

Public Finance

Instructor: Professor Roger Congleton
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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. (2003) *Public Finance and Public Policy, Responsibilities and Limitations of Government*. Cambridge: Cambridge University Press. (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%
	7 1-pagers	10%
	Marginal extra credit for class participation	(up to 5% bonus)

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 come to be in place. Public Finance studies the subset of public policies that are fiscal in nature. These include government taxation, debt, and expenditures. 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. The aim of this course is to provide students with the micro-economic tools to understand the impacts of those fiscal policies. Students will also use models and concepts from microeconomics to analyze the political pressures that generate a nation's fiscal policies.

TENTATIVE COURSE OUTLINE

<u>Dates</u>	<u>Topics</u>	<u>Readings</u>
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I. Taxation: Positive and Normative Theories

1/28	Introduction to Government Finance	AH: 1
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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

Public Goods and Externalities, the Economic Theory of Government.

Public and Private Goods, the free rider problem; Pareto optimal supply of public goods, Samuelsonian, and Lindahl Taxes; Externalities and Market Failures, Pigovian taxes, political failures.

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. 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.

2/3 **Elementary Principles of Tax Analysis**

Impact of taxes on market prices and output; marginal cost of tax revenue, deadweight loss in the long and short run; labor-leisure tradeoffs, intertemporal aspects of taxation. Impacts of subsidies on market equilibria, deadweight losses in the long and short run, conditional marginal and lump sum subsidies.

Applications: property taxes, excise taxes, head taxes, and income taxes, farm subsidies, food stamps, rent subsidies, public education, and unemployment insurance.

- i. Browning E. K. (1978) "The Burden of Taxation," *Journal of Political Economy* 86: 649-671.
- ii. Mofidi, A and J. A. Stone (1990) "Do State and Local Taxes Affect Economic Growth?" *Review of Economics and Statistics* 72: 686-691.
- iii. Fullerton, D. and D.M. Rogers (1993) *Who Bears the Lifetime Tax Burden?* Washington DC: Brookings.
- iv. Auerbach, A. J. (2005) "Who Bears the Corporate Tax? A Review of What We Know," *NBER Working Paper* No. 11686.

2/10 **Positive and Normative Theories of Taxation**

Theories of Optimal Taxation: Ramsay and Henry Georgian taxation (minimizing dead weight loss), Utilitarian: progressive and regressive taxation, neutral taxation, Contractarian theories of taxation (Buchanan and Rawls), Benefit Taxation (Lindahl), generality norms.

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.

2/17

Economic Theories of Expenditures, Redistribution, and Debt

Altruism, Ricardian neutrality, limits to inter-generational shifting of taxes, political biases favoring debt over taxes, Keynesian macroeconomics, crowding out, balanced budget amendments, redistribution

Applications: History of federal and state borrowing

- i. Roubini, N., J. Sachs, S. Honkapohja, D. Cohen (1989) "Government Spending and Budget Deficits in the Industrial Countries," *Economic Policy* 4: 99-132.
- ii. Hochman, H. M. and J. D. Rodgers (1969) "Pareto Optimal Redistribution," *American Economic Review* 59: 542-557.
- iii. Cooter, R. And E. Helpman (1974) "Optimal Income Taxation For Transfer Payments Under Different Social Welfare Criteria," *Quarterly Journal of Economics* 88: 656-670.
- iv. Feldstein, M and D. W. Elmendorf (1993) "Government Debt, Government Spending, and Private Sector Behavior Revisited: Comment," *American Economic Review* 80: 589-599.
- v. Buchanan, J. M. and R. E. Wagner (1977) *Democracy in Deficit: The Political Legacy of Lord Keynes*. New York: Academic Press.

2/24

Fiscal Federalism: Relationships between Governments

Intranational fiscal competition (the Tiebout Model and its limits). Decentralization Theorem(s). The allocation of services within a Federal polity. Regional externalities, public bads and NIMBY. International fiscal competition.

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. (2005) "Toward a Second Generation of Fiscal Federalism," *International Tax and Public Finance* 12: 349-73.
- 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. (1972) *Fiscal Federalism*. New York: Harcourt, Brace Javonovich.

