

ECONOMICS OF THE PUBLIC SECTOR
Technical University - Varna

Instructor

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Course Description

This course covers the rationale for government provision of goods in a market economy and the effects of taxes on economic efficiency and income distribution. We will also contrast the traditional view of the role of government with the public choice school of thought. The primary emphasis is on expenditures and taxes at the state level. Prerequisite: Micro- and Macroeconomics.

Course Objectives

1. Increased students understanding and awareness of public policy.
2. Further develop student understanding of the basic concepts of economic theory.
3. Introduce students to major concepts in provision of publicly provided goods and services.
4. Introduce students to major concepts in analysis of taxation policy.
5. Develop the ability of students to critically evaluate public policy.

Course Outline

1. Introduction

The Four Questions of the Economics of Public Sector. When Should the Government Intervene in the Economy? How Might the Government Intervene? What Are the Effects of Alternative Interventions? Why Do Governments Do What They Do? Why Study Economics of the Public Sphere? Facts on Government. The Size and Growth of Government. Decentralization. Spending, Taxes, Deficits, and Debts. Distribution of Spending. Distribution of Revenue Sources. Regulatory Role of the Government. Policy Debates over Social Security, Health Care, and Education.

2. Some Theoretical Tools

Constrained Utility Maximization. Preferences and Indifference Curves. Utility Mapping of Preferences. Budget Constraints. Putting It All Together: Constrained Choice. The Effects of Price Changes: Substitution and Income Effects. Putting the Tools to Work. Equilibrium and Social Welfare. Demand Curves. Supply Curves. Equilibrium. Social Efficiency. Competitive Equilibrium Maximizes Social Efficiency. From Social Efficiency to Social Welfare: The Role of Equity. Welfare Implications of Benefit Reductions.

3. Externalities: Problems and Solutions

Externality Theory. Economics of Negative Production Externalities. Negative Consumption Externalities. Positive Externalities. Private-sector Solutions to Negative Externalities. The Solution. The Problems with Coasian Solutions. Public-sector Remedies for Externalities. Corrective Taxation. Subsidies. Regulation. Distinctions Between Price and Quantity Approaches to Addressing Externalities. Basic Model. Price Regulation (Taxes) Versus Quantity Regulation in This Model. Multiple Plants with Different Reduction Costs. Uncertainty About Costs of Reduction.

4. Externalities in Action: Environmental and Health Externalities

Global Warming. The Kyoto Treaty. Can Trading Make Kyoto More Cost-Effective? What Does the Future Hold? Application: The Montreal Protocol. The Economics of Smoking. The Externalities of Smoking. Should

We Care Only About Externalities, or Do “Internalities” Matter Also? The Economics of Other Addictive Behaviors. Drinking. Illicit Drugs. Obesity.

5. Public Goods

Optimal Provision of Public Goods. Optimal Provision of Private Goods. Optimal Provision of Public Goods. Private Provision of Public Goods. Private-sector Underprovision. Application: The Free Rider Problem in Practice. Can Private Providers Overcome the Free Rider Problem? Application: Business Improvement Districts. When Is Private Provision Likely to Overcome the Free Rider Problem? Public Provision of Public Goods. Private Responses to Public Provision: The Problem of Crowd-Out. Measuring the Costs and Benefits of Public Goods. Empirical Evidence: Measuring Crowd-Out. How Can We Measure Preferences for the Public Good?

6. Political Economy

Unanimous Consent on Public Goods Levels. Lindahl Pricing. Problems with Lindahl Pricing. Mechanisms for Aggregating Individual Preferences. Application: Direct Democracy. Majority Voting: When It Works. Majority Voting: When It Doesn't Work. Arrow's Impossibility Theorem. Restricting Preferences to Solve the Impossibility Problem. Median Voter Theory. The Potential Inefficiency of the Median Voter Outcome. Representative Democracy. Vote-Maximizing Politicians Represent the Median Voter. Assumptions of the Median Voter Model. Lobbying. Application: Farm Policy in the United States. Evidence on the Median Voter Model for Representative Democracy. Cycling in Representative Democracies. Empirical Evidence: Testing the Median Voter Model. The Political Business Cycle. Public Choice Theory: The Foundations of Government Failure. Size-Maximizing Bureaucracy. Leviathan Theory. Corruption. Application: Government Corruption. The Implications of Government Failure.

