

## **ECONOMICS 736: PUBLIC FINANCE**

### **DEPARTMENT OF ECONOMICS CORNELL UNIVERSITY SPRING 2008**

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Office Hours: M 2-3, F 11-12

#### **COURSE DESCRIPTION:**

This course provides an introduction to the field of public economics. The first part covers the basic material on public goods, externalities, local public goods, and taxation that all public economists are expected to know. With the hope of stimulating dissertation topics, the second part covers a blend of work on more niche topics and recent work on mainstream topics. The niche topics include education, transfer programs for the poor, public organization, the regulation of addictive goods, and unemployment insurance.

#### **GRADING:**

There will be a mid-term and a final. The mid-term will be held in class around the middle of the semester and will account for 40% of the grade. The final will cover both pre and post mid-term material, but will put greater weight on the latter. Both exams will be closed book.

#### **PREREQUISITES:**

The subject matter is largely theoretical and students will be assumed to have taken and mastered the first year graduate microeconomic and macroeconomic theory sequences.

#### **TEXTS AND READING:**

I have not ordered any books for the course. Comprehensive lecture notes will be provided. Some of the material in the first part of the course is covered in Mas-Colell, Whinston and Green, *Microeconomic Theory*, and Ljungqvist and Sargent, *Recursive Macroeconomic Theory*. The material in the second part is taken from journal articles.

## **COURSE OUTLINE**

### **PART I**

#### **I.1. PUBLIC GOODS**

We will begin by briefly reviewing the neoclassical theory of public goods, distinguishing excludable and non-excludable public goods, exploring the nature of market failure, and describing the idea of Lindahl equilibrium. We will then provide a brief overview of research on public goods since the development of the neo-classical theory. Topics include: mechanism design; the political economy of public good provision; the optimal provision of public goods when taxes are distortionary; and the private provision of public goods.

Mas-Colell, Andreu, Michael Whinston, and Jerry Green, *Microeconomic Theory*, Chapter 11.

#### **I.2. EXTERNALITIES**

We will begin by reviewing the basic idea of externalities and why they cause market failure. We will then discuss the Coase Theorem; the difference between price and quantity regulatory approaches to deal with externalities; and common property externalities.

Leach, John., *A Course in Public Economics*, Cambridge University Press: Cambridge, 2004. Chapters 7 and 8.

Mas-Colell, Andreu, Michael Whinston, and Jerry Green, *Microeconomic Theory*, Chapter 11.

Weitzman, Martin, "Prices vs Quantities," *Review of Economic Studies*, 1974.

#### **I.3. LOCAL PUBLIC GOODS**

We will begin by reviewing Tiebout's classic paper on local public goods and discussing the reactions to it. We will then discuss a class of Tiebout models that have proven useful for analyzing issues in state and local public finance.

Bewley, Truman, "A Critique of Tiebout's Theory of Local Public Expenditures," *Econometrica*, 1981.

Epple, Dennis, Radu Filimon and Thomas Romer, "Existence of Voting and Housing Equilibrium in a System of Communities with Property Taxes," *Regional Science and Urban Economics*, 1993.

Calabrese, Stephen, Dennis Epple, Thomas Romer and Holger Sieg, "Local Public Good Provision, Peer Effects, and Mobility," *Journal of Public Economics*, 2006.

Tiebout, Charles, "A Pure Theory of Local Public Expenditures," *Journal of Political Economy*, 1956.

#### **I.4. STATIC OPTIMAL TAXATION**

We will begin by discussing optimal commodity taxation. We derive the Many Person Ramsey Tax Rule and discuss the Production Efficiency Theorem. We will then study the non-linear taxation of income and discuss the case for commodity taxation when non-linear income taxation is possible.

Saez, Emmanuel., "Using Elasticities to Derive Optimal Tax Rates," *Review of Economic Studies*, 2001.

Salanie, Bernard., *The Economics of Taxation*, Chapters 3, 4 & 5.

## **I.5. DYNAMIC OPTIMAL TAXATION**

We will discuss: the idea of Ricardian equivalence; the tax smoothing problem; the Chamley-Judd result on capital taxation; and the problem of time inconsistency.

Atkeson, Andrew., V.V. Chari and Patrick Kehoe, "Taxing Capital Income: A Bad Idea," *Minneapolis Fed Quarterly Review*, 1999.

Barro, Robert, "On the Determination of the Public Debt," *Journal of Political Economy*, 1979.

Barro, Robert, "The Ricardian Approach to Budget Deficits," *Journal of Economic Perspectives*, 1989.

Chari, V.V. "Time Consistency and Optimal Policy Design," *Minneapolis Fed Quarterly Review*, 1988.

Chari, VV and Patrick Kehoe, "Optimal Fiscal and Monetary Policy," in *Handbook of Macroeconomics*, Volume 1C, John Taylor and Michael Woodford, Eds, North Holland, Amsterdam, 1999.

Ljungqvist, Lars and Thomas Sargent, *Recursive Macroeconomic Theory*, Chapters 10 and 15.

Lucas, Robert and Nancy Stokey, "Optimal Fiscal and Monetary Policy in an Economy without Capital," *Journal of Monetary Economics*, 1983.

## **PART II**

### **II.1. TOPICS IN PUBLIC GOODS**

We will discuss some recent papers on public goods

Anderson, Simon and Stephen Coate, "Market Provision of Broadcasting: A Welfare Analysis," *Review of Economic Studies*, 2005.

Karlan, Dean and John List, "Does Price Matter in Charitable Giving? Evidence from a Large Scale Natural Field Experiment," *American Economic Review*, 2007.

Morgan, John, "Financing Public Goods by Means of Lotteries," *Review of Economic Studies*, 2000.

