

Economics 426-001: Public Economics Spring 2015

Mondays and Wednesdays, 2:00-3:15 PM
Mitchell 191

Professor Scott Drewianka
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Office Hours* Mondays and Wednesdays, 3:30-5:00 PM

* The scheduled office hours are times during which I will be available to meet with students on a walk-in basis. Students who wish to meet with me at other times are invited to contact me to set up a special appointment (attendance mandatory).

Course Web Site (on D2L): <https://uwm.courses.wisconsin.edu/d2l/home/453206>.

Goals of This Course: The principal goal of this course is to introduce students to public economics. Although most of the analytical tools we will use are also used in other fields of economics, there are important differences between the economics of the public and private sectors. The course begins by analyzing the role of the government in the economy, especially the circumstances under which the government may be able to improve the efficiency of markets and the government's ability to alter the allocation of goods across people. The second major topic is deficit finance, an option that governments can employ more freely than consumers or firms. Among other things, students will learn about governmental budget accounting and its weaknesses, the economic impact of deficits in the short- and long-run, and current and future challenges in the U.S. federal budget. The third and final major topic is taxation; among other things, we will discuss incentives created by taxes, who bears the burden of taxes, the consequences of taxes for economic efficiency, and several specific applications. The course will emphasize general tools and methods of analysis, but it will also discuss them in the context of several issues that have attracted considerable current discussion.

Prerequisites: Econ 104 (Principles), Econ 301 (Intermediate Micro), and junior standing. Chapter 2 of our textbook provides a good review the most important tools from Econ 301.

Book (available at the University bookstore): The course will emphasize the material covered during lectures, but a textbook is also available as a study guide. We will also read a book specifically on U.S. government debt:

Textbook: Jonathan Gruber. *Public Finance and Public Policy*. (New York: Worth).

Optional book: Laurence J. Kotlikoff and Scott Burns. 2005. *The Coming Generational Storm: What You Need to Know about America's Economic Future* (Cambridge, MA: MIT Press).

Note: It is NOT critical to get the latest edition of the Gruber book. Homework problems will not be assigned from the textbook, so the main advantage of a newer edition is that examples are more up-to-date. Older editions are usually less expensive.

In addition, there will be a few readings from other sources, especially the following. All are available through JSTOR (<http://www.jstor.org.ezproxy.lib.uwm.edu/action/showJournals?discipline=43693394>).

1. Hayek, F. A., Sep. 1945, "The Use of Knowledge in Society." *American Economic Review* 35, 519-30.
2. Coase, Ronald H. Oct. 1960. "The Problem of Social Cost." *Journal of Law and Economics* 3, 1-44.
3. Einav, Liran, and Amy Finkelstein. Winter 2011. "Selection in Insurance Markets: Theory and Empirics in Pictures." *Journal of Economic Perspectives* 25, 115-138.

(Completely optional) Some other texts you might consider reading for a different presentation:

Harvey S. Rosen and Ted Gayer. 2008. *Public Finance*, 8th ed. (Boston: McGraw-Hill Irwin).

Neil Bruce. 2001. *Public Finance and the American Economy*, 2nd ed. (Boston: Addison-Wesley).

Joseph E. Stiglitz. 2000. *Economics of the Public Sector*, 3rd ed. (New York: W.W. Norton).

EXAM DATES: **Midterms:** March 2, April 13
 Final Exam: Tues., May 12, 12:30 – 2:30 PM (**NOTE THE SPECIAL DAY AND TIME.**)

Grading:

Undergraduates (unless fulfilling the research requirement): Grades will be based on homework (15 percent), class participation (5 percent), two midterm exams (50 percent), and the final exam (30 percent). However, your grade may be reduced for poor attendance and/or tardiness. See below for a description of each component.

Graduate students and undergraduates doing the research requirement: Grades will be based on homework (10 percent), class participation (5 percent), two midterm exams (40 percent), a final exam (25 percent), and a research paper (20 percent, including intermediate assignments and a presentation). However, your grade may be reduced for poor attendance and/or tardiness. See below for a description of each component.

1. Homework: A packet containing all of the homework assignments for the semester can be downloaded from the course D2L page: <https://uwm.courses.wisconsin.edu/d2l/le/content/453206/Home>.

The purpose of homework is not to *test* your understanding (that is what exams are for), but rather to *develop* it. This idea guides the homework policies in this class:

- a. The goal in grading homework is to reward the effort to understand, rather than immediate understanding itself. It is okay to make mistakes—sometimes you can learn a lot from them, provided you put in some thought and effort. You will thus receive full credit for any homework assignment on which you show reasonable effort to answer the questions.
- b. Because discussion promotes learning, students are encouraged to work together and discuss homework assignments. However, each student must submit assignments individually—in his or her own words—and properly acknowledge all sources and assistance received.
- c. Homework must be turned in on time. Late work will not be accepted.