7. Education

Why Should the Government Be Involved in Education? Productivity. Citizenship. Credit Market Failures. Failure to Maximize Family Utility. Redistribution. How Is the Government Involved in Education? Free Public Education and Crowding Out. Solving the Crowd-Out Problem: Vouchers. Problems with Education Vouchers. Evidence on Competition in Education Markets. Direct Experience with Vouchers. Experience with Public School Choice. Experience with Public School Incentives. Bottom Line on Vouchers and School Choice. Measuring the Returns to Education. Effects of Education Levels on Productivity Empirical Evidence: Estimating the Return to Education and Evidence for Screening. Effect of Education Levels on Other Outcomes. The Impact of School Quality. The Role of the Government in Higher Education. Current Government Role. What Is the Market Failure and How Should It Be Addressed?

8. Social Security and Social Insurance

What Is Insurance and Why Do Individuals Value It? What Is Insurance? Why Do Individuals Value Insurance? Formalizing This Intuition: Expected Utility Model. Why Have Social Insurance? Asymmetric Information and Adverse Selection. Asymmetric Information. Example with Full Information. Example with Asymmetric Information. The Problem of Adverse Selection. Does Asymmetric Information Necessarily Lead to Market Failure? Application: Adverse Selection and Health Insurance “Death Spirals”. How Does the Government Address Adverse Selection? Other Reasons for Government Intervention in Insurance Markets. Externalities. Administrative Costs. Redistribution. Paternalism. Social Insurance Versus Self-Insurance: How Much Consumption Smoothing? Example: Unemployment Insurance. Lessons for Consumption-Smoothing Role of Social Insurance. The Problem with Insurance: Moral Hazard. Application: The Problems with Assessing Workers' Compensation Injuries. What Determines Moral Hazard? Moral Hazard Is Multidimensional. The Consequences of Moral Hazard. Putting It All Together: Optimal Social Insurance.

9. Income Distribution and Welfare Programs

Facts on Income Distribution. Relative Income Inequality. Absolute Deprivation and Poverty Rates. Application: Problems in Poverty Line Measurement. What Matters—Relative or Absolute Deprivation? Welfare Policy. Cash Welfare Programs. In-Kind Programs. The Moral Hazard Costs of Welfare Policy. Moral Hazard Effects of a Means-Tested Transfer System. Solving Moral Hazard by Lowering the Benefit Reduction Rate. The “Iron Triangle” of Redistributive Programs. Reducing the Moral Hazard of Welfare. Moving to Categorical

Welfare Payments. Using “Ordeal Mechanisms”. Application: An Example of Ordeal Mechanisms. Increasing Outside Options.

10. Taxation

Types of Taxation. Taxes on Earnings. Taxes on Individual Income. Taxes on Corporate Income. Taxes on Wealth. Taxes on Consumption. Taxation Around the World. Structure of the Individual Income Tax. Computing the Tax Base. Tax Rates and Taxes Paid. Measuring the Fairness of Tax Systems. Average and Marginal Tax Rates. Effective Versus Statutory Rates. Vertical and Horizontal Equity. Measuring Vertical Equity. Application: The Political Process of Measuring Tax Fairness. Defining the Income Tax Base. The Haig-Simons Comprehensive Income Definition. Deviations Due to Ability-to-Pay Considerations. Deviations Due to Costs of Earning Income. Application: What Are Appropriate Business Deductions? Externality/Public Goods Rationales for Deviating from Haig-Simons. Charitable Giving. Spending Crowd-Out Versus Tax Subsidy Crowd-In. Consumer Sovereignty Versus Imperfect Information. Housing. Tax Deductions Versus Tax Credits. Application: The Refundability Debate. Bottom Line: Tax Expenditures. The Appropriate Unit of Taxation. The Problem of the “Marriage Tax”. Marriage Taxes in Practice.

