

# The Political Economy of Public Goods; Why Economists Should Care

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The intent of this paper is to encourage economists to analyze questions of public involvement in the array of public and private activities where public participation is an issue. The scope encompasses goods and services where there is the most universal acceptance of public involvement and extends into less clear distinctions of quasi-public goods and merit goods. The concern here is not so much with the definition and bounding of different categories of goods and services as with the need for considered analysis and assessment of such goods.

It is increasingly important to understand public and related goods as public perception changes and public and private resources are being shifted between them. What we have is a continuum with pure public goods at one end of the continuum and pure private goods at the other end. The public and policy makers regularly make judgments about the public and private provision of goods and services on the basis of

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perceptions about the nature, cost, and efficacy of such goods. In recent years public perceptions have shifted and redefined public goods more as private goods. If economists can clarify, rationalize, and determine the cost effectiveness of different approaches to providing such goods, then they need to engage in the analysis of these public and quasi-public goods and assess whether they are appropriate for public expenditure, privatization or some combined support between the two extremes.

Wassily Leontief's presidential address "Theoretical Assumptions and Nonobserved Facts" (p. 1) delivered in 1970 to the American Economics Association is a good starting point for such analysis. First, there is still truth in his basic criticisms of the state of economic analysis. He also praises agricultural economics implying an advantage to this sub-discipline of economics in undertaking assessments of the kind being proposed here. Reflecting on his feelings about the state of economics, Leontief was first encouraged by the degree of relevance of the practical problems that his fellow economists were addressing, but he was concerned with "the palpable inadequacy of the scientific means with which they try to solve them" (Leontief 1971). What he identified was a lack of internal validity, where the data or methods were insufficient or inadequate to address the question at hand. Leontief's concerns focused on a lack of attention to the observable reality of the economic phenomena under consideration as well as a lack of attention to real supporting data for analysis of these phenomena. He was equally concerned that economists had not been willing to reach beyond the limits of economic phenomenon to other disciplines relevant to the issue at hand – to the engineering sciences for production and to other social and behavioral sciences for better

understanding of basic household behavior in order to turn up new factual information highly relevant to the economic analysis.

In the course of his criticism of his peers in economics, he also recognized agricultural economics as an “exceptional example of a healthy balance between theoretical and empirical analysis and of the readiness of professional economists to cooperate with experts in the neighboring disciplines” (p. 5). He mentioned the extensive agricultural statistics, close collaboration with other agricultural and social sciences and the early utilization of advanced methods of mathematical statistics as a complement to and not a substitute for empirical research. We can only hope that agricultural economists have not fallen into the bad habits of analysis that Leontief decried and that agricultural economists have maintained the virtues claimed for them. The characteristics that Leontief praises are important for giving adequate attention to issues resulting from the changing public perception of public and quasi-public goods and assessing what it means for society.

Economists place most public goods in the arena of market failure. A common textbook definition shared by Baumol and Blinder (p. 256) defines a public good “as a commodity or service whose benefits are not depleted by an additional user and from which it is generally difficult or impossible to exclude people, even if people are unwilling to pay for the benefits. These are socially valuable commodities whose provision cannot be financed by private enterprise, or at least not at socially desirable prices. Thus, government must pay for public goods if they are to be provided at all”. It

may be difficult, costly or impossible to collect fees for the public goods provided. In addition if the opportunity cost of serving an extra user is zero, then the good should be provided at no charge. Private goods are at the opposite end of the spectrum and are both depletable and excludable. Baumol and Blinder go on to say: “It is usually not possible to charge a price for a pure public good because people cannot be excluded from enjoying its benefits. It may also be undesirable to charge a price for it because that would discourage some people from benefiting, even though using a public good does not deplete its supply. For both of these reasons, government supplies many public goods. Without government intervention, public goods simply would not be provided.” Following on this definition they identify “national defense, public health, police and fire protection, and research as among the services governments provide because they offer beneficial externalities or are public goods.” While it may appear clear how one might define public goods so that they can be precisely identified, in fact policy and public perception can effectively redefine such goods. Most societies go through periods when public goods become quasi-public or private goods, and the reverse can occur as well. This is part of the political public policy debate over what goods government should be involved in providing or supporting because they offer beneficial externalities as compared with providing them through the private market.