2. Class Participation: Obviously, you will learn more (and probably a lot more) if you are actively involved in the class. Beyond that, your active participation will help your *classmates* learn more as well. For instance, when you ask a question in class, you identify a concern that is likely shared by many of your fellow students. Similarly, bringing up a new example in discussion will help others see how the course material can be applied in practice.

Accordingly, part of your grade will reward class participation. Everyone will start with a B on this factor, but that mark will be raised or lowered throughout the semester depending on how much you participate. (Last semester the average mark was a B+ on this part.) Since everyone will be better off if the class “stays together,” you may also receive participation credit for attending the professor’s office hours with questions about substantive material from the course.

3. Exams: There will be two midterm exams and a cumulative final exam. Each exam will test students’ understanding of course material and their ability to apply the theories to specific real-world problems. Most questions will have a “short answer” form (where the desired answer is 1-2 sentences), though some may be a bit more involved. There will be no “multiple choice” questions.

4. Paper (Only for graduate students and students completing the undergraduate research requirement): These students will be assigned a paper that will be due on the last day of class. Graduate students should see me early in the semester for instructions.

For students who wish to complete the college’s research requirement: The College now requires students to complete a research requirement in order to graduate. Junior or senior-level economics majors may complete the requirement in this class by writing a 10 to 15-page paper on an approved topic and presenting the findings. **Papers on topics that have not been approved in advance shall not be accepted.** Students seeking topics might find inspiration in the chapters of the textbook that we will not cover extensively, such as cost-benefit analysis (ch. 8), political economy (ch. 9), applied topics (chs. 14-17) or taxation (chs. 21-25). The paper will be due on the last day of class. While presentations may be made in class if time permits, it is more common to organize a symposium outside of class in which several students make their presentations in sequence.

Eligible students who so desire may earn one additional credit for this task by registering for a one-credit independent study (Econ 699). In that case the paper will be graded only for the independent study. Otherwise, students who write the paper for the research requirement without registering for an independent study will be graded using the formula for graduate students.

For a complete set of instructions and advice on this requirement, **see the handout entitled “Instructions for completing the College of Letters & Science Research Requirement.”**

TWO WARNINGS:

(A) Three intermediate assignments MUST be completed by particular deadlines in order to complete the research requirement. See the research requirement handout for details.

(B) Once the second assignment is completed (the preliminary bibliography), students will be committed to the “research requirement” grading scheme described above, even if they do not subsequently complete the paper. Accordingly, a student who submitted the preliminary bibliography but did not submit a completed paper by the last day of class would receive a score of zero for twenty percent of their semester grade.

All students who would like help with writing are encouraged to use the UWM Writing Center (Curtin 127). The Center “offers one-on-one assistance...to generate topics, conduct research, organize ideas, develop thesis statements and revise drafts...at any stage of the project.” Writing tutors are also available on a walk-in basis in the northwest corner of the first floor of the East Wing of the library. Web: www.writingcenter.uwm.edu. Phone: (414) 229-4339. E-mail: writing@uwm.edu.

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| Expected time commitment: | Class meetings and final exam: | 48 hours |
| | Homework (6 assignments @ 2 hours) | 12 hours |
| | Reading (approx 22 chapters/articles @2 hours) | 44 hours |
| | Study (approx 4 hours/week through final exam) | <u>64 hours</u> |
| | | 168 hours across the semester |

Note that this is merely an estimate for an average student; actual time is likely to vary widely across students. Graduate students may be able to devote less time to study, but both they and undergraduates completing their research requirement should plan to spend roughly 50 additional hours researching and writing their papers (see above).

Course and Departmental Policies

1. Attendance and Promptness Policy: Attendance and promptness are mandatory. Both absences and entering/exiting the class during lectures are unfair to other students: absences make it difficult to keep everyone “on the same page,” and late arrivals/early exits create a distraction.

These considerations will be factored into students’ grades. If a student misses more than three class periods, his or her grade shall be reduced by two percentage points for each additional absence. For example, a student who misses five classes will incur a penalty of 4 percentage points, which is likely to make a difference of about ½ letter grade (e.g., B instead of B+).

Students who arrive after attendance has been taken must notify the professor after the class session in order to assure that they receive credit for attending.

Absences will be excused for exceptional circumstances—such as when a student is ill, attending a funeral, or observing a religious holiday. (Vacations are NOT exceptional circumstances.) It is the student’s responsibility to inform the instructor of these circumstances at the earliest practical opportunity. Those are also the only circumstances in which a student who misses an exam will be allowed to take a makeup exam.

Important note: Due to the risk of communicable diseases, students are strongly encouraged to report illnesses via e-mail rather than in person. See also the policy below on the H1N1 virus.

2. Clarity Policy: No credit will be granted for work that is unintelligible. This includes, but not exclusively, work that is illegible, incoherently organized, or poorly worded.

