Econ 741 Fall, 2011

Public Economics I

WVU

Instructor: Professor Roger Congleton

Office: 405 B&E
Office Hours: Monday and Wednesday: 2:30-3:45 and most other times by appointment.
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Suggested Texts:

Tanzi, V. and L. Schuknecht (2000) *Public Spending in the 20th Century: A Global Perspective.* Cambridge: Cambridge University Press. (paper)

Hillman, A. L. (2009) *Public Finance and Public Policy, Responsibilities and Limitations of Government.* Cambridge: Cambridge University Press. (2nd Ed., paper)

Congleton, R. D. and B. Swedenborg (2006) *Democratic Constitutional Design and Public Policy.* Cambridge: MIT Press. (paper)

Grades:		
	1 Exam	45%
	1 Final Research Paper (14-20 pages)	45%
	8 1-pagers	10%
	Marginal extra credit for class participation	(up to 5% bonus)

Course Focus

Public economics is the study of government policies. It analyzes the effects of those policies on economic activities and the political processes by which those policies are adopted. Public Finance studies the subset of public policies that are fiscal in nature. These include government taxation, debt, and expenditures. The aim of this course is to provide students with the micro-economic tools to understand the impacts of basic regulatory and fiscal policies. Students will also use models and concepts from microeconomics to analyze the political pressures that generate a nation's fiscal and regulatory policies. Modern democratic governments directly control more than a third of their gross national products and influence much of the rest through their fiscal and regulatory policies.

TENTATIVE COURSE OUTLINE**

Dates **Topics** **Readings**

I. An Introduction to Public Economics

8/22 Introduction to Public Economics and Government Finance AH: 1, T&S: 1-3

What is the public sector? Overview of fiscal policy in the United States and OECD countries: growth of tax and expenditures, composition of, increasing centralization. A short history of public finance. Some Methodological ideas and principles.

i. Buchanan, J.M. (1949) "The Pure Theory of Government Finance: A Suggested Approach," *Journal of Political Economy* 57: 496-505.

ii. Congleton, R. D. (2001) "The Politics of Government Growth," in Shughart, W. F. and Razzolini L. *Elgar Companion to Public Choice*, Edward Elgar Publishers, Ltd. , 457-478.

iii. Bergson, A. (1938) "A Reformulation of Certain Aspects of Welfare Economics," *Quarterly Journal of Economics* 52: 310-34.

iv. Harsanyi, J. C. (1953) "Cardinal Utility in Welfare Economics and in The Theory of Risk Taking," *Journal of Political Economy* 61: 434-35.

v. Buchanan, J. M. (1959) "Positive Economics, Welfare Economics, and Political Economy," *Journal of Law and Economics* 2: 124-38.

vi. Rawls, J. (1971/1999) *A Theory of Justice.* Cambridge: Belknap, Harvard University Press.

8/24 - 29 A Review of Tools for Modeling Taxation and Public Service Demand

The simple benefit-cost model of rational choice, implications for markets, externalities, taxation, and tax burden. Understanding the distributional effects of taxes and policies on firms and consumers.

i. Browning, E. K.(1987) "On the Marginal Welfare Cost of Taxation," *American Economic Review* 77: 77:11-23.

ii. Zodrow, G. R. (2001) "The Property Tax as a Capital Tax: A Room with Three Views," *National Tax Journal* 54.

iii. Parry, I. W. H. and K. A. Small (2005) "Does Britain or the United States Have the Right Gasoline Tax?" *American Economic Review* 95: 1276-89.

iv. Conesa, J. C. and D. Krueger (2006) "On the Optimal Progressivity of the Income Tax Code," *Journal of Monetary Economics* 53: 1425-1450.

v. Laffer, A. B. (2004) "The Laffer Curve: Past, Present, and Future," Heritage Foundation (1765) [http://gates-home.com/files/Laffer%20Curve%20-%20Past%20Presetn%20and%20Future.pdf]

8/31 Setting the Stage: Productive and Extractive Models of the State and Demand for Public Services

Two rational choice theories of the emergence of the state have been explored in the Public Choice and Political Economy literatures. Models of the "productive state" draws on the Hobbesian conception of the social contract as extended by Locke, Rawls, and Buchanan. The second group of models can be regarded as "extractive states," and stress the role of conquest and rent-extraction. These models are often used to explore the incentives of successful dictators, authoritarians, and kings. It turns out that both productive and extractive states are likely to provide an array of public services.

