

Public Economics I

Instructor: Professor Roger Congleton

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

Grades:	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 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 conceptual and micro-economic tools to understand the impacts of basic regulatory and fiscal policies. Students will 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 40-60% of their gross national products and influence much of the rest through their fiscal and regulatory policies. In such countries, economics cannot be fully understood without understanding both economics and politics.

The class is delivered for the most part through conventional lectures that are based on materials listed on the "web syllabus."

TENTATIVE COURSE OUTLINE

Dates _____ Topics _____ Readings

I. An Introduction to Public Economics

8/27 Introduction to Public Economics 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 economics in the West. 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.

9/3 Exogenous and Endogenous Models of the Impact of Taxation

The simple benefit-cost model of rational choice, efficiency of competitive markets without externalities, taxes and tax burden, externalities. Understanding the distributional effects of taxes and policies on firms and consumers is useful for both understanding voter incentives to favor one tax system over another and also for various normative issues. Origins of demands for taxation: productive vs. extractive states.

- 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%20Present%20and%20Future.pdf>]

- vii. Hettich, W., & Winer, S. L. (1988). Economic and political foundations of tax structure. *The American Economic Review*, 701-712.
- viii. Bush, W. C., & Mayer, L. S. (1974). Some implications of anarchy for the distribution of property. *Journal of Economic Theory*, 8(4), 401-412.
- ix. Buchanan, J. M. (1978). A contractarian perspective on anarchy. *Nomos*, 19, 29-42.
- x. Wärneryd, K. (1993). Anarchy, uncertainty, and the emergence of property rights. *Economics & Politics*, 5(1), 1-14.
- xi. Olson, M. (1993). Dictatorship, democracy, and development. *American political science review*, 87(3), 567-576.
- xii. Skaperdas, S. (1992). Cooperation, conflict, and power in the absence of property rights. *The American Economic Review*, 720-739.

II. Public Policies and Democracy: Regulation, Taxation, and Government Production

9/10 Democracy Public Policies: Public Goods, Externalities, and Taxation

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 an institution through which ordinary (moderate) citizens obtain services, 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 takes place. A third model can be constructed by combining elements of mainstream electoral and interest group models. This lecture focuses on the electoral basis of policies chosen within democracies.

- xiii. Samuelson, P. A. (1954). The pure theory of public expenditure. *The review of economics and statistics*, 387-389.
- xiv. Downs, A. (1957). An economic theory of political action in a democracy. *Journal of Political Economy*, 65(2), 135-150.
- xv. 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.
- xvi. Meltzer, A. H. and Richard, S. F. (1981) "A Rational Theory of the Size of Government," *Journal of Political Economy* 89: 914 - 927.
- xvii. Hettich, W., & Winer, S. L. (1988). Economic and political foundations of tax structure. *The American Economic Review*, 701-712.
- xviii. Besley, Timothy; and Coate, Stephen Source (1997) "An Economic Model of Representative Democracy," *Quarterly Journal of Economics* 112:85-114.
- xix. Becker, G. (1983) "A Theory of Competition Among Pressure Groups for Political Influence," *The Quarterly Journal of Economics* 98: 371-400.
- xx. Brennan, G.; Buchanan, J. M. (1977) "Towards a Tax Constitution for Leviathan," *Journal of Public Economics* 8:255-273.
- xxi. 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.

- xxii. 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.

9/17 Democratic Public Policies: 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 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*.

9/24 Democratic Policies: 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. 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.
- vi. Mankiw, N. G., Weinzierl, M., & Yagan, D. (2009). Optimal taxation in theory and practice. *Journal of Economic Perspectives*, 23(4), 147-74.
- vii. Scheve, K., & Stasavage, D. (2012). Democracy, war, and wealth: lessons from two centuries of inheritance taxation. *American Political Science Review*, 106(1), 81-102.
- viii. Piketty, T. (2015). About capital in the twenty-first century. *American Economic Review*, 105(5), 48-53.

10/1 Democratic Policies: 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
- iii. 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.

10/8 Midterm Exam

10/15 Rational Ignorance and 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.

10/22 Agency Problems and Democratic Public Policies

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 other wise 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*.

10/29 Leviathan and Dictatorship

Type of government determines the incentives of senior members of government, which in turn affects public policies. Historically, democracies are a relatively rare form of government and although they are about as common today as they have ever been, authoritarian regimes are approximately as common today as democracies. (Here there are issues in measurement and classification—under some classification schemes they are more common than democracies.) The literature on authoritarian regimes and their public policies remains somewhat sparse, although there is a good deal of evidence that dictatorships have systematically different public policies than “well functioning” democracies.

- i. Brennan, G., & Buchanan, J. M. (1977). Towards a tax constitution for Leviathan. *Journal of Public Economics*, 8(3), 255-273.
- ii. Tullock, G. (1987/2012). *Autocracy*. Springer Science & Business Media.
- 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. Bernholz, P. (1991). The constitution of totalitarianism. *Journal of Institutional and Theoretical Economics (JITE)/Zeitschrift für die gesamte Staatswissenschaft*, 425-440.
- vi. Olson, M. (1993). Dictatorship, democracy, and development. *American political science review*, 87(3), 567-576.
- vii. Knack, S., & Keefer, P. (1995). Institutions and economic performance: cross-country tests using alternative institutional measures. *Economics & Politics*, 7(3), 207-227.

- viii. 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.
- ix. Congleton, R. D., & Lee, S. (2009). Efficient mercantilism? Revenue-maximizing monopoly policies as Ramsey taxation. *European Journal of Political Economy*, 25(1), 102-114.
- x. Cheibub, J. A., Gandhi, J., & Vreeland, J. R. (2010). Democracy and dictatorship revisited. *Public choice*, 143(1-2), 67-101.

11/5 Constitutional Political Economy

Political institutions affect public policies and through those policies affect economic development for reasons discussed at the beginning of the course. Including such effects in neoclassical 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 empirically as development economists found that institutions affected economic growth rates and average income levels. However, the project began as part of the public choice research program and it began with theoretical analyses. Not only do differences between dictatorships and democracies matter, but so do differences among authoritarian regimes and democracies.

- 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.

11/12 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.

11/19 Thanksgiving Break / no class

11/26 Fiscal Federalism Continued / Paper Workshop / Review for Second Exam

12/3 Second Exam

12/10 Exams Returned / Paper Workshop / Forest from Trees Lecture

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

12/18 midnight

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