3. Academic Honesty Policy: For the protection of honest students, **academic dishonesty—including all forms of cheating and plagiarism—will not be tolerated.** Violators will be reported to university administrators for disciplinary action. See the university’s web page on academic misconduct for more information: http://www4.uwm.edu/acad_aff/policy/academicmisconduct.cfm.

Permission is hereby granted for students to collaborate on all homework assignments (but not exams!), as discussed above in the section on “homework.” When students work together, each student must submit his or her assignment individually.

4. Cell Phones: To prevent disruptions and cheating, all phones should be turned off and stored during lectures and exams.

5. H1N1 Virus Preparedness: As you are undoubtedly aware, public health officials are concerned about the risk of a global pandemic caused by the H1N1 virus (“swine flu”). Since the disease is spread primarily by personal contact, the University politely asks students to refrain from shaking hands, sharing food, and other activities that could transmit the virus.

The Dean’s Office has asked that all syllabi contain the following notice: “In the event of disruption of normal classroom activities due to an H1N1 swine flu outbreak, the format for this course MAY be modified to enable completion of the course. In that event, you will be provided an addendum to this syllabus that will supersede this version.”

6. Accommodations and Other Departmental/University Policies: Information on UWM’s and the Department of Economics’ official policies on participation by students with disabilities, accommodation for religious observances, academic conduct, complaint procedures, grade appeal procedures, sexual harassment, incompletes, and other standing policies is available at <http://www.uwm.edu/Dept/SecU/SyllabusLinks.pdf> or in the Economics Department office. Students needing accommodations of any sort (e.g., for disabilities or due to religious observances) should contact me during the first two weeks of class.

Expectations and General Orientation:

- Plan to spend about 2 hours on each homework assignment. If it is taking you much longer, consider coming to my office hours or making an appointment to see if there is any way to streamline the process.
- In a typical week the course will cover roughly two to three chapters from the textbook or articles of similar length.
- Students should come to class prepared. At the least, this means skimming over your notes from the last class session, but obviously it would be better to do more—read all assignments, study your notes, identify questions you have, etc.
- Attendance and promptness are mandatory. See above.
- Please come to my office hours or make an appointment to resolve any concerns or difficulties you may have.

Course Outline

I. Introduction (Gruber, Ch. 1; see also Ch. 2 for review of Econ 301)

II. The Role of Government

- A. Advantages of a Free Market
 - 1. Pareto Efficiency and the First Welfare Theorem (Gruber, Ch. 2.3)
 - 2. Hayek's Critique: Prices as Information (Hayek, "The Use of Knowledge in Society.")
 - 3. Public Choice Theory (Gruber, Ch. 9.4)
 - 4. Excess Burden of Taxation (Gruber, Ch. 20.1)
- B. Market Failures: Situations in Which Public Involvement Might Increase Efficiency
 - 1. Missing Markets (Gruber, Chs. 5 through 7)
 - a. Externalities: Problems and Remedies
 - i. Regulation
 - ii. Pigouvian Taxation
 - iii. The Coase Theorem and Property Rights (Coase, "The Problem of Social Cost.")
 - b. Public Goods
 - c. Credit Constraints (with special application to human capital investments; Gruber, Ch. 11)
 - 2. Transactions Costs
 - 3. Strategic Behavior: Monopoly and Anti-trust Law
 - 4. Asymmetric Information (Gruber, Ch. 12; Einav and Finkelstein, "Selection...;" applications in Chs. 13-16)
 - a. Adverse Selection
 - b. Moral Hazard
 - c. Application: Insurance Markets
- C. Distributional Concerns (Gruber, Chs. 2.3 and 17)
 - 1. Second Welfare Theorem
 - 2. Applications: Social Welfare Programs

III. Deficit Finance (Gruber, Chs. 4 and 13, and Kotlikoff and Burns, *The Coming Generational Storm*.)

- A. General discussion
 - 1. Deficits versus Debts
 - 2. Deficit Accounting: Actual versus Ideal
- B. Effects of Debt
 - 1. Who Bears the Burden?
 - 2. Crowding Out
 - 3. Ricardian Equivalence
- C. The U.S. Federal Budget, Present and Future

IV. Taxation

- A. Systems of Taxation (Gruber, Ch. 18)
- B. Tax Incidence (Gruber, Ch. 19)
 - 1. Incentives and Responses to Taxation
 - 2. Who Really Bears the Burden of Taxes?
- C. Taxes and Efficiency
 - 1. Tax Evasion and Tax Avoidance
 - 2. Deadweight Loss of Taxation
 - 3. Ramsey Taxation and Equity-Efficiency Tradeoffs
- D. Applications (Optional topic, covered as time permits—Gruber, Chs. 10, 21-25)
 - 1. Property Taxes
 - 2. Taxes on Labor: Payroll and Income Taxes
 - 3. Taxes on Capital
 - 4. Tax Reform