i. Buchanan, J. M. (1975) *The Limits of Liberty.* Chicago: University of Chicago Press. Chapters 2-4.

ii. Olson, M. (2000) *Dictatorship, Democracy and Development.* Oxford: Oxford University Press.

iii. Congleton (2011) *Perfecting Parliament* (Ch. 4). Cambrdige: Cambridge University Press.

iv. Congleton, R. D. (1980) "Competitive Process, Competitive Waste, and Institutions," in *Towards a Theory of the Rent-Seeking Society*, Edited by J. Buchanan, R. Tollison, and G. Tullock, Texas A & M Press:153-179.

v. Axelrod, R. (1986) "An Evolutionary Approach to Norms," *American Political Science Review* 80.

vi. Olson, M (1993) "Dictatorship, Democracy, and Development," *American Political Science Review* 87: 567-576.

vii. Grossman, H. I. (1995) "Swords or Plowshares? A Theory of the Security of Claims to Property," *Journal of Political Economy* 103: 1275-1288.

viii. Hirshleifer, J. (1995) "Anarchy and its Break Down," *Journal of Political Economy* 103:26-52.

II. Collective Decisionmaking and Public Economics

9/7-19 Electoral and Interest Group Models of Collective Choice in Contemporary Governments

Two broad models of public policy formation in contemporary democracies exist. The first stresses the role of elections and electoral competition. This literature thinks of the state as a an institution through which ordinary (moderate) citizens obtain services. The second stresses the role of special interest groups. In the latter models, narrow interest groups (rent seekers) often obtain privileges that disadvantage ordinary citizens. Both models suggest that public goods will be provided and that transfers will tend to favor those controlling government. However, the two models differ in their predictions about the size of government and the extent and kind of redistribution takes place. A third model can be constructed by combining elements of mainstream electoral and interest group models.

i. Congleton, R. D. "The Median Voter Model," *The Encyclopedia of Public Choice*, C. K. Rowley and F. Schneider, Eds, Kluwer Academic Press (2003): 382-386.

ii. Congleton, R. D. (2007) "Informational Limits to Democratic Public Policy: the Jury Theorem, Yardstick Competition, and Ignorance," Public Choice 132: 333-352.

iii. Meltzer, A. H. and Richard, S. F. (1981) "A Rational Theory of the Size of Government," *Journal of Political Economy* 89: 914 - 927.

iv. Besley, Timothy; and Coate, Stephen Source (1997) "An Economic Model of Representative Democracy," *Quarterly Journal of Economics* 112:85-114.

v. Becker, G. (1983) "A Theory of Competition Among Pressure Groups for Political Influence," *The Quarterly Journal of Economics* 98: 371-400.

vi. Brennan, G.; Buchanan, J. M. (1977) "Towards a Tax Constitution for Leviathan," *Journal of Public Economics* 8:255-273.

vii. McGuire, M. C. and Olson, Mancur, Jr. (1996) "The Economics of Autocracy and Majority Rule: The Invisible Hand and the Use of Force," *Journal of Economic Literature* 34:72-96.

viii. Tullock, G. (1967/95) "The Welfare Costs of Tariffs, Monopolies, and Theft," Western Economic Journal V:224-232. (reprinted in The Economic Analysis of Rent Seeking.)

ix. Laband, D. W. and Sophocleus, J. P. (1992/6) "An Estimate of Resource Expenditures on Transfer Activity in the United States," *Quarterly Journal of Economics*, reprinted in *The Economics Analysis of Rent Seeking.*

x. Congleton, R. D. And R. Bennett (1995) "On the Political Economy of State Highway Expenditures: Some Evidence of the Relative Performance of Alternative Public Choice Models," *Public Choice* 84: 1-24.

III. Public Policies and the Choice of Delivery Systems: Regulation, Taxation, and Government Production

9/21-26 Public Goods and Public Policy.

There are a number of properties of goods that are often taken for granted in economic text books. Three useful categories for public economics are: public goods, club goods, and private goods, which together create a spectrum of good types. The supply of public and club goods may suffer free rider problems, which implies that private markets tend to undersupply such goods. Pareto optimal supplies of public goods have been characterized by Samuelsonian and Lindahl, who theories are reviewed in these lectures.

