

UNIVERSITY OF VIRGINIA

E.O. Olsen

Economics 4310 (TR 930-1045)

Fall 2016

ECONOMICS OF THE PUBLIC SECTOR

COURSE REQUIREMENTS AND OTHER USEFUL INFORMATION

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PREREQUISITE: ECON 3010 or 3110

COURSE CONTENT

In almost every country, governments play a large role in determining the levels of well-being enjoyed by its residents. In the U.S., they achieve these effects through thousands of expenditure programs and regulations and many taxes. The tax revenue and the expenditure of all levels of government in the U.S. exceed 30% of GDP. This course covers the largest areas of government activity in the U.S., namely, health, education, welfare, retirement, and to lesser extents national defense and environmental protection, and the largest taxes used to finance these activities. It discusses the justifications for government activity in each area, considers evidence on the effects of the programs covered, and uses economic theory to understand why the programs have these effects. It is particularly concerned with whether the programs have effects that are consistent with their justifications and how they can be redesigned to better achieve their goals. The course also considers briefly what types of economic outcomes should be expected from a particular type of political system that is similar to our current system. The primary purpose of the course is to develop your ability to think clearly about public policy issues. The concepts and models covered in intermediate microeconomics are heavily used in this course.

GRADES

There will be six graded take-home problems. Your best four will count 10 percent apiece of your final grade. The graded problems will be available on the course's website no later than 3:30 PM on September 13, September 20, October 11, October 25, November 8 and November 29. You will receive notification of their availability via email. They will be due at the beginning of the next lecture. Late answers will not be accepted. You may work with one other student on each problem, and you can work with a different student on different problems. If you work with another student, submit a single assignment with both names on it. If you submit a joint answer, I expect you to contribute to the work. Signing your name to an answer to which you did not contribute is an honor offense. You can also choose to work alone. I will entertain clarifying questions via email until 9:00 P.M. on the day before the problem is due. If they are truly clarifying questions, I'll provide an answer via email to all members of the class. To maintain a level playing field, I will not discuss a graded problem at any other time before the answer is due.

The midterm exam will be on September 29. It will count 20 percent of your final grade unless you have a valid reason for missing it. In this event, your final exam will count 60 percent rather than 40 percent. There will be no makeup midterm exam. Any student with a valid reason for missing the regularly scheduled midterm exam must contact me before this exam unless this is impossible.

The final exam will be on Tuesday, December 13 from 1400 to 1700. It will be comprehensive but with emphasis on the material covered after the midterm exam and will count 40 percent of your final grade unless you miss the midterm exam for a valid reason. In that case, your final exam will count 60 percent. The makeup final exam for those with a valid reason for missing the regularly scheduled final exam will be on Saturday, December 17 from 900 to 1200 unless another single time preferred by all students taking it can be found. Any student with a valid reason for missing the regularly scheduled final exam must talk with me before this exam unless this is impossible. A student who wishes to take the makeup exam due to congestion in his or her exam schedule must complete the required paperwork by the deadline. You should not take this course if you know now that you would not be able to take a makeup exam at the scheduled time, and you should not later schedule optional activities at this time. In extraordinary cases such as severe illness or injury at the time of the final and makeup exams, a later time for the final exam will be arranged.

SPECIAL ACCOMMODATIONS

Students with special needs requiring accommodations must present the appropriate paperwork from the Student Disability Access Center (SDAC) within the first two weeks of class. It is the student's responsibility to present this paperwork in a timely fashion and follow up with the instructor about the accommodations being offered.

READINGS

The readings for the class will be available in electronic form on the course's website.

I. JUSTIFICATIONS FOR GOVERNMENT ACTION

A. Invisible Hand Theorem (August 25, 30)

Frank, *Microeconomics and Behavior*, 6th ed., 2006, Chapter 16; or the chapter on economic efficiency or welfare economics toward the end of any intermediate microeconomics textbook

B. Cash v. In-Kind Grants & Equality v. Efficiency (September 1)

Olsen, "Lump-Sum Grants v. In-Kind Subsidies," online

Olsen, "Equality v. Efficiency," online

Mankiw, Defending the One Percent, *Journal of Economic Perspectives*, Summer 2013

C. Imperfectly Competitive Markets (September 6)

Frank, *Microeconomics and Behavior*, 6th ed., 2006, pp. 407-426; or the chapter on monopoly in any intermediate microeconomics textbook

D. External Effects (September 8)

Olsen, "The Simple Analytics of External Effects," *Southern Economic Journal*, January 1979

E. Public Goods (September 13, 15)

Browning and Browning, *Public Finance and the Price System*, 4th ed., 1994, pp. 26-32

Abboud and Clevstrom, "Stockholm's Syndrome," *Wall Street Journal*, August 29, 2006

F. Altruism (September 15, 20)

Olsen, "The Simple Analytics of the Externality Argument for Redistribution" in Ballabon (ed.), *Economic Perspectives: An Annual Survey of Economics*, Vol. 2, 1981

NPR, "The Charity that Gives Money to Poor People," August 23, 2013

<http://www.npr.org/sections/money/2013/08/23/214210692/the-charity-that-just-gives-money-to-poor-people>

NPR, "Cash, Cows and the Rise of Nerd Philanthropy," August 23, 2013

<http://www.npr.org/blogs/money/2013/08/23/214875696/cash-cows-and-the-rise-of-nerd-philanthropy>