Scripture like references to Adam Smith are often invoked to demonstrate the efficacy of more private market-based solutions for the provision of public or quasi-public goods. The debate over the role of government involvement in the provision of public goods was underway during Smith’s time in the latter part of the 18<sup>th</sup> century. If

nothing else, Smith was a pragmatist and talked about those goods and services government ought to provide in a non-doctrinaire way that reflected the political and social reality of his times. Smith was not a Libertarian, but Jacob Viner (p. 200) suggests that he started from the near Libertarian stance: “Little else is required to carry a state to the highest degree of affluence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice; all the rest being brought about by the natural course of things.” Smith stressed extending his system of natural liberty through the abolition of the then-existing systems of government regulation which included the free choice of occupation, free trade in land, internal free trade and free trade in foreign commerce. There was joint benefit here for both individuals and the public interest, which had been hindered by the interference of government. Smith is arguing in reaction to traditional and social strictures and the mercantilist regime of trading monopolies and chartered companies. He was particularly concerned about the negative impacts of monopolies and repeatedly stressed that they were disadvantageous to the public.

While desiring to restrict the activities of a central government that exercised substantial control over individual economic choice, Viner (pp. 217-218) notes that Smith identified three duties for government: national defense, the administration of justice and “the duty of erecting and maintaining certain public institutions and certain public works.” Viner sees Smith arguing against those specific actions of government he believed injurious to the individual and to society, while also believing that government activity was natural and appropriate when it promoted the general welfare. One thing to recognize here is that public or government administration in late 18<sup>th</sup> century England

was often inefficient, unintelligent and corrupt. Smith made specific exceptions about the extent of government's role for the higher quality public administration of Venice and Amsterdam that enabled them to be more positively involved in the affairs of their citizens. Smith firmly endorsed the role of government in defense (his first role for government) and extended this to strategic goods as well. He held a broad view of the government role in justice, including enforcement and punishment. For his third role related to public support for certain institutions, he supported government involvement in: setting standards and promoting consumer labeling; enforcing contracts; protecting slaves; regulating currency and banking; and setting fire regulations so the acts of a few did not endanger all. In terms of public works, one of his criteria for assigning government responsibility for roads was that private management would not have the incentive to maintain them properly. An additional criteria for public involvement was whether government could make a profit from the function (i.e., be a better trader or manager than private enterprise for that function); if so, then it was an appropriate public function.

In Viner's view, Smith had little trust in either the competence or good faith of government but saw that "it was necessary, in the absence of a better instrument, to rely upon government for the performance of many tasks which individuals as such would not do, or could not do, or would do badly" (p.232). Smith saw merit in government's participation in education which would yield multiple social benefits. Proper education would make the populace better citizens, prepare them for industry, prepare them for the military, and improve their health and happiness. Public education also would mitigate

class distinctions in the division of labor and in the inequality of income. Smith endorsed government's important role in public health. He approved of restrictions on trade, if conditions warranted, and also of government involvement to alleviate indebtedness and limit interest rates. Smith did not endorse taxation as an instrument of social reform, but he did give support to progressive taxation in several instances. Smith's approach was not a doctrinaire division between what government should and should not do relative to the private sector. He continuously made extremely pragmatic calculations of what should be undertaken by government based on criteria of individual and public benefit in the context of his time and situation.

The notion that societies change the extent of public involvement over time is borne out in the history of the United States where one can follow cycles of change in the public-private economic mix starting from the 18<sup>th</sup> century to today (Davis and North 1970). At the time of Adam Smith, government in the former colonies participated in a wide variety of economic activities perceived as appropriate from the English mercantilist heritage. Using government to help capture profits by reducing transactions costs, among other things, when scale and markets were small, seemed most appropriate. It was government (state in most cases) that underwrote much of the canal investments in the 1830s. The widespread defaults of state government bonds following the 1839-1843 depression began to change the perception of the efficacy of government involvement in economic affairs. With the growth of the American market in the mid-nineteenth century, increased scale and innovative technology lowered transactions costs and resulted in new market institutions and an expansion of the private sphere of activity. This expansion of

the private scope in the public/private mix shifted again with the First World War and succeeding wars in the 20<sup>th</sup> Century. Efforts to effect more equal income distribution that were not possible under the Marshall Court at the beginning of the 18<sup>th</sup> century became possible in the early 20<sup>th</sup> Century. The Great Depression of 1929 resulted in a public perception that government intervention was preferable to private sector management. This acceptance of government involvement and management was further strengthened by the Second World War. This changed again in the 1980s, as exemplified by the Reagan Revolution, and we see a shift away from the perception that government is an efficient and wise promoter and manager of the public good. Part of the impetus for this has been the general desire to decrease taxes and by libertarian groups desire to reduce the functions of government to the barest minimum through fiscal starvation if necessary.