Applications: national defense, clean air and water, highways, welfare, carbon taxes.

i. Samuelson, P. A. (1954) "The Pure Theory of Public Expenditure." *Review of Economics and Statistics* 36: 387-9.

ii. Buchanan, J. M. (1965) An Economic Theory of Clubs," *Economica* 32: 1-14.

iii. Ledyard, J. O. (1994) "Public Goods: A Survey of Experimental Research," Handbook of Experimental Economics also available at: http://129.3.20.41/eps/pe/papers/9405/9405003.pdf

iv. Goulder, L. H. (1995) "Environmental Taxation and the Double Dividend: A Reader's Guide," *International Tax and Public Finance* 2: 157-183.

v. Cornes, R. and T. Sandler (1996) *The Theory of Externalities, Public Goods, and Club Goods*. New York: Cambridge.

vi. Fischbacker, U., S. Gachter, and E. Fehr (2001) "Are People Conditionally Cooperative? Evidence from a Public Goods Experiment," *Economic Letters* 71: 397-404.

9/28-31 Externalities and Public Policy.

Activities that produce spillover benefits for others not directly involved in those activities tend to be produced at Pareto deficient or excessive levels. That is to say, externality problems are often said to be instances of market failures. However, some externality problems can be solved via contracts (Coase) or torts. Others may be addressed through Pigovian taxes and subsidies, regulations, and "cap and trade" systems.

Applications: national defense, clean air and water, highways, welfare, carbon taxes.

i. Pigou, A. C. (1952) *The Economics of Welfare*, 3rd edition. New York: MacMillan.

ii. Buchanan, J. M. and W. C. Stubblebine (1962) "Externality," *Economica* 29: 371-384.

iii. Goulder, L. H. (1995) "Environmental Taxation and the Double Dividend: A Reader's Guide," *International Tax and Public Finance* 2: 157-183.

iv. Cornes, R. and T. Sandler (1996) *The Theory of Externalities, Public Goods, and Club Goods*. New York: Cambridge.

10/3 - 5 Redistribution versus Social Insurance

A good deal of what looks like redistribution may actually be social insurance programs rather than pure transfers. These lectures analyze the politics of redistributive systems and that of social insurance systems. Governments can often provide insurance more efficiently

than private clubs and private firms. To account for the rapid growth of public insurance programs in post war period, however, probably requires more than an economic explanation. Adverse selection and moral hazard problems are asociated with all insurance, including that provided by governments. Are "bailouts" social insurance?

i. Hochman, H. M. and J. D. Rodgers (1969) "Pareto Optimal Redistribution," *American Economic Review* 59: 542-557.

ii. Cooter, R. And E. Helpman (1974) "Optimal Income Taxation For Transfer Payments Under Different Social Welfare Criteria," *Quarterly Journal of Economics* 88: 656-670.

iii. Hubbard, R. G., J. Skinner and S. P. Zeldes (1995) "Precautionary Saving and Social Insurance," *Journal of Political Economy*, 103: 360-99.

iv. Congleton, R. D. (2007) "On the Feasibility of a Liberal Welfare State: Agency and Exit Costs in Income Security Clubs," *Constitutional Political Economy* 18: 145-159.

v. Sefton, J., J. van de Ven, M. Weale. (2008) "Means Testing Retirement Benefits: fostering equity or discouraging savings?" The *Economic Journal* 118: 556-590.

vi. Franks, P., C. M. Clancy, and M. R. Gold (1993) "Health Insurance and Mortality. Evidence from a National Cohort." *Journal of the American Medical Association* 270:737-741.

vii. Feldstein, M. S. (1973) "The Welfare Loss of Excess Health Insurance." *Journal of Political Economy* 81: 251-280.

IV. Funding Government

10/10 - 17 On the Properties of Alternative Tax Systems

Once governments begin to provide public services (or extract rents), the question of how to finance them arises. There are many alternative ways of raising money through taxes and economists have tried to develop theories that can rank those systems. Theories of optimal taxation include: ideas of neutral taxation, Ramsay and Henry Georgian taxation (minimizing dead weight loss), Utilitarian and Contractarian theories of taxation (Buchanan and Rawls). A variety of equity (fairness) norms are often used in public debates including notions of horizontal and vertical equity, progressive, proportional, and regressive taxation.

