announced a few years ago, "is over." In its place we have the market. But can the market deliver?

MARKET MYTHS

Markets, boosters contend, foster individual freedom. Consumers in market economies are free to express their individuality, assert their unique identity, by buying the precise things they want. For Americans raised on 28 choices of breakfast cereal, one-size-fits-all, big-government fire departments and health-care programs just won't do. Competition, so the story goes, will lead to more and better choices. Why? Because firms can only make money by producing what consumers are willing to pay for.

Governments and non-profit institutions might be less greedy, more humane in their motives, but they are under no particular pressure to cater to consumer demand. The profit motive is the consumer's best friend, forcing firms, as the textbooks say, to allocate resources efficiently, producing only the goods consumers desire.

MARKET REALITIES

The problem with this rosy view of things is that all voices are not equal in the market place. Upper-income consumers, with cash to spare, can bid up prices and walk away with the lion's share of society's output. For poorer folks, the vaunted "rationing" function of prices often means being priced out of the market, unable to afford the goods they want and need.

There is no question that market economies deliver goods in abundance. Wherever capitalism has been given free reign, streets are choked with automobiles and shops overflow with goods. When the former Soviet countries embraced capitalist markets several years ago, for example, commentators noted the extraordinary increase in goods available for sale. Formerly barren store shelves suddenly burst with local and imported goods of every manner and description. Unfortunately, though, few people in Russia could afford to buy any of it. The markets operated mainly for the benefit of a small and wealthy elite.

MARKET INEQUITIES

Evidence abounds that markets, unless tempered by active government interventions, open up vast chasms of social and economic inequality, generating unprecedented affluence but also astounding poverty. The United Nations in its most recent report on human development found that, as markets expanded throughout the world, the richest one fifth of the world's population consumed 86% of the world's output, while the poorest fifth received just over 1%. The richest 225 people in the world today have assets equal to the annual income of the poorest 2.5 billion people.

In the United States, where faith in markets amounts to a state religion, such issues are rarely broached. Staggering levels of inequality are everywhere to be seen, yet rarely discussed. In a country where exclusion on the basis of race or gender is widely regarded as intolerable, Americans routinely accept exclusion on the basis of income. Imagine if every up-scale suburb were to post signs at their borders saying, "Minimum Annual Income of $1,000,000 Required for Residence." Americans might be shocked by the candor, but not by the sentiment.

In America, the wealthy are distrusted, but not despised, and Bill Gates, whose personal wealth (now some $40 billion) equals the total wealth of the poorest 106 million Americans, is feted in the press, a kind of cultural icon.

MARKETS AND FREEDOM

Advocates of free markets don't apologize for these tremendous inequities. The freedom to choose, they contend, isn't only about breakfast cereals and fashion statements. Individuals in market economies must compete for the rewards the market doles out. People can choose to be rich, or not to be; to work hard or to take it easy; to succeed or to fail. In a market economy, people get what they deserve, or so the myth goes.

But this myth ignores the very serious inequities in power that flow, inevitably, from inequities in income.

High incomes lead to wealth and wealth to the exercise of power, the ability to control others, to command their labor and constrain their freedom, including their freedom to buy and sell. This is why it is illegal, in most countries, to sell your organs for transplant, though there is no lack of willing buyers and sellers. It is legal to sell your blood for transfusion or (in some places) your body for sex, and studies of the markets for blood and for prostitutes come to the same finding: when human bodies are exchanged for money, the poor lose control of their bodies.

MARKETS AND DEMOCRACY

The freedom promised by markets is, for this reason, incompatible with democratic ideals of free, self-governing citizens. In democratic countries, governments provide basic goods and services and restrict market transactions not because doing so is "efficient," but because the freedom from want and exploitation is a precondition for meaningful citizenship. For example, 43 million Americans currently lack even minimal health care coverage; as the health care system shifts into for-profit mode, these people are at risk of falling too ill to compete in the marketplace or even to participate freely in governance.