### **II.2. TOPICS IN BEHAVIORAL PUBLIC ECONOMICS**

We will discuss some recent papers on the regulation of addictive goods and, more generally, on optimal policy intervention when individuals have self-control or temptation problems.

Amador, Manuel, Ivan Werning and George-Marios Angeletos, "Commitment vs. Flexibility," *Econometrica*, 2006

Becker, Gary and Kevin Murphy, "A Theory of Rational Addiction," *Journal of Political Economy*, 1988.

Bernheim, B. Douglas and Antonio Rangel, "Behavioral Public Economics: Welfare and Policy Analysis with Non-Standard Decision Makers," *NBER Working Paper 11518*, 2005.

Bernheim, B. Douglas and Antonio Rangel, "Addiction and Cue-Triggered Decision Processes," *American Economic Review*, 2004.

Gul, Faruk and Wolfgang Pesendorfer, "Harmful Addiction," *Review of Economic*

*Studies*, 2007.

Gruber, Jonathan and Botund Koszegi, "A Theory of Government Regulation of Addictive Bads: Tax Levels and Tax Incidence for Cigarette Excise Taxation," *Journal of Public Economics*, 2004.

O'Donoghue, Ted and Matthew Rabin, "Optimal Sin Taxes," *Journal of Public Economics*, 2006.

Orphanides, Athanasios and David Zervos, "Rational Addiction with Learning and Regret," *Journal of Political Economy*, 1995.

### **II.3. TRANSFER PROGRAMS FOR THE POOR**

We will briefly discuss: the case for government provision of poor support; the optimal design of cash assistance programs; the role of in-kind transfers; some implications of behavioral economics for program design; and the determinants of public generosity towards the poor.

Akerlof, George, "The Economics of Tagging as Applied to the Optimal Income Tax, Welfare Programs, and Manpower Planning," *American Economic Review*, 1978.

Besley, Timothy and Stephen Coate, "The Design of Income Maintenance Programmes," *Review of Economic Studies*, 1995.

Blackorby, Charles and David Donaldson, "Cash versus Kind, Self Selection and Efficient Transfers," *American Economic Review*, 1988.

Coate, Stephen, "Altruism, the Samaritan's Dilemma and Government Transfer Policy," *American Economic Review*, 1995.

Fang, Hanming and Dan Silverman, "On the Compassion of Time-limited Welfare Programs," *Journal of Public Economics*, 2004.

Piketty, Tomas, "Social Mobility and Redistributive Politics," *Quarterly Journal of Economics*, 1995.

Salanie, Bernard, *The Economics of Taxation*, Chapter 8.

### **II.4. EDUCATION**

We will discuss: the debate concerning vouchers vs public provision and the implications of alternative mechanisms of school finance.

Epple, Dennis and Richard Romano, "Competition between Private and Public Schools, Vouchers, and Peer-Group Effects," *American Economic Review*, 1998.

Epple, Dennis and Richard Romano, "Educational Vouchers and Cream Skimming" *NBER Working Paper #9354*, 2002.

Fernandez, Raquel and Richard Rogerson, "Public Education and Income Distribution: A Dynamic Quantitative Evaluation of Education-Finance Reform," *American Economic Review*, 1998.

Hoxby, Caroline, "Does Competition among Schools benefit Students or Taxpayers?" *American Economic Review*, 2000.

Hsieh, Chang-Tai and Miguel Urquiola, "The Effects of Generalized School Choice on Achievement and Stratification: Evidence from Chile's School Voucher Program," *Journal of Public Economics*, 2006.

Nechyba, Thomas, "Mobility, Targeting and Private School Vouchers," *American Economic Review*, 2000.

## II.5. PUBLIC ORGANIZATION

We will discuss when privatizing the provision of a public service is a good idea.

Hart, Oliver, Andrei Shleifer and Robert Vishny, "The Proper Scope of Government: Theory and an Application to Prisons," *Quarterly Journal of Economics*, 1997.

Levin, Jon and Steven Tadelis, "Contracting for Government Services: Theory and Evidence from U.S. Cities," mimeo, Berkeley, 2007.

## II.6. UNEMPLOYMENT INSURANCE

We will discuss the problem of designing unemployment insurance schemes.

Chetty, Raj, "Moral Hazard vs Liquidity in Unemployment Insurance," mimeo, Berkeley, 2007.

Ljungqvist, Lars and Thomas Sargent, *Recursive Macroeconomic Theory*, Chapter 21.

Shimer, Robert and Ivan Werning, "Liquidity and Insurance for the Unemployed," mimeo, MIT, 2007.

## II.7. TOPICS IN DYNAMIC OPTIMAL TAXATION

We will discuss: fiscal policy and growth; the dynamic Mirrlees problem; and time consistent taxation.

Barro, Robert, "Government Spending in a Simple Model of Endogenous Growth," *Journal of Political Economy*, 1990.

Barro, Robert, "Public Finance in Models of Economic Growth," *Review of Economic Studies*, 1992.

Golosov, Mikhail and Aleh Tsyvinski, "Designing Optimal Disability Insurance: A Case for Asset Testing," *Journal of Political Economy*, 2006.

Golosov, Mikhail, Aleh Tsyvinski and Ivan Werning, "New Dynamic Public Finance: A User's Guide," *NBER Macro Annual*, 2006.

Klein, Paul and Victor Rios-Rull, "Time-Consistent Optimal Fiscal Policy," *International Economic Review*, 2003.

Krusell, Per, "Time-Consistent Redistribution," *European Economic Review*, 2002.

Phelan, Christopher and Ennio Stachetti, "Sequential Equilibria in a Ramsey Tax Model," *Econometrica*, 2001.

Werning, Ivan, "Optimal Fiscal Policy with Redistribution," *Quarterly Journal of Economics*, 2007.