11. The Equity Implications of Taxation: Tax Incidence

The Three Rules of Tax Incidence. The Statutory Burden of a Tax Does Not Describe Who Really Bears the Tax. The Side of the Market on Which the Tax Is Imposed Is Irrelevant to the Distribution of the Tax Burdens. Parties with Inelastic Supply or Demand Bear Taxes; Parties with Elastic Supply or Demand Avoid Them. Reminder: Tax Incidence Is About Prices, Not Quantities. Tax Incidence Extensions. Tax Incidence in Factor Markets. Tax Incidence in Imperfectly Competitive Markets. Balanced Budget Tax Incidence. General Equilibrium Tax Incidence. Effects of a Restaurant Tax: A General Equilibrium Example. Issues to Consider in General Equilibrium Incidence Analysis.

11. Tax Inefficiencies and Their Implications for Optimal Taxation

Taxation and Economic Efficiency. Graphical Approach. Elasticity’s Determine Tax Inefficiency. Application: Tax Avoidance in Practice. Determinants of Deadweight Loss. Deadweight Loss and the Design of Efficient Tax Systems. Optimal Commodity Taxation. Ramsey Taxation: The Theory of Optimal Commodity Taxation. Inverse Elasticity Rule. Equity Implications of the Ramsey Model. Application: Price Reform in Pakistan. Optimal Income Taxes. A Simple Example. General Model with Behavioral Effects. The Structure of Optimal Income Tax Rates: A Simulation Exercise. Tax-benefit Linkages and the Financing of Social Insurance Programs. Issues Raised by Tax-benefit Linkage Analysis.

Class behavior

1. Eating in class and using phones is prohibited. Turn cell phones off before entering class. A student who has a phone that rings during class will be asked to leave.
2. Visitors are not permitted in class.
3. Students who fall asleep or disrupt class by talking excessively will be asked to leave.
4. Feel free to ask any questions during class, and after class. I encourage you to make use of my time. Please do not wait until the day of an exam to ask for my assistance.
5. As a courtesy to your classmates, make every effort to arrive at class on time.
6. Cheating will be prosecuted to the fullest extent of the University regulations.

Absences and Tardiness

1. Regular class attendance is crucial to your success in this course. If you miss a class you are responsible for any material covered during the lecture. Missing class could seriously affect your grade!

2. Students are expected to be in class on time. After the scheduled beginning of class a student will not be allowed to enter the classroom except during a class break.

3. Once class has begun students are not allowed to leave class or behave in any other manner that would be considered disruptive or distracting to fellow students.

Grading

There will be three exams during the semester; each is worth 1/3 of your final grade. The exams will consist of essay questions and graphical questions.

All exam dates, except for the final, are tentative. I have the right to reschedule the exam dates.

There will be no make-up exams or quizzes for any reason. If you miss an exam due to a documented excuse consistent with University policy, such as medical or family emergencies, then that particular exam will not count towards your final grade. That is, the missed exam will neither hurt nor benefit you. If you miss an exam and do not have a valid, documented excuse, you will receive zero points for that exam. Please note the tentative dates of the exams and plan around them.

Grade table

Points	Grade
87.00-100.00	Excellent 6
75.00-86.99	Very Good 5
62.00-74.99	Good 4
50.00-61.99	Fair 3
0.00-49.99	Poor 2

Course website

<http://www.e-litera.com/en/> - Economics of the Public Sector (Code 1472)

During the first week of the semester enrolment to the online materials will be free of charge and you will have free access till the end of the semester. Enrolment key for this period is *eps11*. Late enrolment will cost you 20 BGN, so don't miss this opportunity.

Course textbooks

David Hyman, *Public Finance: A Contemporary Application of Theory to Policy with Economic Applications*, Eighth Edition (South-Western, 2005).

Harvey Rosen and Ted Gayer, *Public Finance*, Eighth Edition (New York: McGraw-Hill/Irwin, 2007).

Jonathan Gruber, *Public Finance and Public Policy*, Second Edition (New York: Worth, 2007).

Joseph Stiglitz, *Economics of the Public Sector*, Third Edition (New York: W.W. Norton & Co., 2000).