Public Expenditures and Public Choice

Econ 445, Binghamton University, Spring 2008

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Office Hours:
Tuesday: 10:30 – 12:00pm
Friday: 9:00 – 10:30am
or by appointment

Class Meetings: TTH 1:15 – 2:40pm, LH012

Textbook: **Harvey S. Rosen and Ted Gayer, *Public Finance*, 8th ed**

Course web page: http://bingweb.binghamton.edu/~fplass/econ445/

I will post homework questions, lecture summaries, announcements, and all grades on this web page. The web page also contains my student evaluations (SOOT) for the ECON 445 classes that I have taught in the last 8 years.

Content of the course:

Most of contemporary neoclassical economics deals with the behavior of individuals who are assumed to act independently of each other when they pursue their own goals. Certain goals, however, can only be achieved if there is some degree of coordination among the individuals (e.g. decisions of when to have joint events (parties etc.), provision of national defense, police and fire protection, preservation of certain resources like oil and the rainforest, definition of constitutional rights, etc.). Governments are one (but not the only) outcome of such coordinated actions.

'Public Economics' is an application of microeconomic theory to the role of government in a market-based economy, and can be divided into three broad categories:

1. *Public Expenditure*
   'Public Expenditure' deals with the efficiency and equity of the impact of public spending on various parts of the economy, and with the question of when (and why) government intervention in the market will lead to more desirable outcomes than cases in which the market yields an outcome without government interference.

2. *Public Revenue*
   'Public Revenue' deals with the efficiency and equity of various ways of raising funds to finance public expenditure. Econ 446, 'Economics of Taxation,' analyzes these topics in great detail, so we will not spend much time on them.

3. *Public Choice*
   Joint decision-making requires that individuals coordinate their behavior. 'Public choice' is an application of economic theories to political science, and it examines political behavior using tools from economics. Among other topics, Public Choice deals with voting procedures, mechanisms of inducing people to make efficient choices, and with questions of fairness and ethics regarding public decisions.

Course Requirements:

I. Prerequisites:

Econ 160, Econ 360, and Econ 366.

I strongly encourage you to take these requirements seriously. In this course we will rely very heavily on the material taught in Econ 360; be assured that you will have difficulties following the lectures and the textbook if you do not know this material reasonably well.

NOTE: Students who do not meet these requirements will be deregistered from this course by the Economics Department. It is your responsibility to adjust your schedule if you have registered for this course without fulfilling the prerequisites.

II. Grades:

Your grade will be based on **five homework assignments**, **two midterms**, and **one cumulative final exam**. The final exam will count for 40%, the two midterms will count for 25% each, and the four best homework assignments will count for 10% of your final grade.

If you are on the boundary between two grades at the end of the semester, my subjective judgment will be influenced by your class participation. While this does not mean that participation is required, it is my experience that participation is extremely helpful. The more active you are in class, the more interesting the material will become. I am always willing to spend time discussing current events that relate in one way or another to this course or economics in general. But you need to tell me what you want to discuss!

III. Two extra lectures:

Between February 18 and 29, I will be in Vienna with the *International Monetary Fund* to advise government officials from transition economies in Eastern Europe and Asia on issues of public enterprise reform and fiscal sustainability. Our TA will teach the class on February 19, and Midterm#1 will be on February 21. The two classes on February 26 and 28 are canceled.

We will make up these two classes in two evening lectures (time and room: TBA) on Wednesday, February 6 and Wednesday, February 16. These two evening lectures are mandatory, and we will discuss material that is relevant for the midterm.

IV. Exam dates:

The midterms and the final exam will be on the following days:

- Midterm 1: Thursday, February 21
- Midterm 2: Thursday, April 10
- Final Exam: Tuesday, May 13, 2:00 – 4:00pm, FA 212

Before you decide to take this course, check that your personal schedule does not conflict with these dates.

V. Missed Exams:

(1) **Midterms:** If you miss a midterm, then I will **automatically** substitute your final exam grade as the missing midterm grade.

Note:
- If you show up for a midterm and receive the question sheet, then you need to finish the midterm and the grade counts (i.e. no substitution). NO EXCEPTIONS!
- Don't take this as an invitation to skip the midterms. You might have a bad day when you take the final (e.g. because you were busy studying for other classes), and every midterm helps you to spread the risk of getting a bad grade in the course. In past semesters, most of the students who received Ds and Fs in my classes decided not to take the midterms!