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Discussion and Review for the Midterm Exam (last hour)

Study Guide

3/3 **Midterm Exam (proctored)**

3/10 **Spring Break**

3/17

The Political Demand for Government Services and Taxes, An Overview of Public Choice

The median voter model, bureaucracy as an interest group, interest groups, rent-seeking, fiscal illusion, and the jury theorem.

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

- ii. Petlzman, S. (1976) "Toward a More General Theory of Regulation," *Journal of Law and Economics* 19: 211-240.
- iii. 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.
- iv. Congleton, R. D. (2007) "Informational Limits to Democratic Public Policy: the Jury Theorem, Yardstick Competition, and Ignorance," *Public Choice* 132: 333-352.
- v. Persson, T., G. Roland, G. Tabellini (1997) "Comparative Politics and Public Finance," *Journal of Political Economy* 108: 1121-1161.

3/24 **Institutions and the Effective Demand for Government Services**

Aggregating Preferences and Intra-Governmental Bargaining. The effects of electoral systems, bicameralism, presidential and prime ministerial institutions on government expenditures, taxation and debt.

- i. Poterba, J. M. (1994) "State Responses to Fiscal Crises: The Effects of Budgetary Institutions and Politics," *Journal of Political Economy* 102: 799-821.
- ii. Hansen, J. M. (1998) "Individuals, Institutions, and Public Preferences over Public Finance," *American Political Science Review* 92: 513-531.
- iii. Kirchgässner, G. (2001) "The Effects of Fiscal Institutions on Public Finance: A Survey of the Empirical Evidence," *CEPR Working Paper Series* No. 617.
- iv. Pommerehne, W. W. And F. Schneider (1978) "Fiscal Illusion, Political Institutions, and Local Government Spending," *Kyklos* 31: 381-408.
- v. 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.

3/31** **Applications: The Public Demand for Social Insurance**

The demand for insurance, why governments can sometimes provide insurance more efficiently than private clubs and private firms, rapid growth of public insurance programs, difference between insurance and transfers, are "bailouts" social insurance? Adverse selection and moral hazard problems.

- i. 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.
- ii. Hubbard, R. G., J. Skinner and S. P. Zeldes (1995) "Precautionary Saving and Social Insurance," *Journal of Political Economy*, 103: 360-99.
- iii. Sefton, J., J. van de Ven, M. Weale. (2008) "Means Testing Retirement Benefits: fostering equity or discouraging savings?" *The Economic Journal* 118: 556-590.
- iv. 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.
- v. Feldstein, M. S. (1973) "The Welfare Loss of Excess Health Insurance." *Journal of Political Economy* 81: 251-280.

4/7 **Applications: the Demand and Supply of Public Pensions**

The median voter model and the demand for social insurance. Electoral and interest group politics: the private demand for redistribution; the demand for transfers and the cost of rent seeking.

- 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 working paper.

4/14 Applications: The Budget and Budgetary Reforms (some stories from CBO, or Tax Reform)

- i. Lindbeck, A. and J. W. Weibull (1987) "Balanced Budget Redistribution as the Outcome of Political Competition," *Public Choice* 52: 273-297.
- ii. 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*.
- iii. Buchanan, J. M. (1997) "The Balanced Budget Amendment: Clarifying Arguments," *Public Choice* 90: 117-138.
- iv. Buchanan, J. M., and R. E. Wagner (1977) *Democracy in Deficit: the Political Legacy of Lord Keynes*. New York: Academic Press.

4/21 International Organizations as Public Goods Providing Clubs

- i. Barnett, M. N. and M. Finnemore (1999) "The Politics, Power, and Pathologies of International Organizations," *International Organization*.
- ii. Vaubel, R. and T. D. Willett (1991) *The Political Economy of International Organizations, A Public Choice Approach*. Westview Press.
- iii. Fratianni, M. and J. Pattison (2007) "The Economics of International Organizations," *Kyklos*.
- iv. Congleton, R. D. (2006) "International Public Goods and Agency Problems in Treaty Organizations," *Review of International Organizations*.

4/29 Workshop for papers

5/5 Overview of Class

5/12 14-20 Page paper due on an applied public finance topic**

** date may be changed

If you are a student with a disability and you need academic accommodations, please see me and contact the disability Resource Center (DRC) at 703-993-2474. All academic accommodations must be arranged through that office.