

# Behavior, resources, and credible rules

Examine the chapter's two omitted responses: a changing tax base and a changing production process. Use its windfall-tax, debt-relief, and monetary examples to build conditional analysis that includes benefits, costs, design differences, and credible counterfactuals.

2 lessons · approximately 5 hours, plus multi-day practice

## How to use this workbook

Read the assigned manuscript first. This workbook contains accompanying teaching and invented cases, not a revision of the source. Attempt exercises before consulting the rubrics and explanations. Written work is self-assessed or discussed with a tutor; no secure examination, academic credit or certificate is implied. Use a clearly labelled fictional case when live practice or personal disclosure would be unsuitable. Links use the course's intended publication address; for offline review, open the supplied source PDF at the full-book page numbers shown.

- Decompose taxable-base responses.
- Calculate static and behavioral revenue scenarios.
- Distinguish claims from real resources.
- Compare relief designs and future credit effects.
- Apply the five-question diagnostic without requiring ideological agreement.

[Open the module and source reading links](#)

## Lesson sequence

1. Model a changing tax base
2. Test relief against real resources and institutional trust

# Model a changing tax base

Allow approximately 100 minutes, plus any continuing activity.

## Learning objectives

- Distinguish real activity, reporting, and timing responses to taxation.
- Compare static revenue arithmetic with behavioral scenarios.
- Evaluate a windfall-tax argument under alternative designs.

## Assigned source readings

Complete consecutive source range, including its arguments and examples

Full-book PDF pages 43–46. Section links open the chapter at the relevant page.

## Develop the argument

### The first omission: treating people as fixed objects

The chapter opens with Adam Smith's chessboard image: people have purposes of their own and cannot be rearranged like passive pieces. Its governing claim identifies two omissions, ignoring behavioral response and ignoring real scarcity. The first lesson concentrates on the former. A statutory tax rate describes the legal rule; it does not describe the final tax base. The source calls the static-base assumption a lie, but analysis should distinguish deliberate deception from a simplifying forecast or an uncertain estimate. Begin by stating the assumption explicitly. A static projection is often useful as an accounting benchmark. It becomes misleading when presented as a complete forecast despite material responses. The question is not whether people are morally entitled to respond, but which responses are feasible, how large they may be, and what they do to revenue and welfare.

### Three channels that must not be conflated

The source lists marginal decisions, structure and timing, and investment composition. Marginal decisions concern an additional project, hour, or investment whose expected return changes. Timing and structure concern when income is recorded and in what legal form. Composition concerns which assets, financing methods, or jurisdictions receive resources. These channels can overlap, but they are not equivalent. Lower reported taxable income need not mean an equal decline in output: income may have been deferred or reclassified. Likewise, a shift from equity to debt can alter financial risk even when total investment initially stays constant. Design a ledger with separate columns for real activity, reported base, administrative cost, and distribution. The book's directional claim that lower returns reduce activity is a useful starting hypothesis. Its magnitude depends on elasticities and other responses, including income effects, credit constraints, and how the revenue is used.

## Windfall profits and future expectations

The windfall-tax example argues that retrospective taxation can change expected future returns, discourage capacity, and reward lobbying. Reconstruct the sequence carefully: a shock raises profit; the government taxes the increment; investors update beliefs about future policy; some projects or locations become less attractive. The expectation step is essential. A tax imposed on an unanticipated past gain cannot change that past investment, though it can affect later decisions if investors expect repetition or face financing constraints. Distinguish a broad revenue tax, a profit tax, and a tax designed around economic rents. Investment allowances, loss treatment, duration, and credibility can change incentives. The source's claim that taxing a signal necessarily reduces supply is therefore a proposition to test across designs, not a universal theorem. Also ask whether the gain reflected scarcity, market power, public support, or successful risk-taking; each may support different policy objectives.

