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CONTENT ARTICLES IN ECONOMICS

On welfare economics in the principles course

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I much enjoyed reading these articles by Steve Schmidt and Jonathan B. Wight on the normative underpinnings of how we teach introductory economics. I have long believed that teaching the fundamentals of economics to the next generation of voters is among the highest callings of our profession. It is therefore useful to regularly reflect on whether we are doing it well and how we might do it better.

I agree with many of the substantive points raised in the articles, although I think that the current crop of textbooks (including my own) do a better job than Schmidt and Wight sometimes give them credit for. Rather than quibble with details, however, let me lay out five of the main lessons that I emphasize as I teach this material:

(1) *Efficiency is a useful lens through which to view outcomes*. Understanding market success and market failure is a central feature of my course, especially in the microeconomics half. Adam Smith's invisible hand is best understood as the proposition that the equilibrium of supply and demand maximizes the sum of producer and consumer surplus. The market failures that arise from externalities or monopoly power are best understood as the departure of the unregulated outcome from the surplus-maximizing allocation of resources.

(2) *Efficiency is not the only goal of policy*. When introducing the notion of efficiency, I make clear that policymakers have other objectives as well. In chapter 1 of my text (Mankiw 2015, 12), I wrote, "Even when the invisible hand yields efficient outcomes, it can nonetheless leave sizable disparities in economic well-being. … The invisible hand does not ensure that everyone has sufficient food, decent clothing, and adequate healthcare. This inequality may, depending on one's political philosophy, call for government intervention. In practice, many public policies, such as the income tax and the welfare system, aim to achieve a more equal distribution of economic well-being."

(3) *Measures of efficiency presume that people are rationally looking out for their best interests*. The definition of efficiency that I use (i.e., maximizing total surplus) relies crucially on a degree of rationality on the part of market participants. When introducing the concept of consumer surplus in chapter 7, I wrote, "Consumer surplus, the amount that buyers are willing to pay for a good minus the amount they actually pay for it, measures the benefit that buyers receive from a good *as the buyers themselves perceive it*. Thus, consumer surplus is a good measure of economic well-being if policymakers want to satisfy the preferences of buyers" (emphasis in the original) (p. 140).

(4) *People aren't always rational*. Once one states the assumption underlying standard welfare measures, it is important to emphasize that it might not always apply. Immediately after defining consumer surplus, I wrote, "In some circumstances, policymakers might choose to disregard consumer surplus because they do not respect the preferences that drive buyer behavior. For example, drug addicts are willing to pay a high price for heroin. Yet we would not say that addicts get a large benefit from being able to buy heroin at a low price (even though addicts might say

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they do)" (p. 140). Similarly, many books (including mine) have a section on behavioral economics, a subfield that calls standard models of rationality into question, even for individuals whose decision-making is less impaired than that of drug addicts.

(5) *Government policymakers aren't perfect either*. Understanding the success and failure of markets is only a part of thinking through good policy. The alternative to free markets is government intervention, and government is not run by the benevolent, omniscient social planners we sometimes like to imagine. In chapter 1, I wrote, "To say that the government *can* improve on market outcomes does not mean that it always *will*. Public policy is made not by angels but by a political process that is far from perfect. Sometimes policies are designed simply to reward the politically powerful. Sometimes they are made by well-intentioned leaders who are not fully informed. As you study economics, you will become a better judge of when a government policy is justifiable because it promotes efficiency or equality and when it is not" (emphasis in the original) (p. 12).

As we teach introductory economics, it is important to keep in mind that we are throwing a lot of information at our students. To keep things manageable, we must ruthlessly simplify. I believe that the five lessons offered above are simple enough for first-year students to understand, yet nuanced enough to faithfully capture much of the wisdom of our profession.

Reference

Mankiw, N. G. 2015. *Principles of economics*. 7th ed. Stamford, CT: Cengage Learning.