

**Public Economics I**

WVU

Instructor: Professor Roger Congleton

Office:

Office Hours: Wednesday and Thursday: 2:30-3:30 and most other afternoons 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. (2019) *Public Finance and Public Policy, Responsibilities and Limitations of Government*. Cambridge: Cambridge University Press. (3rd Ed., paper)

<b>Grades:</b>	2 Exams	70%
	1 Final Research Paper (14-20 pages)	30%
	8 1-pagers	5%
	Marginal extra credit for class participation	(up to 5% bonus)

**Course Overview and 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, e.g. taxes and expenditures. These include government taxation, debt, and expenditures and account for between 40 and 60% of all expenditures in developed countries. Additional influence is generated by innumerable regulations that encourage or discourage various forms of economic activities. Thus, economic analyses that neglect these and other government policies with economic consequences are ignoring substantial causal elements in their analyses.

The aim of the course is to provide students with the conceptual and micro-economic tools to understand the impacts and origins of basic regulatory and fiscal policies. Students will use models and concepts from microeconomics and public choice to analyze the origins and effects of a city's, state's, or nation's fiscal and regulatory policies.

The class is delivered for the most part through conventional lectures that are based on materials linked to the "web syllabus." The lectures will use mathematical and geometric models to explore the effects of election and interest groups on public policies. The literature referred to tends to be mainly theoretical because the course aims to induce students to think systematically about political economy of contemporary well-developed economies. In most cases, the theories have been subjected to statistical and/or experimental validation, although we do not have sufficient time to focus much attention on that research.

## TENTATIVE COURSE OUTLINE

<u>Dates</u>	<u>Topics</u>	<u>Readings</u>
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### I. An Introduction to Public Economics

#### 8/17 Introduction to Public Economics AH: 1, T&S: 1-3

What is the public sector? On the nature of and many interdependencies within political economic systems. 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 economics in the West. Normative theories and public economics.

- i. Buchanan, J.M. (1949) "The Pure Theory of Government Finance: A Suggested Approach," *Journal of Political Economy* 57: 496-505.
- ii. Wagner, R. E., & Weber, W. E. (1977). Wagner's law, fiscal institutions, and the growth of government. *National Tax Journal*, 30(1), 59-68.
- iii. Congleton, R. D., & Bose, F. (2010). The rise of the modern welfare state, ideology, institutions, and income security: analysis and evidence. *Public Choice*, 144(3-4), 535-555.
- iv. Bergson, A. (1938) "A Reformulation of Certain Aspects of Welfare Economics," *Quarterly Journal of Economics* 52: 310-34.
- v. Buchanan, J. M. (1959) "Positive Economics, Welfare Economics, and Political Economy," *Journal of Law and Economics* 2: 124-38.
- vi. Buchanan, J. M. (1964). What should economists do?. *Southern Economic Journal*, 213-222.
- vii. Rawls, J. (1971/1999) *A Theory of Justice*. Cambridge: Belknap, Harvard University Press.

#### 8/22 Exogenous and Endogenous Models of Taxation

The simple net-benefit maximizing model of rational choice, efficiency of competitive markets without externalities, taxes and tax burden, externalities. Burden shifting: the distributional effects of taxes and policies. Differences in the demands for taxation in productive vs. extractive states. Anticipated effects as causal factors.

- 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
- vi. Hettich, W., & Winer, S. L. (1988). Economic and political foundations of tax structure. *The American Economic Review*, 701-712.
- vii. Olson, M. (1993). Dictatorship, democracy, and development. *American political science review*, 87(3), 567-576.

## II. Public Policies and Democracy

### 8/31 Democracy The Electoral Demand for Public Services and Taxation

Two broad models of public policy formation within democracies exist. The first stresses the role of elections and electoral competition. This literature models the state as an institution through which ordinary (moderate) citizens obtain services, that are determined for the most part through voting. 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 that takes place. A third model can be constructed by combining elements of mainstream electoral and interest group models. These lectures focus on the electoral basis of policies chosen within democracies.

- i. Samuelson, P. A. (1954). The pure theory of public expenditure. *The review of economics and statistics*, 387-389.
- ii. Downs, A. (1957). An economic theory of political action in a democracy. *Journal of Political Economy*, 65(2), 135-150.
- iii. Congleton, R. D. (2003) "The Median Voter Model," *The Encyclopedia of Public Choice*, C. K. Rowley and F. Schneider, Eds, Kluwer Academic Press pp. 382-386.
- iv. Winer, S. L. (2018). The Political Economy of Taxation: Power, Structure, Redistribution. *Oxford Handbook of Public Choice*. Oxford University Press.
- v. Meltzer, A. H. and Richard, S. F. (1981) "A Rational Theory of the Size of Government," *Journal of Political Economy* 89: 914 - 927.
- vi. Becker, G. (1983) "A Theory of Competition Among Pressure Groups for Political Influence," *The Quarterly Journal of Economics* 98: 371-400.
- vii. Brennan, G.; Buchanan, J. M. (1977) "Towards a Tax Constitution for Leviathan," *Journal of Public Economics* 8:255-273.
- viii. 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.
- ix. 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.