## From rhetoric to a falsifiable comparison

The source warns that firms may purchase political protection instead of productive capacity. That is an institutional channel, not merely another label for a tax bill. A study would need evidence on lobbying, investment plans, financing, and counterfactual projects to establish it. Compare taxed firms with a credible control while accounting for the shock that produced the windfall; otherwise falling investment caused by changing demand could be wrongly attributed to taxation. Chapter references to taxable-income elasticity and historical energy taxation are research leads. Their numerical summaries and bibliographic details have not been independently verified here. A defensible recommendation can support, redesign, or reject a tax, provided it states the objective, distinguishes the three response channels, assesses uses of revenue, and explains what evidence would alter the judgment. Do not confuse rejecting a costless-tax story with proving that every tax has a negative net social effect.

## The port repair levy

Invented for this course.

A fictional port forecasts 12 million units of revenue from a 10% levy on 120 million of extraordinary repair-sector profits. Analysts consider a 10% fall in the reported base, split between deferred billing and canceled projects.

1. The static calculation is  $0.10 \times 120 \text{ million} = 12 \text{ million}$ . Label it a benchmark rather than a behavioral forecast.
2. With a 10% base reduction, revenue is  $0.10 \times 108 \text{ million} = 10.8 \text{ million}$  before administration. Do not call the entire 12 million base reduction lost output.
3. If 8 million is deferred billing and 4 million relates to canceled projects, the timing and real-activity channels require separate treatment and later follow-up.
4. Compare a predictable temporary design with a surprise recurrent one, and specify how emergency port repairs funded by the levy might affect productive capacity.

The scenario shows why revenue and output effects differ. It does not identify the actual elasticity or establish the best tax design.

## Practice and evidence

### 1. Build a response decomposition

Recalculate the port case under three stated response assumptions, including no response. Separate reporting, timing, real activity, and administrative costs.

Deliverable: A transparent scenario ledger and 200-word interpretation.

1. Compute each tax base and receipt.
2. Explain which effects reverse later.
3. Identify who receives benefits from the funded repairs.

### Arithmetic · 3 points

Rates and bases are distinguished and calculations are reproducible.

### Decomposition · 3 points

Does not equate every reporting change with lost production.

### Balance · 3 points

Includes public benefits and their uncertainty as well as private costs.

### 2. Compare two windfall-tax designs

Design two hypothetical tax rules with the same initial revenue target but different timing, investment allowances, or loss treatment.

Deliverable: A design comparison and an evidence-based evaluation plan.

1. State legal bases precisely.
2. Trace an investor's expectations under each.
3. Propose observations that could distinguish their effects.

### Design specificity · 3 points

Explains features that materially change incentives.

### Mechanism · 3 points

Connects expected after-tax returns and financing to decisions.

### Testability · 3 points

Names counterfactual comparisons and potential confounders.

### Reflection

When have you mistaken a change in reported numbers for an equal change in the activity those numbers describe?

## Formative self-check

Choose an answer before looking at the answer key. These questions are open practice, not a secure assessment.

### 1. Reported taxable income falls after a rate increase. What can be concluded immediately?

- A. Output fell by exactly the same amount
- B. The reported base changed; real, timing, and reporting channels must be separated
- C. The tax collected no revenue
- D. Everyone relocated

### 2. A tax applies to a completed, unexpected gain. Which channel can still affect future investment?

- A. Changing the already completed decision
- B. Eliminating the original shock
- C. Revised expectations about future policy and available finance
- D. The word windfall alone

### 3. Which comparison best tests the source's windfall-tax concern?

- A. Investment trends adjusted for the underlying shock and credible comparison firms
- B. Taxed firms' complaints alone
- C. The popularity of the tax
- D. The government's announced revenue target

## Answer explanations

### 1. B — The reported base changed; real, timing, and reporting channels must be separated

Reported income is not identical to output. The chapter's own three channels require decomposition before interpreting welfare or production.

### 2. C — Revised expectations about future policy and available finance

Past choices cannot be changed retroactively, but beliefs and financing for later projects can change. The label itself supplies no magnitude.

### 3. A — Investment trends adjusted for the underlying shock and credible comparison firms

A credible counterfactual helps separate the tax effect from the shock. Complaints and targets are evidence about positions or plans, not causal estimates.

# Test relief against real resources and institutional trust

Allow approximately 100 minutes, plus any continuing activity.