(2) **Final exam:** The following is the Economics Department policy regarding make-up final exams:

ALL make-up final exams in Economics will be given **Friday, May 16 from 8:00 to 10:00 AM.** Currently all officially scheduled final exams are listed in the BUSI system - check it **NOW** for conflicts. If a conflict exists you may request a make-up exam from the instructor of **ANY** of the conflicting courses. If you choose to request a make-up exam for this course, a sign-up list to request the make-up exam will be available in class after the add/drop deadline – ask the instructor. Students ***MUST*** make their request for a make-up exam in economics **NO LATER THAN FRIDAY, February 29.**

It is **the student's responsibility** to learn from the instructor if the request has been approved. Only students who are approved may take a make-up final exam. Students who have not requested a make-up exam in an economics course by February 29 will be required to resolve conflicting exams with the instructor in one of their other courses.

Make-up final exams are approved **ONLY** for the following conditions:

- Conflicts with the **OFFICIAL** final exam schedule (e.g. exams at the same time or more than two exams within 24 hours).
- **DOCUMENTED** personal illness or family emergency.

VI. Miscellaneous

(1) Under no circumstances will I give you a passing grade in this class only because you might *need* such a grade to graduate in May. **Grades will neither be based on need nor on effort**, but solely on proofs that you understand the material.

Do not ask for "extra credit assignments" at the end of the semester if your grades are not sufficient for a C (I would have to give everybody the opportunity to earn such extra credit, in which case it would stop being "extra" credit).

The following table shows the distributions of final grades in Econ 445 during the past 8 years. Note that there is **a fair number of As** but also **several grades of C- and below**. In my experience, students who do not earn a grade of C or better either do not spend enough time on this class or have insufficient knowledge on Intermediate Microeconomics.

Grade distribution for ECON 445, Public Expenditures and Public Choice

Year	Enrollment:	A	A-	B+	B	B-	C+	C	C-	D	F	Mean
Fall 1999	39	5	5	1	6	3	3	4	4	6	2	C+ (2.45)
Fall 2000	13	4	2	1	2	0	0	0	2	1	1	B- (2.73)
Fall 2001	26	6	0	0	5	4	2	3	3	2	1	B- (2.60)
Fall 2002	34	4	2	2	4	2	6	3	9	1	1	C+ (2.46)
Fall 2003	26	4	1	1	4	1	3	5	2	5	0	C+ (2.43)
Fall 2004	35	5	3	1	5	3	2	5	3	3	3	C+ (2.49)
Spring 2005	45	9	1	6	8	4	7	6	1	1	2	B- (2.78)
Spring 2006	36	4	3	3	3	9	6	6	1	1	0	B- (2.74)
Fall 2006	19	3	1	1	4	1	2	3	0	1	3	C+ (2.38)

(2) You should consider ***not*** taking this class if

- you earned a grade below B in Econ 360 (Micro Theory). In this class we will rely heavily on the tools that are discussed in Econ 360, and you are likely to get lost if you are not familiar with them. If you have sold your book from Econ 360, you should consider buying it again!
- you are not willing to put considerable effort into the homework assignments. If you do not try to solve the questions on your own, then you will be unable to solve the problems in the exams!
- you are not interested in *Public Economics*, and simply need this class to fulfill a requirement. Some of the theories that we will discuss in this class are very complex, and you will find it difficult to muster enough energy to follow the discussions if you are not interested in the topic!

You are not likely to get a good grade in this class if one or more of these apply to you!

(3) Every semester I encounter students who do not drop my courses by the official withdrawal date (April 4), and later try to convince Academic Advising to approve a late withdrawal. Academic Advising usually does not approve these late withdrawal, and I want you to be aware that I will **not** give you an incomplete if this happens. I will only give incompletes in case of a true emergency (e.g. documented personal illness, or a documented family emergency).

(4) Academic dishonesty on an examination will result in a score of zero. NO EXCEPTIONS!

(5) Please let me know as soon as possible if you have a disability that requires special accommodation for lectures or exams. Do NOT wait until the day before the exam.

How to do well in this class:

(1) **Understand that this class is *not* a memorization course**! If you try to cram the night before the exam, you will get a crummy grade! Even if you did memorize everything that I said in class, you will not do well in this course!

Why is that? Any "facts" that you might be able to memorize will be outdated in a couple of months or years, so I consider it inappropriate to waste your valuable time with them. Instead, this course will teach you various important ***tools*** that you can apply to future economic scenarios that will be of interest to you. I want you to be able to ***understand*** and to ***apply*** these tools, and you cannot achieve this by sheer memorization but ***only through practice***.

(2) **Spend enough time on this class**! As a rule of thumb, you should spend 3 hours per week for each credit that you take. This class carries 4 credits, so you ought to plan to work on average 12 hours per week for this class. (3 hours in class, and ***9 hours outside of class***.)