### 9/12 Democratic Public Policies: Redistribution via Taxation 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 associated 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.
- viii. Knight, B. (2008). Legislative representation, bargaining power and the distribution of federal funds: Evidence from the US congress. *The Economic Journal*, 118(532), 1785-1803.
- ix. Bergh, A., & Bjørnskov, C. (2014). Trust, welfare states and income equality: Sorting out the causality. *European Journal of Political Economy*, 35, 183-199.
- x. Congleton, Kim, and Marcella (2019, forthcoming) On the Stability of U.S. Politics: Post-Sample Forecasts and Refinements of the Congleton-Shughart models of Social Security and Medicare Benefit Levels. *Public Choice*.

## 9/21 Normative Theories for Choosing among 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 loopholes.

- 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.
- iii. Buchanan, J. M. (1976). Taxation in fiscal exchange. *Journal of Public Economics*, 6(1-2), 17-29.
- iv. Congleton, R. D. (2023) Optimal Tax Theory for Democracies, *Kyklos* (2023).

- v. G. Brennan and J. M. Buchanan (1977) "Towards a Tax Constitution for Leviathan," *Journal of Public Economics* 8: 255-273.
- vi. Sobel, R. S. (1997) "Optimal Taxation in a Federal System of Government." *Southern Economic Journal* 64:468-485.
- vii. Mankiw, N. G., Weinzierl, M., & Yagan, D. (2009). Optimal taxation in theory and practice. *Journal of Economic Perspectives*, 23(4), 147-74.
- viii. Scheve, K., & Stasavage, D. (2012). Democracy, war, and wealth: lessons from two centuries of inheritance taxation. *American Political Science Review*, 106(1), 81-102.
- ix. Piketty, T. (2015). About capital in the twenty-first century. *American Economic Review*, 105(5), 48-53.

## 9/28 Government Debt as Public 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. Barro, R. J. (1974). Are government bonds net wealth?. *Journal of Political Economy*, 82(6), 1095-1117.
- ii. Buchanan, J. M. (1976) "Barro on the Ricardian Equivalence Theorem," *Journal of Political Economy* 84: 337-42.
- iii. Buchanan, J. M. and R. E. Wagner (1977) *Democracy in Deficit: The Political Legacy of Lord Keynes*. New York: Academic Press
- iv. Roubini, N., J. Sachs, S. Honkapohja, D. Cohen (1989) "Government Spending and Budget Deficits in the Industrial Countries," *Economic Policy* 4: 99-132.
- v. Congleton, R. D. (1992) "The Politics of Debt," *Journal of Public Finance and Public Choice*.
- vi. Feldstein, M and D. W. Elmendorf (1993) "Government Debt, Government Spending, and Private Sector Behavior Revisited: Comment," *American Economic Review* 80: 589-599.
- vii. Reinhart, C. M., & Rogoff, K. S. (2010). Growth in a Time of Debt. *American economic review*, 100(2), 573-78.
- viii. Reinhart, C. M., Reinhart, V. R., & Rogoff, K. S. (2012). Public debt overhangs: advanced-economy episodes since 1800. *Journal of Economic Perspectives*, 26(3), 69-86.

**10/3-7 Midterm Exam (take home) (Open Notes, BUT NO AI Textbots permitted)**

## 10/12 Information Costs, Fiscal Illusion, and Electorally Driven Public Policy

One of the main challenges of public policy formation by both voters and legislatures is the problem of information and related problems associated with predicting the consequences of public policies. Some of these problems are ones associated with the limits of social science. Others are related to decisions made by individuals about how much to invest in particular types of knowledge. What an individual knows is only a subset of what is potentially knowable—and often for good reasons. Rational ignorance can easily undermine both democratic and authoritarian public policy making.

- i. Downs, A. (1960). Why the government budget is too small in a democracy. *World Politics*, 12(4), 541-563.
- ii. Stigler, G. J. (1961). The economics of information. *Journal of Political Economy*, 69(3), 213-225.
- iii. Congleton, R. D. (2001). Rational ignorance, rational voter expectations, and public policy: A discrete informational foundation for fiscal illusion. *Public Choice*, 107(1-2), 35-64.
- iv. Caplan, B. (2002). Systematically biased beliefs about economics: robust evidence of judgmental anomalies from the survey of Americans and economists on the economy. *The Economic Journal*, 112(479), 433-458.
- v. Congleton, R. D. (2007). Informational limits to democratic public policy: The jury theorem, yardstick competition, and ignorance. *Public Choice*, 132(3-4), 333-352.
- vi. Somin, I. (2016). *Democracy and political ignorance: Why smaller government is smarter*. Stanford University Press.