## Learning objectives

- Distinguish redistribution, resource creation, and institutional effects.
- Analyze debt relief without conflating it with every form of restructuring.
- Apply the chapter's five diagnostic questions symmetrically.

## Assigned source readings

Complete consecutive source range, including its arguments and examples

Full-book PDF pages 46–53. Section links open the chapter at the relevant page.

## Develop the argument

### The ledger and the factory

The second alleged lie is that claims can be redistributed without affecting the process that produces goods. The chapter explicitly allows arguments for social insurance, public goods, and emergency relief; preserving this qualification is essential. Its objection is to costless redistribution, not to every transfer. The factory metaphor distinguishes ownership or spending claims from real productive capacity. A transfer can change consumption, work, investment, risk-bearing, and demand. Some changes may reduce output, while others can improve health, education, risk sharing, or the ability to undertake productive activity. The book emphasizes adverse incentives, but a complete application of its method tests both directions. Incentive compatibility asks whether a design makes needed actions worthwhile for participants. It does not mean that all redistribution is incompatible with production or that observed recipients can fairly be labeled dependent.

### Debt relief and the terms of future lending

The debt-jubilee example treats a loan as both a burden for one party and a contractual asset for another. The proposed causal chain runs from unexpected cancellation to revised lender expectations, tighter credit, higher collateral requirements, and possible exclusion of future borrowers. Separate immediate balance-sheet relief from future credit access, and identify who absorbs the loss: lenders, investors, guarantors, taxpayers, or other parties. Then distinguish blanket political cancellation from negotiated restructuring, ordinary bankruptcy, targeted relief, and changes announced before contracts are written. Predictable resolution can itself support lending by making losses manageable. Also consider debt overhang: a borrower unable to invest or work effectively may become more productive after restructuring. These possibilities do not make relief free. They specify what evidence is required before accepting the chapter's claim that relief necessarily shrinks future opportunity.

## Currency claims and real constraints

The monetary section explicitly distinguishes sophisticated, conditional modern monetary arguments from slogans claiming that currency issuance removes meaningful constraints. Preserve that distinction rather than attributing the slogan to an entire school. The resource point is straightforward: issuing additional nominal claims does not mechanically create additional machines, workers, energy, or useful output. But the effect on prices and output depends on spare capacity, supply bottlenecks, spending composition, expectations, imports, and institutional response. The chapter calls inflation a tax, an analogy emphasizing purchasing-power losses rather than a literal identical incidence across households. Debtors, creditors, workers, owners, and public budgets may be affected differently. Likewise, the source's description of fiscal-dominance research is conditional theory presented rhetorically as a broad proof; learners should identify assumptions before converting it into a prediction about a particular economy.

## Use the diagnostic on every side

The chapter joins its two warnings into a feedback story: defensive behavior and weakened production can worsen the problem that redistribution was intended to solve. This is a possible dynamic, not evidence that all societies with transfers follow the same trajectory. Its five questions ask what behavior changes, what substitutes emerge, where incidence lands, when harm arrives, and what happens to investment and trust. Apply them to relief, no relief, and feasible alternatives. The closing ladder language prioritizes stable rules, entry, reliable money, and contracts; articulate these values and any competing goals explicitly. The chapter-end material repeats the governing claim and three Hazlitt examples, and includes a Keynes quotation with an editorial parenthesis about community-wide liquidity. Read it as supplied source material, not an extra verified argument: changing individual ownership does not automatically create real resources for the community. A strong conclusion gives a conditional design recommendation supported by a complete comparison, rather than agreeing with the chapter's rhetoric.

## Flooded-market loans

Invented for this course.

An invented flood leaves 100 vendors unable to repay equipment loans. The council considers blanket cancellation, subsidized restructuring, or no intervention. Some equipment can be repaired; the future flood risk is uncertain.