(3) **Come to class regularly, and keep up with the readings!** All of the topics in this course are closely related to each other, and we will always rely on the material that we have covered early in the semester. If you miss classes without making up the missed work, you will be lost later on. The material is too complex to understand it during the day or night before an exam! Put enough effort into the homework assignments! They are not meant to torture you, but to help you to practice your economics skills, and to prepare you for the midterms and the comprehensive final.

(4) **Read the assigned readings *before* class <u>and</u> read them again *after* class; don't rely solely on your notes!** If you come to class unprepared, you are likely to get lost and bored. If you have spent some time with the material before we talk about it, you are in a much better position to identify difficult points and ask for clarification. If, on the other hand, you see the material in class for the first time, then you will spend too much time digesting the new stuff, and not enough time thinking about it. I always put a tentative outline of the upcoming class periods on the course web page, so you know what we will be talking about.

(5) **Be critical!** Don't believe the theories that we will discuss in this class only because somebody with a PhD presents them to you. I invite you to challenge my preconceptions and beliefs in the same way in which I intend to challenge your beliefs. Being critical helps you to better understand new ideas and permits you to place them within your own system of beliefs.

And most importantly:

(6) **<u>Ask questions *in class* if you don't understand something</u>**! If you have a question, it is very likely that some of your classmates have the same question, but don't dare to ask. There are ***<u>NO</u>*** stupid questions. Don't be intimidated to speak up in class. ***Your questions are necessary feedback for me*** to see if I am too fast or too slow. If nobody asks questions, I have to assume that everyone understands the material, and I will go on to the next topic.

(7) **<u>Come and talk to me if you begin to feel lost!</u>** Economics can be a bit tricky, and every semester I encounter students who are lost and too lethargic to do anything against it. Don't wait until the midterm or (even worse) until the final exam to seek for help; come as early as possible.

Tentative Course Outline:

	Relevant Chapters and Articles:
I. Introduction	
1. Introduction	Ch. 1
2. The Efficiency of Markets	Ch. 3
II. Public Expenditure Theory	
1. Externalities	Ch. 5
2. Interlude: The Burden and Excess Burden of Taxation	Ch. 15
3. Public Goods	Ch. 4
4. The Demand-Revealing Process	Tideman & Tullock (1976)
5. Club Goods and Multigovernment Public Finance	Ch. 22
III. Public Choice	
1. Individual, Jointly Voluntary, and Collective Actions	Buchanan & Tullock (1962, Ch.5)
2. The Origin of Governments	Olson (1993)
3. Bureaucracy	Ch. 6, Galiani *et al.* (2005)
4. Rent Extraction and Rent Seeking	McChesney (1987) and Coffman (1992)
5. Collective Decisions	Ch. 6
IV. Public Expenditure Programs	
1. Overview of Social Insurance	Feldstein (2005a)
2. Social Insurance I: Health Care	Ch. 9 and 10, Culter and Reber (1998)
3. Social Insurance II: Social Security	Ch. 11, Diamond and Orszag (2005), Feldstein (2005b)
4. Welfare Programs and the Redistribution of Income	Ch. 12 and 13
5. Education (*if time permits*)	TBA

- Buchanan, James and Gordon Tullock. 1962. "The Calculus of Consent."*Ann Arbor: University of Michigan Press* (On the web at http://www.econlib.org/LIBRARY/Buchanan/buchCv3Contents.html)
- Coffman, Richard. 1992. "Mud Farming and Political Extortion." *The Freeman* **42**:7.
- Culter, David and Sarah Reber. 1998. "Paying for Health Insurance: The Trade-Off between Competition and Adverse Selection." *Quarterly Journal of Economics* **113**:2, pp.433-466.
- Diamond, Peter and Peter Orszag. 2005. "Saving Social Security." *Journal of Economic Perspectives* **19**:2, pp.11-32.
- Feldstein, Martin. 2005a. "Rethinking Social Insurance." *American Economic Review* **95**:1, pp.1-24.
- Feldstein, Martin. 2005b. "Structural Reform of Social Security." *Journal of Economic Perspectives* **19**:2, pp.33-55.
- Galiani, Sebastian; Paul Gertler; Ernesto Schargrotsky. 2005. "Water for Life: The Impact of the Privatization of Water Services on Child Mortality." *Journal of Political Economy* **115**:1, pp.83-120.
- McChesney, Fred. 1989. "Extortion for Not Passing Laws Is a Political 'Big Easy.'" Wall Street Journal, 09/15/1987.
- Olson, Mancur. 1993. "Dictatorship, Democracy and Development." *American Political Science Review* **87**:3, pp. 565-576.
- Tideman, Nicolaus and Gordon Tullock. 1976. "A New and Superior Process for Making Social Choices." *Journal of Political Economy* **84**:6, pp.1145-1159.