## 10/17 Agency Problems within Democratic Public Polities

To this point, it has been assumed that politicians follow through on their promises and that the bureaucracy is uniformly well meaning and/or incentivized. In many cases, these are reasonable assumptions as a first approximation in well-functioning competitive democracies. In such systems, the government can be thought of as “agents” of the median voter (or her moderate co voters). We now consider how interest groups inside and outside government may shift policies away from median voter interests. Interest groups can profit from policies that block entry in their markets or otherwise protect them, as with tariffs of various kinds. Bureaucracy may benefit by lobbying for policies that increase their salaries or improve their working conditions over those of their opportunity cost employment opportunities.

- i. Olson, M. (1965/2009). *The logic of collective action* (Vol. 124). Harvard University Press.
- ii. Tullock, G. (1967). The welfare costs of tariffs, monopolies, and theft. *Economic Inquiry*, 5(3), 224-232.
- iii. Stigler, G. J. (1971). The theory of economic regulation. *The Bell journal of economics and management science*, 3-21.
- iv. Niskanen, W. A. (1975). Bureaucrats and politicians. *The Journal of Law and Economics*, 18(3), 617-643.
- v. Peltzman, S. (1976). Toward a more general theory of regulation. *The Journal of Law and Economics*, 19(2), 211-240.
- vi. Tollison, R. D. (1982). Rent seeking: A survey. *Kyklos*, 35(4), 575-602.

- vii. Orden, D. (1996). Agricultural Interest Groups and the North American Free Trade Agreement. In *The political economy of American trade policy* (pp. 335-384). University of Chicago Press.
- viii. Congleton, R. D., Hillman, A. L., & Konrad, K. A. (2008). Forty years of research on rent seeking: an overview. *The Theory of Rent Seeking: Forty Years of Research*, 1, 1-42.
- ix. Aidt, T. S. (2003). Economic analysis of corruption: a survey. *The Economic Journal*, 113(491), 632-652.
- x. Congleton, R. D. (2018). The Political Economy of Rent Creation and Rent Extraction. In *The Oxford Handbook of Public Choice, Volume 1*.

### 10/24 Fiscal Federalism: Relationships among Governments and Public Policy

Until this point, we have assumed that governments operate within a single town, county, state, nation etc. and their public policies are not affected by the policy choices of others. This is the case for many domestic policies, but it is not always the case. Within federal systems, towns, counties, and states benefit from subsidies from higher levels of government and also compete with each other for such grants and for mobile sources of tax base. Their regulations and tax laws often affect neighboring governments both through competitive effects and through various types of externalities. These effects also affect public policies and the extent of economic activity within a government's territory.

- i. Tiebout, C. M. (1956). A pure theory of local expenditures. *Journal of political economy*, 64(5), 416-424.
- ii. Oates, W. E. (1972). *Fiscal Federalism*. New York: Harcourt Brace Jovanovich.
- iii. Oates, W. E. (1985) Searching for Leviathan: An Empirical Study. *American Economic Review* 75(4): 748-757.
- iv. Shleifer, A. (1985). A theory of yardstick competition. *The RAND Journal of Economics*, 319-327.
- v. Marlow, M. L. (1988). Fiscal decentralization and government size. *Public Choice*, 56(3), 259-269.
- vi. Persson, T., & Tabellini, G. (1994). Does centralization increase the size of government?. *European Economic Review*, 38(3-4), 765-773.
- vii. Kirchgässner, G., & Pommerehne, W. W. (1996). Tax harmonization and tax competition in the European Union: Lessons from Switzerland. *Journal of Public Economics*, 60(3), 351-371.
- viii. Mintz, J., & Smart, M. (2004). Income shifting, investment, and tax competition: theory and evidence from provincial taxation in Canada. *Journal of public Economics*, 88(6), 1149-1168.
- ix. Zodrow, G. R. (2003). Tax competition and tax coordination in the European Union. *International tax and public finance*, 10(6), 651-671.
- x. Inman, R. P. (2008). *The flypaper effect* (No. w14579). National Bureau of Economic Research.
- xi. Bodenstein, M., & Ursprung, H. W. (2005). Political yardstick competition, economic integration, and constitutional choice in a federation. *Public Choice*, 124(3-4), 329-352.

- xii. Hall, J. C., & Ross, J. M. (2010). Tiebout competition, yardstick competition, and tax instrument choice: Evidence from Ohio school districts. *Public Finance Review*, 38(6), 710-737.
- xiii. Congleton, R. (2014). Coercion, taxation, and voluntary association. In Martinez-Vazquez, J. & Winer, S. L. (Eds.) *Coercion and social welfare in public finance*, Cambridge UK: Cambridge University Press, 91-116.