Reflecting Smith's view of appropriate government involvement, education in the United States has effectively displayed public good status. This has occurred within a social context determined by public perception. As an example, with the rapid expansion westward in the 19<sup>th</sup> century, land was often set aside to support a local school in a township. The passing of the Morrill Act in 1862 was a striking federal embodiment of a pragmatic public good approach to higher education. The argument for the 1944 GI Bill was also pragmatic in that it would provide a more highly trained workforce and spur economic development after the Second World War. There was also a short-term fear that the large number of returning GIs would flood the workforce and cause unemployment. While Conant of Harvard and Hutchins of Chicago were fearful that the influx might damage academic standards (Humes, 2006, p. 32), Conant strongly supported the notion

that opportunities for higher education needed to be grounded on merit, independent of prevailing social and economic mores that tended to direct some to higher education over others. Being too true to its time, the GI Bill stumbled badly in terms of lost opportunity to advance racial and sexual equality. Even so, it was probably the most significant piece of social legislation of its time and set a pattern for supporting access to higher education that was effective for several decades. The impact has dwindled as the number of veterans and level of support has decreased.

The basic premise of the public goods nature of education is changing today. Within think tanks, state legislatures, public forums and commissions of higher education, publicly financed higher education is being increasingly redefined as more of a private good that deserves less public support based on a narrower view of the benefits and where the benefits accrue. The current mantra is that the benefits accrue primarily to the students; therefore they should pay for them. The public perception of the public goods content of education is being determined on the one hand by the argument about the locus of benefit for higher education and on the other by arguments for more cost-effective, more parent-controlled provision of quality services for primary and secondary education with charter schools and vouchers. While the perception of public support remains for traditional primary and secondary education, there is the increasing advocacy of public support for formerly private education at this level and public support for charter schools that have many private school characteristics. The general assumption that existed 30 years ago, that all education was more of a public good in terms of a valid claim on public resources, is now much more complex.

As we look at today's public decisions about what goods and services to support, we must address the relevance of the definitional criteria to the decisions at hand. Do such properties as being non-depletable and non-excludable serve as critical benchmarks for decision makers? What role should economists play in setting these benchmarks? At one end of the spectrum of views, Malkin and Wildavsky (1991) see public goods in terms of context – a product of societal desires at the time. Alternatively, any number of economists has pondered at length over the definition of public goods and how one could permanently categorize them sufficiently precisely to reduce or eliminate ambiguity and make these definitions useful in guiding policy. Economists such as Samuelson, Head, Buchanan and others have written extensively on such public goods issues.

Musgrave (p. 13) avoided much of the battle for definitional and operative precision by introducing the concept of merit goods. These are goods or wants “considered so meritorious that their satisfaction is provided for through the public budget and paid for by private consumers.” While merit goods might well be public or quasi-public goods, they could also be private goods. One of the distinctions raised here is the extent to which a merit good might interfere with consumer sovereignty – when these goods are satisfied or serviced through the market. Medical services and housing are two services/goods that present such a dilemma. Ver Eecke (1999) argues that in a sense, public, private and merit are tags that give general shades of meaning to classes of goods. He then goes on to construct his own multi-faceted definition of public goods, in which he simplifies the complexities of other definitions by squeezing a number of seemingly different concepts together. The question is whether it is necessary to delve

exhaustively into the realm of what constitutes a public, quasi-public, merit or other good along the continuum between public and private goods in order to contribute to public decisions about the degree and character of the involvement of government in the lives and activities of citizens.