1. Record existing debt and repairable capacity separately. Canceling a claim is not the same event as repairing a machine.
2. Trace immediate relief and losses for vendors, lenders, guarantors, and taxpayers under each option.
3. Model future lending under several expectations: a unique disaster response, recurring cancellation, or a predictable insurance arrangement.
4. Compare debt-overhang benefits, moral-hazard risks, administrative costs, and credit exclusion. Collect evidence rather than choosing an effect solely from its moral appeal.

Relief may restore activity and may alter future credit terms. The relevant question is the net result under a specified design and comparison, not whether relief has a benevolent label.

## Practice and evidence

### 1. Design a credit-access safeguard

Use the flood case to propose a bounded relief design and a plan for evaluating future credit access.

Deliverable: A 400-word policy memo with immediate and two-year outcomes.

1. Apply all five diagnostic questions.
2. Identify who absorbs losses.
3. Address both repeated-relief expectations and debt overhang.

### Scope · 3 points

Specifies eligibility, duration, and loss allocation.

### Trade-offs · 3 points

Explains both productive benefits and incentive risks.

### Evaluation · 3 points

Measures credit availability as well as current debt reduction.

### 2. Audit a costless-spending claim

Analyze the statement: “The town can issue vouchers, so every requested repair can be funded without sacrifice.” Treat vouchers as claims accepted locally.

Deliverable: A resource inventory, bottleneck map, and conditional rebuttal or defense.

1. Identify available labor, materials, and idle capacity.
2. Distinguish nominal funding from real provision.
3. Show how rationing and distribution change when capacity is reached.

### Resources · 3 points

Names concrete constraints rather than merely invoking scarcity.

### Conditions · 3 points

Explains when output can expand and when prices may rise.

### Distribution · 3 points

Identifies who bears delay, price, and financing burdens.

### Reflection

Which form of trust does your preferred reform depend on, and how would participants know whether it is being preserved?

## Formative self-check

Choose an answer before looking at the answer key. These questions are open practice, not a secure assessment.

### 1. Which statement accurately preserves the chapter's qualification?

- A. It rejects every public good
- B. It accepts that social insurance and emergency relief may be justified while rejecting claims of no cost
- C. It says redistribution never changes behavior
- D. It treats all monetary theories as identical

### 2. A predictable bankruptcy process reduces unpayable debts and improves recovery compared with disorderly default. What does this show?

- A. All debt cancellation is costless
- B. Trust never matters
- C. Relief design and the counterfactual matter for credit effects
- D. Lenders have no losses

### 3. Which is the strongest use of the five questions?

- A. Apply them only to policies you oppose
- B. Use them to reject all transfers in advance
- C. Replace evidence with the word scarcity
- D. Apply them to the proposal, no-action baseline, and competing designs

## Answer explanations

### 1. B — It accepts that social insurance and emergency relief may be justified while rejecting claims of no cost

The source explicitly allows reasons for redistribution and distinguishes sophisticated monetary analysis from slogans. Removing those qualifications misrepresents it.

### 2. C — Relief design and the counterfactual matter for credit effects

The chapter's trust mechanism must be evaluated against realistic alternatives. Predictable restructuring can differ from surprise blanket cancellation without eliminating costs.

### 3. D — Apply them to the proposal, no-action baseline, and competing designs

Symmetric evaluation prevents the method from becoming an ideological shortcut. The status quo and preferred alternatives also change behavior and impose costs.

## Module assessment

### Fund and deliver flood recovery

A regional council proposes an unexpected tax on a profitable logistics sector, cancellation of vendors' loans, and newly issued local vouchers to restore flood-damaged markets. Assess the package and two alternative designs.

#### Required evidence

- A linked tax, credit, and resource-flow analysis.
- A group-by-time incidence ledger and monitoring plan.
- A conditional recommendation with the strongest objection to it.

#### Assessment criteria

##### Integration · 5 points

Explains interactions among tax expectations, credit terms, and repair capacity.

##### Counterfactual · 5 points

Compares realistic alternatives including no intervention.

##### Evidence · 5 points

Separates source claims, stipulated facts, and uncertain forecasts.

##### Fairness of reasoning · 5 points

Represents relief benefits and costs without grading moral identity or policy agreement.