### 10/31 International/Comparative Political Economy: Democracies

Formal and informal political institutions determine how public policies are chosen, which affects both the policies that are most likely to be adopted and thereby the effects of government finance and regulation on the economy. Including the effects of constitutional design in political-economic analysis was a major step in the process of integrating economics, politics and institutions into a single coherent field of study.

Much of this work took place in the last twenty years as empirical research by development economists found that institutions affected economic growth rates and average income levels. However, the constitutional project began as part of the public choice research program was initially a theoretical line of research. Not only do major differences between dictatorships and democracies matter, but so do minor differences among authoritarian and democratic regimes.

- i. Buchanan, J. M. and Tullock G. (1962) *The Calculus of Consent: Logical Foundations of Constitutional Democracy*. Ann Arbor: University of Michigan Press.
- ii. Crain, W. M., & Miller III, J. C. (1989). Budget process and spending growth. *Wm. & Mary L. Rev.*, 31, 1021.
- iii. Mueller, D. C. (1996). *Constitutional democracy*. Oxford University Press, USA.
- iv. Poterba, J. M. (1996). *Budget institutions and fiscal policy in the US states* (No. w5449). National Bureau of Economic Research.
- v. Congleton, R. D., & Swedenborg, B. (Eds.). (2006). *Democratic constitutional design and public policy: analysis and evidence* (p. 373). Cambridge: Mit Press.
- vi. Knack, S., & Keefer, P. (1997). Does social capital have an economic payoff? A cross-country investigation. *The Quarterly Journal of Economics*, 112(4), 1251-1288.
- vii. Persson, T., Roland, G., & Tabellini, G. (2000). Comparative politics and public finance. *Journal of political Economy*, 108(6), 1121-1161.
- viii. Doucouliagos, H., & Ulubaşoğlu, M. A. (2008). Democracy and economic growth: a meta-analysis. *American Journal of Political Science*, 52(1), 61-83.
- ix. Congleton, R. D. (2010). *Perfecting parliament: Constitutional reform, liberalism, and the rise of western democracy*. Cambridge University Press.
- x. Congleton, R. D. (2011). Why local governments do not maximize profits: on the value added by the representative institutions of town and city governance. *Public Choice*, 149(1-2), 187.
- xi. Bjørnskov, C., & Paldam, M. (2012). The spirits of capitalism and socialism. *Public Choice*, 150(3-4), 469-498.

### 11/9 International/Comparative Political Economy/International Treaties

- i. Relatively few international externalities cannot be solved by national governments acting alone because the externalities are generated by the joint effects of their



regulations. Such regulatory externalities require governments to coordinate their regulatory decisions so that unrealized gains from controlling the externalities of interest can be realized. The only method for solving such problems are self-enforcing Coasian contracts. Thus it turns out that the largest problems and the smallest problems are addressed through bargaining and agreements.

- i. Vaubel, R. (1986). A public choice approach to international organization. *Public Choice*, 51(1), 39-57.
- ii. Vaubel, R. (2006). Principal-agent problems in international organizations. *The Review of International Organizations*, 1, 125-138.
- iii. Hillman, A. L., & Katz, E. (1987). Hierarchical structure and the social costs of bribes and transfers. *Journal of public economics*, 34(2), 129-142.
- iv. Congleton, Roger D. "Political institutions and pollution control." *Review of Economics and Statistics* (1992): 412-21.
- v. Murdoch, J. C., Sandler, T., & Sargent, K. (1997). A tale of two collectives: sulphur versus nitrogen oxides emission reduction in Europe. *Economica*, 64(254), 281-301.
- vi. Knack, S., & Keefer, P. (1995). Institutions and economic performance: cross-country tests using alternative institutional measures. *Economics & Politics*, 7(3), 207-227.
- vii. Gwartney, J. D., Lawson, R. A., & Holcombe, R. G. (1999). Economic freedom and the environment for economic growth. *Journal of Institutional and Theoretical Economics (JITE)/ Zeitschrift für die gesamte Staatswissenschaft*, 643-663.
- viii. Congleton, R. D. (2020). The institutions of international treaty organizations as evidence for social contract theory. *European Journal of Political Economy*, 63, 101891.
- ix. Bernholz, P., Schneider, F., Vaubel, R., & Vibert, F. (2004). An alternative constitutional treaty for the European Union. *Public Choice*, 118(3-4), 451-468..

11/16 Forest from the Trees Lecture

11/18-26 **Thanksgiving Break / no class**

11/18-12/5 **Second Take Home Exam Due**

12/7 **Exams Returned / Paper Workshop**

12/16 **15-22 Page paper due on an applied public economics topic due midnight**

\*\* some dates may be changed because of weather or speaking engagements