At this point we are faced with something of a morass when we ask how economists relate to, are interested in or should even care about public goods and the decisions made by society about them. Lionel Robbins (1981) in his lecture “Economics and Political Economy” gives us operational guidelines for approaching the analysis of public and related goods. This lecture is quite different from his pre-World War II *The Nature and Significance of Economic Science*, through which economists that know Robbins at all tend to see him today. Since writing that piece, Robbins was involved in the economic planning of the war effort, became Chairman of the *Financial Times* after the war and also chaired the commission that produced the seminal report on higher education in Britain. By the time of his lecture in 1981, Robbins was practicing as an applied economist as well as brilliantly teaching the history of economic thought.

If one starts from Viner’s quip that economics is what economists do, then the key question to ask is what do they do? According to Robbins (p. 3), what economists do is analyze “behavior conditioned by scarcity,” where scarcity is “the relationship between objectives, either personal or collective, and the means of satisfying them.” Expanding beyond Friedman’s (1953) tight prescription for positive economics, Robbins widens the scope well beyond Friedman’s notion that positive economics is either a value free

exercise or can be conducted so that values do not matter. Robbins (p. 6) first refers to the intermingling of values and politics with economics in the work of Adam Smith. He goes on to say that if economists (and those using economic analysis) “are aware of what they are doing and do not claim scientific authority for conclusions which clearly go beyond science, there is much to be said for the practitioners of scientific economics discussing such questions of policy. They may not agree on the extra-scientific elements in their arguments. But, provided the distinction is observed, there is everything to be said for the discussions of policy to be conducted by those who are aware of the objective implications of the values on which policy rests.”. He continues in this vein: “It should be clear then that Political Economy in this sense involves all the modes of analysis and explicit or implicit judgments of value which are usually involved when economists discuss assessments of benefits and the reverse or recommendations for policy” (p.8).

If one takes the broad view of an economist’s role that Robbins employs, then where does this lead? For those considering the political economy of public goods, this leads to concern over cost effectiveness and the trade-offs involved, quite different from the concerns of those economists who attempt to prescribe public/private good status by definition. There is an almost infinite number of combinations and permutations from one end of the public/private spectrum to the other. Roads can be public and private. Firefighters and often police were historically private, then largely public, and private police and fire services continue to exist today. The delivery of letters and packages is both public and private today with an increasing portion becoming private. One must necessarily look at a specific slice of a continuum as one moves from public goods

towards private goods and assesses the trade-offs in their provision. Many of the concerns that economists deal with in the course of applied policy analysis impinge on or are enveloped by this operational treatment of public goods. The specific typology of a good does not appear to really matter to the public and private decisions taken about the good or service in question?

The political economy approach was evident in the expansion of government involvement (and thus a broadening of public, quasi-public or merit goods) during the Great Depression. Here we see examples of the expanded range of concerns that economists were addressing within the context of the values and perceptions of an appropriate role for government. Writing in the *1940 Yearbook of Agriculture*, Howard Tolley (pp.1160-1161) initially backs away from promoting a dominant government role and claims that the implication of the broad coverage of public and private activities in the *1940 Yearbook* does not imply “that government by sweeping fiat should move militantly upon the Nation’s problems, agricultural or otherwise. Rather, the emphasis is upon the encouragement of democratic channels of national energy and confidence, national consultation and decision, national tolerance and accommodation of views, together with the recognition that international affairs also have a bearing here.”

Tolley first discusses the provision of the basics of life: food, clothing, and shelter. He (p.1162) decries the inability of the country to “make its economy get food to those who need it and are willing to work for it.” Tolley asks for “at least some measure of security in the enjoyment of the fundamentals of the good life.” Improved medical care

and facilities in rural areas, quality public education, improved transportation, and improved communications are essential to this good life for people in rural areas. The implication is that these should be governmental concerns at least in facilitation if not provision. These concerns are well beyond the existing and proposed agricultural policies to: increase buying power for agricultural commodities; control production and marketing to raise prices; provide credit and crop insurance; and promote conservation. For the future Tolley identifies such broad public goals as the essential development of increased commercial and industrial employment to soak up excess rural population. The goods and services Tolley refers to certainly have varying aspects of being public goods, but what drives his list is the perception of what government might do to help a large number of its citizens. Tolley has in his own mind for his own time an appropriate balance between public and private involvement in the provision of goods and a firm sense of where government should be involved and where the individual needs to take responsibility in the Adam Smith sense of liberty for the individual.