Applications: flat taxes, consumption taxes, proportional taxes, VAT, elimination of loop holes.

i. Lindahl, E. (1958) *Just Taxation—A Positive Solution* included in Musgrave R. and A. Peacock (eds.) *Classics in the Theory of Public Finance.* New York: Macmillan.

ii. Diamond, P. A. and J. A. Mirrlees (1971) "Optimal Taxation and Public Production II: Tax Rules," *American Economic Review* 61: 261-278.

iii. Jones; L. E., R. E. Manuelli; P. E. Rossi (1993) "Optimal Taxation in Models of Endogenous Growth," *Journal of Political Economy* 101: 485-517.

iv. G. Brennan and J. M. Buchanan (1977) "Towards a Tax Constitution for Leviathan," *Journal of Public Economics* 8: 255-273.

v. Sobel, R. S. (1997) "Optimal Taxation in a Federal System of Government. *Southern Economic Journal* 64:468-485.

10/19 Principles Debt of Debt Finance

Of course, governments rarely pay for all of their services (or castles) with taxes alone. In many cases debt as well as taxes play a major role in government finance. Economists have analyzed the impact of public debt and reached a variety of conclusions, including predictions of (Ricardian) neutrality, inter-generational shifting of taxes, political biases favoring debt over taxes, Keynesian macroeconomic rationales for debts, and concern that public debt reduces (crowds out) private capital formation. Possible solutions to excessive use of debt include balanced budget rules, which are used by many state governments.

Applications: history of federal and state borrowing

i. Buchanan, J. M. (1976) "Barro on the Recardian Equivalence Theorem," *Journal of Political Economy* 84: 337-42.

ii. Buchanan, J. M. and R. E. Wagner (1977) *Democracy in Deficit: The Political Legacy of Lord Keynes*. New York: Academic Press

iii. Roubini, N., J. Sachs, S. Honkapohja, D. Cohen (1989) "Government Spending and Budget Deficits in the Industrial Countries," *Economic Policy 4:* 99-132.

iv. Congleton, R. D. (1992) "The Politics of Debt," *Journal of Public Finance and Public Choice* X.

v. Feldstein, M and D. W. Elmendorf (1993) "Government Debt, Government Spending, and Private Sector Behavior Revisited: Comment," *American Economic Review* 80: 589-599.

V. Institutions and the Effective Demand for Government Services

10/21 Central Government Decision Making and the Effective Demand for Public Services

Democratic governments are similar in that votes ultimately determine public policies, but the manner in which votes do so vary among democracies. Alternative electoral systems, bicameralism, presidential and prime ministerial institutions, all have recently been found to have systematic effects on government expenditures, taxation and debt.

i. Pommerehne, W. W. And F. Schneider (1978) "Fiscal Illusion, Political Institutions, and Local Government Spending," *Kyklos* 31: 381-408.

ii. Poterba, J. M. (1994) "State Responses to Fiscal Crises: The Effects of Budgetary Institutions and Politics," *Journal of Political Economy* 102: 799-821.

iii. Persson, T., G. Roland, G. Tabellini (1997) "Comparative Politics and Public Finance," *Journal of Political Economy* 108: 1121-1161.

iv. Hansen, J. M. (1998) "Individuals, Institutions, and Public Preferences over Public Finance," *American Political Science Review* 92: 513-531.

v. Kirchgässner, G. (2001) "The Effects of Fiscal Institutions on Public Finance: A Survey of the Empirical Evidence," *CESifo Working Paper* Series No. 617.

vi. Keen, M. and C. Kotsogiannis (2003) "Leviathan and Capital Tax Competition in Federations," *Journal of Public Economic Theory* 5: 177-99.

10/24-26 Fiscal Federalism: Fiscal Relationships Among Governments

Among the more important institutions of government are ones that determine the extent to which authority to make public policies is decentralized or not. Within federal systems authority to make public policy is distributed among many layers of governments: central, states, county, towns, etc.. Relationships among governments affect policy decisions in a variety of ways. One of the most famous of these was developed by Tiebout (1956) who suggested that competition between local governments was similar to competition in markets. Similarities also exist when governmental policies produce externalities. For example both free riding and the NIMBY problems may be associated with local government decisions.