If education were to become a buy-and-sell proposition, as some conservatives advocate, large numbers of citizens (and prospective citizens) will go uneducated and unable, therefore, to exercise their rights or protect their freedoms.

Economic inequities are not the only injury markets cause to democratic practice. The insatiable quest for gain that propels behavior in the marketplace disrupts the ecology of the earth and uproots communities. All over the world, clear-cutting, deforestation, strip-mining, toxic-dumping, and other environmentally damaging excesses of unrestrained markets have torn apart stable, self-governing towns and villages, turning secure citizens out on the open road; the hobos and homeless of our modern era.

The competitiveness engendered by markets is also at odds with democratic ideals. Psychologist Alfie Kohn has shown, for example, that people in competitive situations are more likely to cheat and to express feelings of distrust. Yet a spirit of trust and cooperation is essential to successful governance.

In opposing the private takeover of their fire department, the citizens of Lake County, Florida, seem to have understood a basic truth about limitations of markets. It may well be that private, for-profit firms can fight fires or patrol the streets more cheaply than the government can, but a trusted government can fight fires and patrol streets more democratically.

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DOES THE 'NEW ECONOMY' TILT TO THE RIGHT?

BY PHINEAS BAXANDALL

The Soviet vision of a computer-planned future may seem silly today, but it puts in perspective the recent free-market hype about the so-called "New Economy." Free-marketeers, no less than Soviet bureaucrats, tend to project their own fondest wishes onto technology itself. "Governments of the Industrial World, you weary giants of flesh and steel," cyberlibertarian John Perry Barlow demands, "on behalf of the future, I ask you of the past to leave us alone." The main effect of the "New Economy" has been to convince people that information technology and computer networks somehow make government regulation obsolete—more or less the Soviet dream in reverse.

Today, the bloom is off the rose of the "New Economy." With high-tech stock prices plummeting after March 2000 (the NASDAQ index lost over half its value within a year), few people still believe that a computer and an online stock account guarantee overnight riches. Dot-com millionaires no longer represent the glorious future, and chastened "New Economy" boosters have had to accept that the business cycle is not just an iron-age relic. Nonetheless, even in today's recession, we still hear that government regulation is an "Old Economy" dinosaur.

Three largely unexamined myths perpetuate this nonsense. First, the belief that information inherently resists regulation. Second, that the networked economy favors spontaneous markets over slow-footed government bureaucracies. And third, that new technologies have globalized the economy beyond the influence of national governments. There is a grain of truth in each, but none of it leads to the conclusion that public regulation is either impossible or undesirable.

Myth #1: Information must be governed by "free markets" because "information must be free."

Free-market enthusiasts have missed the most novel thing about information goods as a commodity—that after the research and development is done, the cost of producing each unit is very low. Think of software giants. It costs just a few cents to burn each copy of WindowsXP or Excel onto a CD. For digitalized property such as databases, electronic music files (such as the "MP3s" exchanged on Napster), or password-protected information, there is virtually no cost for an additional copy. In economics lingo, the "marginal cost" of these goods is zero or close to zero.

Mainstream "neoclassical" economics argues that the most efficient price for a product is equal to its marginal cost. If the price is lower, people who do not value the product as much as its cost will buy it. If the price is higher, people who value the product more than its cost will forego it. Either way, there will be a "net welfare loss" to society. The neoclassical argument that competitive markets are efficient depends on the view that they push prices to this efficient level. But "zero marginal cost" goods turn these arguments on their head. In the words of Berkeley economist Brad DeLong, the "assumptions ... of the invisible hand fray when transported into tomorrow's information economy."

THE MORE INTERNATIONAL FINANCE SYSTEMS ARE DIGITAL AND NETWORKED, THE MORE VIABLE REGULATION WILL BECOME.