The broad public goods sense held by the agricultural establishment for rural America continued in the post World War II period. The Farmers' Home Administration financed rural water systems. Rural and community development programs were instituted that included rural health activities. While the Country Life movement declined and died, there was still a political desire for the provision of goods and services to rural areas that continued for a time some of the expansive vision of the depression era. A nagging question that has returned from the past is whether increases in income

inequality should be an argument for an increase in the provision of the broad public goods, like medical care, to which Tolley (1941) referred.

Part of the delineation of public involvement in citizens' affairs relates to technology and institutions as well as history. The invention of barbed wire helped make possible the privatization of what initially was a public good of endless grassland in the United States. Improved transportation made rural free delivery possible. A copper wire-dependent technology resulted in the regulation of telephones as a utility. A change in technology (the elimination of the dependence on wires) brought about deregulation that lowered cost and enhanced service for many. In contrast the deregulation of electricity was implemented in a way that resulted in declines in the quality and reliability of power because these ancillary goods were not supported by the market forces that were proscribed to provide cheaper power for consumers. The disruptions in California in 2001 were partially the result of this lack of incentive for reliability and also stemmed from a set of deregulation rules that both limited the scope to utilize market institutions and invited gaming. Might we appropriately consider electric power reliability a public good? The case of electric power reliability is really intriguing. Under deregulation today the power itself is a pure private good. Once one is on the grid, then such things as reliability take on strong public good characteristics. The free market economic theory that has been used to restructure the electric power industry has not successfully ensured the co-provision of the public goods associated with electric power in terms of quality and reliability (Toomey et al. 2005).

If one starts from the public good of property rights and then extends to the historically-based public institutions of money, law and credit in the context of the last several decades in the former Soviet Union, one can see how the lack of such institutional public goods can make a difference in economic progress. The contrast need not be with the United States or Western Europe. Eastern Europe was at a similar starting point economically as the former Soviet Union, but had a more recent and richer history of the institutions that make freer markets possible. Hicks' (1973) writings on these institutions demonstrate their integral role in the development of both free markets and government. Few of the economists advising the former Soviet Union fully understood the importance of these public goods to the development of actual free market approaches to important economic decisions.

For many, food safety is a global public good (Unnevehr 2006). This identification is strongly based on the development of technology and the development of international markets. There is a long history in the United States of the public nature of food safety. In the early 20<sup>th</sup> century, food safety was propelled towards public good status by public concern fuelled by Upton Sinclair's *The Jungle* (2003) and developments in technology that made centralized public standards and monitoring both increasingly effective in improving health and more cost effective. The long tradition of public service by the institutions responsible, the Food and Drug Administration and the Department of Agriculture, set a perception in the minds of the public about the public nature of the good. This perception and the effectiveness of the institutions affect the efficacy of the process and the public acceptance of when a food is considered safe or not. The actual

realization of food safety as a global public good still must overcome the differences in both expectations and standards and create an international regulatory regime coupled with sufficient incentives for the wide range of players in the international food system. Issues abound including the trade-off between benefits from trade at home versus foreign consumer risk and whether harmonization of standards would increase or decrease consumer welfare (and whose consumer welfare). Placing this in a clear, economically-defined public goods context without considering a host of other factors is almost impossible. The same dilemmas occur when considering something like scientific knowledge as a global public good (Dalrymple 2003).

Some claim that energy security is a public good. In terms of policy, energy security is being treated to a large extent as a private good, with the exceptions of national defense policy to protect the oil supply and substitute liquid fuels policy to encourage biofuels. In contrast Senator Lugar (2006) has challenged the current private goods status concerning strategic vulnerability of liquid transportation fuels and emphasized the public goods component: “I do not suggest this lightly, but my observation of the post – Katrina response by car companies, oil companies and consumers is that, in the short run, the evolution of market forces won’t be capable of producing the progress that we need to achieve our national security goals.” He then suggested the need for legislation requiring annual improvements in vehicle efficiency and set this in the overall context of energy security as a political problem, not a market problem.