Applications: competitive governance, race to the bottom, menu federalism, fiscal externalities.

i. Buchanan, J. M. (1950) *Federalism and Fiscal Equity. American Economic Review* 40: 583-599.
ii. Tiebout, C. M. (1956) "A Pure Theory of Local Expenditures," *Journal of Political Economy* 64: 416-424.
iii. Oates, W. E. (1972) *Fiscal Federalism.* New York: Harcourt, Brace Javonovich.
iv. Congleton, R. D., and A. Kyriacou and J. Bacaria (2003) "A Theory of Menu *Constitutional Political Economy* 14:167- 190.
v. Oates, W. E. (2005) "Toward a Second Generation of Fiscal Federalism," *International Tax and Public Finance* 12: 349-73.
vi. Mueller, D. C. (2006) in Congleton and Swedenborg (2006).

10/31 Review for Midterm

11/2 Midterm Exam (may be a take home exam)

VI. Applications to Contemporary US Policy Issues

11/7-9 The Demand and Supply of Social Insurance in the Present and Future

The last third of the course is devoted to studying contemporary policy issues. Among the most important in the US (and in many other Western democracies) is the demand for social insurance programs. What drives the demand for such services? Are those programs sustainable? If present programs are not sustainable, are there politically feasible reforms that can make them sustainable?

i. Browning, E. K. (1975) "Why the Social Insurance Budget Is Too Large in a Democracy," *Economic Inquiry.*
ii. Congleton, R. D. and W. F. Shughart (1990) "The Growth of Social Security: Electoral Push or Political Pull," *Economic Inquiry.*
iii. Tabellini, G. (2000) "A Positive Theory of Social Security," *Scandinavian Journal of Economics.*
iv. Agell, J. (2002) "On the Determinants of Labor Market Institutions: Rent Seeking versus Social Insurance," *German Economic Review.*
v. Feldstein, M. S. (2005) "Rethinking Social Insurance," *NBER* wroking paper.
vi. Congleton, R. D. and F. Bose (2010) "The Rise of the Modern Welfare State: Ideology, Institutions, and Income Security," *Public Choice* 144: 535-555.

11/14-16 Applications: Deficits and the Public Debt: Is there a Debt Crisis?

Another important issue in the US (and in many other Western democracies) is the expansion of public debt. The politics of debt sometimes appears to be intractable. Why are their periods in which debt appears to get out of hand and others in which it seems to be within sustainable limits. What drives the politics of debt creation? If present programs are not sustainable, the result may be an explosion of debt beyond that which can be sold in world markets. Are we all doomed to a Greek scenario? Why or Why not?

i. Buchanan, J. M., and R. E. Wagner (1977) *Democracy in Deficit: the Political Legacy of Lord Keynes*. New York: Academic Press.

ii. Lindbeck, A. and J. W. Weibull (1987) "Balanced Budget Redistribution as the Outcome of Political Competition," Public Choice 52: 273-297.

iii. Bohn, H. and R. P. Inman (1996) "Balanced Budget Rules and Public Deficits: Evidence from the US States," *Carnegie-Rochester Conference Series on Public Policy*.

iv. Buchanan, J. M. (1997) "The Balanced Budget Amendment: Clarifying Arguments," *Public Choice* 90: 117-138.

v. CBO director's blog:http://cboblog.cbo.gov/?m=201106

vi. GAO report: http://www.gao.gov/new.items/d07389t.pdf

11/21-23 No Class, Thanksgiving Break

11/28-30 Applications: Crisis Management and the Public Sector

In every country, there are periodic emergencies for which "we" are unprepared. How do countries engage in crisis management. Is there anything different about times of crisis? Can these differences and the policies adopted be analyzed with rational choice models? Recent US examples indclude: 9-11, Katrina, and the Financial Crisis of 2008-09.

i. Congleton, R. D. (2005) "Toward a Political Economy of Crisis Management," *Dynamics of Intervention. Advances in Austrian Economics*, Springer.

ii. The 9-11 Commission Report. (2004) National Commission on Terrorist Attacks upon the United States. (link)

iii. Congleton, R. D. (2006) "The Story of Katrina: New Orleans and the Political Economy of Catastrophe," *Public Choice* 127: 5-30.

iv. Sobel, R. S. and P. T. Leeson (2006) "The Federal Response to Hurricane Katrina: Lessons Learned," *Public Choice* 127: 55-73.

v. Congleton, R. D. (2009) "On the Political Economy of the Financial Crisis of 2008-09," *Public Choice* 140: 287-317.

12/5 Workshop for Papers

12/7 Overview of Class: Forest from the Trees

12/12 15-22 Page paper due on an applied public economics topic due

** some dates may be changed