Take the analogy of paying for a bridge. The bridge is expensive to build, but once it is constructed there is virtually no additional cost for an additional individual to use it. If people are charged more than this miniscule cost, there will be a net welfare loss (since some people who would benefit from using the bridge will be prevented from using it by the artificial cost of the toll). Even mainstream economists are forced to conclude that a private toll is a less efficient way to pay for a bridge than a general tax. The same is true for information goods like digital music files. Once you pay the members of the band and the sound engineers, for example, pretty much all the costs of producing a Metallica song are accounted for, whether you create one digital sound file or millions. Therefore, charging people to download the file would cause a net welfare loss. "Even though economic theory is severely biased toward markets," concludes economist Michael Perelman, "according to the criteria of economics, information should not be treated as private property."

Following this logic, the Canadian government levies a small tax on recording media, such as blank CDs and tapes, and uses the revenue to fund Canadian artists who lose sales as a result of people recording their work for free. Germany and other European countries have explored attaching a fee to the sale of computers and other devices that can be used to copy recorded music. The revenue from this fee would then be distributed to recording companies to compensate them for royalties lost due to unauthorized copying of their copyrighted music. As economist Dean Baker of the Economic Policy Institute argues, this approach has great advantages over prosecuting information "pirates" or adding elaborate mechanisms to disrupt copying: "While there are problems with the system devised by Germany, it should lead to vast economic gains compared to the systems being developed in the United States. The inefficiency associated with the traditional copyright is enormous in the Internet age."

The Internet itself did not result from "free markets" but centralized planning. In the early years of the Cold War, the U.S. Defense Department sought to establish communications networks that might survive a nuclear war. At the time, only the military and large universities had powerful computers, which researchers across the country wanted to use. Networking prevented them from sitting idle. In order to enable different computers to talk to each other, the Defense Department funded the development of communications standards called TCP/IP, adopting them in 1980.

The Defense Department then released the standards for free to the general public. Nobody has to pay to use these technical protocols to send email or post or view web pages. The U.S. government even pushed for the widespread adoption of the freely available TCP/IP standards, instead of alternate versions developed by private European companies that refused to share their inventions. The Web has grown so quickly and become such a rich and varied source of information largely because these open standards make it accessible to anyone with a computer and a modem.

Even outside of government, some of the fastest-growing parts of the "New Economy" have flourished by making technologies freely available. The most important email transport software (Sendmail), the most important Internet server software (Apache), the most widely used programming language on the Web (Perl), the domain-name service for the entire Internet (BIND), and the fastest-growing computer operating system (Linux) are all examples of public domain (or "open-source") software.

Linux is the best known of these "open-source" products. Linus Torvalds, a Finnish computer-science student, invented the new computer operating system in 1991, based on the existing strengths of the UNIX system. But instead of applying for a patent, he posted the code on the Internet for other programmers to add to and improve. Many programmers were interested in the Linux project because UNIX had just been taken over by private firms like IBM. These companies kept their underlying code secret and designed their programs to lock users into their products. Programmers were also worried about the growing dominance of Microsoft's clumsy operating systems. By 1998, over 10,000 software developers from 31 different countries had contributed improvements or helped develop new versions of Linux. By the year 2000, the program boasted about 16 million users and a quarter of the market share. Major high-tech firms, like Intel, Oracle, Dell, Hewlett-Packard, IBM, and Compaq, have all made major commitments to use Linux or cater to Linux users.

A conventional argument for private ownership is that owners have greater incentive to produce things. People are more willing to cultivate a garden on a piece of ground they can fence off, more willing to improve a house when they own it, and more willing to work hard in a business if they share in the profits. But intellectual products can be shared with others without diminishing their value. In fact, computer programs and other information technology are often more valuable when many other people also have them. Many users, for example, do not buy Microsoft Word because they think it is the best word-processing program, but because they know others use the program and will be able to read their files. Likewise, Linux and similar "open-source" projects work so well because they have large numbers of users who identify glitches and devise improvements. They can expect that future versions of the operating system will include not only their contributions but also those of thousands of other contributors. Online communities of programmers voluntarily contribute their efforts to building better software because the product remains in the public domain.