#### Model response: consult after your attempt

A strong analysis recognizes that receipts and vouchers cannot themselves repair equipment without labor and materials. It distinguishes reporting changes from lost investment, current debt relief from future credit supply, and surprise policy from predictable resolution. It can support a redesigned package if expected recovery benefits outweigh documented costs, or reject it if bottlenecks and institutional risks dominate. Either answer must specify assumptions, distribution, and observations that would change the conclusion.

### Source cautions and interpretation

- Footnotes 8–11 and all chapter-end material, including the Keynes quotation, editorial parenthesis, repeated governing claim, and Hazlitt summary, were read in full.
- Historical numerical estimates and cited bibliographic details are reported by the source and have not been independently verified.
- Claims about fiscal dominance, dependence, and investment are conditional or contestable; the course does not present them as universal laws.

- No figures occur in the assigned chapter; source text remains unchanged.

## Source coverage

### Chapter 2: The Two Lies That Ruin Policy

The complete opening quotation and chapter introduction establish the problem and author's governing position; the first teaching section reconstructs the argument and separates its assumptions from evidence.

[Read source section: full-book PDF page 43](#)

#### The Governing Claim

Introduces the two omitted responses and distinguishes a simplifying static benchmark from a misleading forecast.

[Read source section: full-book PDF page 43](#)

#### Lie 1: “We Can Tax a Thing Without Changing It”

Tests whether the legal rate and initial base suffice for revenue prediction, with explicit response scenarios.

[Read source section: full-book PDF page 44](#)

#### The three ways taxes change the thing being taxed

Separates marginal real activity, structure/timing, and investment composition in the port-levy ledger.

[Read source section: full-book PDF page 44](#)

#### Windfall taxes: the perfect exhibit

Explains how retrospective policy changes future expectations while leaving past decisions unchanged.

[Read source section: full-book PDF page 45](#)

#### Primary example (14): Windfall taxes

Compares windfall-tax bases, allowances, credibility, financing, public benefits, and potential lobbying responses.

[Read source section: full-book PDF page 45](#)

#### Lie 2: “We Can Redistribute Without Shrinking the Pie”

Preserves the source's allowance for insurance, public goods, and relief while rejecting an assumed costless transfer.

[Read source section: full-book PDF page 46](#)

## **The moral error: mistaking the ledger for the factory**

Distinguishes financial claims from productive capacity and examines both adverse and beneficial incentive channels.

[Read source section: full-book PDF page 46](#)

## **Primary example (31): Debt jubilees**

Compares blanket cancellation, predictable restructuring, debt-overhang relief, loss allocation, and future lending.

[Read source section: full-book PDF page 47](#)

## **Primary example (48): “Modern Monetary” slogans**

Preserves the distinction between sophisticated monetary analysis and slogans; tests spare capacity and real bottlenecks.

[Read source section: full-book PDF page 48](#)

## **How the lies work together**

Reconstructs the proposed feedback loop and the unstyled omission-of-reactions argument as a hypothesis, not an inevitability.

[Read source section: full-book PDF page 49](#)

## **A brief diagnostic: the missing questions**

Applies all five questions to relief, no intervention, and feasible alternatives in the flood-credit memo.

[Read source section: full-book PDF page 50](#)

## **Returning to the ladder**

Connects stable rules, entry, reliable money, and contracts to opportunity while stating competing policy goals.

[Read source section: full-book PDF page 50](#)

## **The Lesson Line**

Uses the claims-versus-resources exercise to test the chapter’s closing constraint statement.

[Read source section: full-book PDF page 51](#)

## **Chapter 2 Notes**

Reads all notes, the Keynes quotation and editorial parenthesis; distinguishes source summaries from verified research.

[Read source section: full-book PDF page 52](#)

### **The "Hazlitt" Examples (Primary)**

Revisits windfall taxes, debt jubilees, and monetary claims in the linked flood-recovery chapter assessment.

[Read source section: full-book PDF page 53](#)

### **The lie by omission: what is not said**

Examines how rhetorical definitions can exclude behavioral reactions, then applies the five-question diagnostic symmetrically.

[Read source section: full-book PDF page 49](#)