The Onion, "Woman a Leading Authority on What Shouldn't Be in Poor People's Grocery Carts," May 1, 2014 <http://www.theonion.com/article/woman-a-leading-authority-on-what-shouldnt-be-in-p-35922>

II. THEORY OF POLITICAL PROCESSES (September 22, 27)

Browning and Browning, *Public Finance and the Price System*, 4th ed., 1994, pp. 64-87
Boadway and Wildasin, *Public Sector Economics*, 1984, Section 6-2(b)

III. EXPENDITURES

A. Education (October 6, 11, 13)

Stiglitz, *Economics of the Public Sector*, 3rd ed., 2000, Chapter 16

Coleman, "Private Schools, Public Schools, and the Public Interest," *The Public Interest*, Summer 1981

Hoxby, "How School Choice Affects the Achievement of Public School Students," *Choice with Equity*, ed. Paul Hill (Stanford, California: Hoover Institution Press, 2002)

B. Health (October 18, 20, 25, 27)

Gruber, *Public Finance and Public Policy*, 2011, Chapter 16

Einav and Finkelstein, "Selection in Insurance Markets: Theory and Empirics in Pictures" *Journal of Economic Perspectives*, Winter 2011

Baicker and others, “The Oregon Experiment – Effects of Medicaid on Clinical Outcomes, *New England Journal of Medicine*, May 2, 2013
 Bodenheimer, “The Oregon Health Plan – Lessons for the Nation,” *New England Journal of Medicine*, August 28, 1997
 Gruber & Holtz-Eakin, Point/Counterpoint on Massachusetts’s Health Care Reform, *Journal of Policy Analysis and Management*, Winter 2011

C. Welfare (November 1, 3, 8, 10)

Browning and Browning, *Public Finance and the Price System*, 4th ed., 1994, pp. 272-293

D. Retirement (November 15, 17)

Bruce, *Public Finance and the American Economy*, 2nd ed., 2001, pp. 253-279

IV. TAXES

A. Overview of U.S. Tax System and General Principles (November 22)

Stiglitz, *Economics of the Public Sector*, 3rd ed., 2000, pp. 451-456
 Rosen, *Public Finance*, 8th ed., 2008, pp. 304-308

B. Federal Individual Income Tax (November 29, December 1)

Rosen, *Public Finance*, 8th ed., 2008, pp. 380-409

V. OVERALL DISTRIBUTIONAL EFFECT OF GOVERNMENT (December 6)

Browning and Browning, *Public Finance and the Price System*, 4th ed., 1994, pp. 251-264
 Haskins, “Decisions that Doom the Future,” *Washington Post*, March 30, 2012

SCHEDULE

- 8/23 Overview
- 8/25 Invisible hand theorem
- 8/30 Invisible hand theorem, second theorem of welfare economics, illustrative government program leading to inefficient allocation
- 9/1 Individual prefers lump-sum grant to any other type of assistance with same cost, tradeoff between equality and efficiency
- 9/6 Monopoly leads to inefficient allocation, what is needed to make everyone better off in the presence of monopoly
- 9/8 Negative external effects
- 9/13 Necessary and sufficient conditions for efficiency with one public and one private good and two people, generalization to many people, public goods, and private goods, free rider problem
- 9/13 **GRADED PROBLEM DISTRIBUTED**
- 9/15 Goods with some characteristics of public goods, externality argument for redistribution

- 9/20 Externality argument for redistribution
- 9/20 **GRADED PROBLEM DISTRIBUTED**
- 9/22 Median voter theorem, majority voting and efficiency
- 9/27 Existence of majority voting equilibrium
- 9/29 **MIDTERM EXAM**
- 10/6 Rationales for government involvement in education and its public provision
- 10/11 Theoretical analysis of effect of public school system
- 10/11 **GRADED PROBLEM DISTRIBUTED**
- 10/13 Empirical evidence on effects of major alternatives to the current system
- 10/18 Markets for health insurance and medical care
- 10/20 Description and rationales for Medicare, Medicaid, and tax subsidies for EPHI
- 10/25 Evidence on effects of Medicare, Medicaid, and tax subsidies for EPHI
- 10/25 **GRADED PROBLEM DISTRIBUTED**
- 10/27 Defects of current programs and recent reforms
- 11/1 Overview of welfare system, rationales for welfare programs, housing assistance
- 11/3 Food stamps
- 11/8 Different types of cash assistance, indifference curve analysis of NIT
- 11/8 **GRADED PROBLEM DISTRIBUTED**
- 11/10 Market effects of NIT vs. wage subsidy, EITC, recent reforms of the welfare system
- 11/15 Overview of social security system, rationales for retirement component, effect of social security on intertemporal consumption and the capital stock
- 11/17 Effect of social security on labor earnings, social security reform proposals
- 11/22 Overview of U.S. tax system, general principles of taxation
- 11/29 Effect of income tax on labor earnings
- 11/29 **GRADED PROBLEM DISTRIBUTED**
- 12/1 Using itemized deductions to subsidize particular activities, preferential treatment of homeownership, IRS Form 1040
- 12/6 Overall effect of government on distribution of consumption
- 12/13 **FINAL EXAM** (1400-1700)
- 12/17 **MAKEUP FINAL EXAM** (900-1200)