Allowing others to reproduce a computer program does not take anything away from the owner. It merely refuses to help the owner get rich from artificially enforced scarcity. As *Wired* magazine puts it, "The central economic distinction between information and physical property is that information can be transferred without leaving the possession of the original owner. If I sell you my horse, I can't ride him after that. If I sell you what I know, we both know it." This feature of information goods might make redistribution from property owners to the public more politically appealing in the "New Economy" than in the "Old Economy." Seizing somebody's land or factory to help the poor deprives the old owners of what was theirs. Not so with computer software or digital audio files.

Myth #2: The "networked" economy favors spontaneous and flexible markets over slow-footed regulators.

To many free-marketeers, the Internet is like heaven on earth. It seems to exhibit all the ideal qualities of markets: decentralized, instantaneous, unregulated. The wild growth of online trading (at sites like E*Trade and Ameritrade) and auction sites (like eBay) seems to prove some kind of affinity between "free markets" and the digital age. A recent article in the *Wall Street Journal* urges us to "think of the Internet as an economic-freedom metaphor for our time. The Internet empowers ordinary people and disempowers government."

While it is true that the 1990s saw a rollback in government regulation at the same time as a rapid growth of information technology, the new technology did not cause the tilt towards "free-market" capitalism. Businesses have certainly implemented new technologies in ways that make certain kinds of regulation more difficult. And politicians have often used the "New Economy" as a pretense for opposing social programs or regulatory policies. But these are ultimately political issues. New information technologies did not require the deregulation associated with the "New Economy," and a changing political tide could reverse the ways those technologies have been implemented.

As with all markets, the results of electronic production and commerce depend on what rules govern businesses: what businesses can own, what privileges and responsibilities come with ownership, what kinds of contracts are legally binding, how they will be taxed, etc. This institutional "architecture" of markets is especially important in information technologies.

Unlike traditional markets, whose rules have evolved over hundreds of years, the online architecture is new enough that we can see how it results from specific policies of governments and corporations. Such thinking challenges the notion that market outcomes are "spontaneous" at all.

> THE ARCHITECTURE OF CYBERSPACE CONSTRAINS ONLINE INTERACTIONS TO SERVE THE ENDS OF THOSE WHO DESIGN OR CONTROL IT.

People in power can use architecture to control the behavior of others, designing environments to encourage certain kinds of actions while discouraging others. If a local government wants to discourage motorists from driving fast down a street, one way is to legislate a speed limit and have police chase down cars that drive too fast. But another way is through the architecture of a speed bump, which changes behavior more automatically, without obvious laws or games of cat and mouse. Architecture can also be used to change behavior in more insidious ways. In the wake of late-1960s campus protests, for example, universities redesigned campuses with fewer open common areas, in order to discourage student demonstrations.

Just as the architecture of buildings manipulates the laws of physics to human ends, so does the architecture of cyberspace constrain online interactions to serve the ends of those who design or control it. America Online (AOL), for example, limits the number of people who can join one of its chat rooms to 23. The AOL rule can't even be broken in protest because the prohibition is enforced automatically by the software code itself. Attempts to be the 24th participant in the conversation are just met with an error message.

As Internet traffic moves increasingly from phone lines into the control of cable-TV companies, these companies will try to exert even greater control over the traffic they carry. Already some cable companies have tried to prevent Internet users from using "streaming video," which competes with the companies' own pay-per-view channels.

Internet companies like Yahoo, which provide "portals" for reaching other websites, already steer people towards businesses that pay to have "banner" ads linking to their sites or to get top billing when people use a search engine. The logical next step is for media conglomerates to use their cable companies to make it faster and easier to reach their product content, to view trailers for their movies, and perhaps to charge users extra for any time spent out of their universe of "infotainment." The trend gives more power to large media conglomerates. The majority of Internet traffic has already been gobbled up by corporations like AOL Time Warner (which owns CNN.com) and Disney (which owns ESPN.com).