All of the examples above are fertile areas for analysis. For energy security the paper by Greene and Leiby (2007) on energy independence is a superb example of a timely analysis that better defines the parameters of the problem and gives initial guidance on what aspects of the problem are likely to be most important for public intervention or support. They first implicitly subsume energy independence into energy security. By setting a target for acceptable levels of economic damage based on the risk of liquid fuel disruptions, they simulate where consumption needs to be in 2030, and what different supplies and uses of liquid fuels will have to be to meet this target. They show that to meet the energy security target, there cannot be growth from current consumption levels. They also show that the largest potential factor to hold consumption constant has to be reductions in potential demand rather than increases in supply. This provides a much clearer focus as to where analysis of energy security should focus and where government involvement might be appropriate.

This discussion of public goods has really been in aid of supporting the economic analysis of public concerns and involvement of government in its citizens lives through something like Robbins' approach of Political Economy (1981). Public goods in this discussion have been couched in terms that reflect their political economy characteristics. We appear to be entering a period where there will be more questioning of economic orthodoxy and expanded exploration of different touchstones for economic analysis. Certainly Alan Blinder's comments earlier this year on the potential negative impacts of free trade drew heated discussion in the economics profession. His rejoinder that there is

too much ideology in economics today and that economics is “often a triumph of theory over fact” has not quieted his critics (Cohen 2007).

Actions taken by government within prevailing perceptions and trends for public goods probably do not receive the analysis of trade-offs and consequences that should be given them. The political rush to centralize and extend government involvement during the Great Depression was often accepted on its political face value. Today, Indiana’s and Illinois’ sale of their toll roads to private operators do not appear to have been preceded by much thought about the long term generational impacts or short term windfalls. Sales of formerly regulated electric power plants at fire sale prices now raise a different kind of customer generational equity concern when the power is sold back to original rate payers at much higher prices. Any current perspective on public goods, e.g. which are appropriate and how are they provided (whether this be expansionist or contractionist), should not limit the economic analysis of policy alternatives.

As another example, the public perceptions and the politics of environmental goods as public goods are extremely difficult to sort out. If ecosystem services at a given moment are not considered a public good, do we solve this by valuing them so that they can compete on a private goods basis? Robbins (1981) makes a point that even the construction of indices is not value free – what about valuations by contingent valuation for market transactions? How do we look at things like a Genuine Progress Indicator which led to the quip that if GDP is up, why is America down? (Cobb and Cobb 1994) Why has Costanza’s and his coauthors’ (1997) valuation of the worlds ecosystem

services not resonated much in decision making. Will the current effort by government agencies and others to value ecosystem services (as a good category of its own) make a meaningful difference in policy formulation? If it is achieved, which side will it end up favoring?

Where does this discussion leave us? Historically and by definition, it is very hard to determine a stable range and extent of public goods. Operationally, democratic societies do determine what goods and services the public should support or be involved in providing. How economists approach this very real world depends on them. The view expressed here is that economists should take an approach along the lines of political economy, declaring values rather than pretending complete independence from them and being aware of the objective implications of the values on which policy rests. The process of politics is critical to choice (Crick 1962). Both Leontief (1971) and Robbins (1981) declare that the perspective and knowledge that can be gained from other disciplines is essential. In addition particularly Leontief (1971) would ask that we take a careful look at how we are conducting analysis today and ensure that agricultural and similar applied economists are actually meeting the necessary standards of internal validity. Are we giving enough attention to the observable reality of the economic phenomenon under consideration? Are our data and methods the most appropriate to address the problem at hand in a way that reflects reality? If we are doing this well, the field of appropriate analysis of the public/private interface is wide open.

Why should economists care? Individuals and nations reflect and are shaped by their choice of heroes (Riis, 1915). Likewise, the decisions a society makes about the provision of public goods – which goods are deemed to be public or quasi-public and which goods are private – reflect and shape the values and attitudes of a society. At any given moment there may appear to be some natural balance between public and private goods, but this balance is the product of conscious public decisions. For example, a society's unwillingness to pay collectively to repair or extend existing public infrastructure provided by past generations says something about that society. One concern is that in the debate about the provision of public goods and services, who speaks for public goods? While it may not be the role of a policy economist to advocate one policy over another, the role of alerting citizens to opportunity costs, trade-offs, and generational impacts of policies is critically important for society. Economists can focus and sharpen the public debate about the provision of public goods and services and in so doing may wean a society away from bad habits like socializing losses and privatizing gains. Public goods may have a critically important role both socially and economically in a winner-take-all society. The public/private goods continuum is where the real action is and will be in coming years. Economists should be there.

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