POLITICIANS HAVE OFTEN USED THE "NEW ECONOMY" AS A PRETENSE FOR OPPOSING SOCIAL PROGRAMS OR REGULATORY POLICIES. BUT THESE ARE ULTIMATELY POLITICAL ISSUES.

Stanford law professor Lawrence Lessig points out, however, that "the changes that make [Internet] commerce possible are also changes that will make regulation easy." For instance, business continues to struggle with how to authenticate who is logging on, and if they really are who they say. E-business has long favored a system of digital certificates that could authenticate a user's identity when surfing the web. Such a system could pose serious dangers—to reduce users' privacy or even threaten their civil liberties. But it could also mean greater abilities to implement public regulations. For example, states do not currently charge state sales tax on purchases made over the Internet. Digital certificates could allow states (or even cities) to charge taxes for online purchases to the certificate holder.

Myth #3: As a result of the information revolution, the global economy can no longer be influenced by government.

New information technologies are often seen as having made governments impotent to influence anything on the Net, since web sites can relocate outside the legal jurisdiction of governments that wish to regulate them. The state of Missouri can make it illegal to host a gambling or pornography site from a computer within the state, but it can't stop people from logging onto such a site launched from another state or country. The Amazon.com site based in Germany may comply with that country's laws by refusing to carry Nazi literature, but cyber-Nazis in Germany can order Hitler's *Mein Kampf* from Amazon.com sites hosted in the United States or other countries.

But electronic finance is different. When a bank wires money, it relies on a centralized infrastructure guaranteed by governments to make sure that money is subtracted from one account and added to another. A system of mutual recognition and settlement between powerful institutions like central banks confirms that the person transferring the money actually has those funds and is not simultaneously promising them to banks all over the world. Globalized money will, for this reason, never fully conform to the libertarian fantasy. The same infrastructure that makes it possible to send money electronically across borders also makes it technically possible to restrict and tax these transfers.

Governments have done just that for over a century. It has been possible to wire funds more or less instantaneously since the invention of the telegraph. Even today, most capital transfers are communicated through faxes or telex machines and authenticated with pen-and-ink signatures. Today's system of capital transfers, however, has become centralized through national central banks. This system already assigns a unique identifying number to each capital transfer. Far from making regulation unfeasible, the more these finance systems are digital and networked, the more viable regulation will become.

A system of capital controls would make it possible to stop international money laundering, which the IMF estimates drains away 2-5% of the world's income, and to squelch corruption—especially in poorer countries where warlords or kleptocrats steal essential investment funds. A tiny transaction fee of the kind charged by the Securities and Exchange Commission (SEC) in the United States could discourage market volatility caused by trigger-happy investors seeking tiny profit margins on huge currency transactions. More ambitiously, a levy of one penny on every million dollars in international financial transfers would not discourage any productive investment, but would raise more money than the U.N. estimates is required to provide for basic health, nutrition, education, and water sanitation to the 1.3 billion people on the planet who live without. (See Thad Williamson, "The Headline Your Newspaper Ignores: Global Economic Inequality.")

Creating an international architecture of capital controls would not be easy. The big U.S. banks might be particularly resistant to capital controls. U.S. banks receive large quantities of international money partially due to the United States' weak laws on disclosure and taxation of foreign funds. Foreign investors, unlike U.S. citizens or residents, pay no tax on interest or capital gains and do not have to disclose the sources of their earnings to the IRS.

Just as the Great Depression made the federal government establish the agencies that regulate domestic finance (the SEC, the Federal Deposit Insurance Corporation, etc.), the September 11 destruction has brought more attention to the need for regulation of international finance. Some commentators have called for greater international scrutiny of secretive Saudi banks, the likely conduits of terrorist funds. Legislation signed into law in October 2001 bars U.S. banks, which often do business with overseas "paper" corporations, from dealing with a foreign bank