

## Economics 503: Public Economics for Developing and Transitional Countries

Fall 2009

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Office hours:  
Tues. 1:30-3:30PM  
and by appointment

### Course description

Public economics is the branch of economics concerned with government expenditure and taxation, focusing primarily on microeconomic aspects of these activities. In this class, we will consider the expenditure side of public economics; an in-depth exploration of tax policy is offered in Econ 517 in the spring semester.

This semester's course begins with the fundamental question: what should the goal of government be? We consider how the concepts of economic efficiency, equity, and social welfare might help us answer that question. We next address the questions: what is true, and how can we tell? Here, we consider why it is so challenging to find convincing empirical evidence on questions of public policy, and begin to learn how to think critically about empirical evidence and how to distinguish more convincing evidence from less convincing evidence.

With that as background, we delve into the *market failures* that provide efficiency rationales for government intervention in the market, including externalities, public goods, imperfect competition, and asymmetric information. We also consider ways that human behavior might deviate from perfect rationality, and what that might imply for policy. Along the way, we apply these concepts to various examples of policy issues, including, among other things, the environment, education, health, infrastructure, security, social insurance, microfinance, and aid to the poor. In each case we will think about the efficiency, equity, and other rationales for government involvement, and the pros and cons of different ways of designing policies to address the problems.

We then turn to the general question of how to make the government work better, addressing questions such as the following. When is it better to have the government own and produce things, and when is it better to privatize? What are the incentives of politicians and government employees, and how does the design of political and budgetary institutions affect the degree to which they serve the public interest? How should responsibilities be divided up between the central government and local governments, and what are the advantages and disadvantages of "decentralization?" What can be done to improve the delivery of basic services? For example, how might one address problems of corruption and absenteeism?

Throughout the course, we consider examples of empirical research, and to facilitate this, we will occasionally introduce econometric tools that are particularly useful for microeconomic policy evaluation, sometimes before you learn about them in your econometrics course. One of my goals is to give you repeated practice at reading, critically evaluating, and writing about policy-relevant empirical research in economics, skills that will serve you well in your other courses and in your career.

### Course materials

There is one required text for the course: *Public Finance and Public Policy*, by Jonathan Gruber (2nd edition, Worth Publishers, 2007), which can be purchased at Water Street Books or online. The 1st edition is an acceptable substitute. Additional required readings, with many applications to developing and transitional countries, will be distributed to the class in the form of reading packets that will be made available at various times throughout the course. All of the readings aside from Gruber will also be available in electronic format on the class Blackboard web site. Students are expected to read the textbook selections and assigned articles from the reading packet before class and be prepared to discuss them on the days indicated in the syllabus. I may periodically review upcoming reading assignments and point out areas to emphasize or skip, and may modify the schedule as the semester progresses. Unless otherwise noted, all readings represent testable material.

### Class meeting time

Class meets in the CDE classroom from 11:00AM to 12:15PM. **There will be four Fridays when the class meets: September 11<sup>th</sup>, September 18<sup>th</sup> (to allow us to cancel class for Eid on Monday Sept. 21<sup>st</sup>), October 23<sup>rd</sup> (for the midterm), and November 20<sup>th</sup>.** Otherwise, class normally meets on Mondays and Wednesdays. You will be required to attend 24 classes in addition to the midterm; the three class meetings before Thanksgiving will be used to divide the class into smaller discussion group sessions, and you will only be required to attend one of these (although you are welcome to attend more).

### Course requirements

Your grade will be determined according to the following grading formula:

	CDE fellows	Undergraduates
CDE orientation problem sets and exam	10%	-
Homework assignments and class participation	10%	10%
Empirical writing assignment #1	5%	5%
Empirical writing assignment #2	15%	15%
Midterm exam, Friday October 23	30%	35%
Final exam, Friday December 18	30%	35%

- Midterm exam. The midterm will be scheduled outside of the regular class period on Friday October 23<sup>rd</sup>. The time slot and location of the exam is still being determined, but we will let you know well in advance. In the event of schedule conflict, undergraduates are welcome to re-schedule for an alternate date and time – please talk with me if that is the case.

- Final exam. The final exam is scheduled on December 18<sup>th</sup>. Further details will be provided later.
- Empirical writing assignment #1 (approximately 3 pages). The first empirical writing assignment will be an introduction to how to think and write about empirical evidence, and will ask you to discuss some empirical evidence on whether education increases productivity. A first draft will be due by 9:00am Thursday September 24<sup>th</sup>, and the final draft will be due on Monday September 28<sup>th</sup>. CDE fellows will have 30 minute individual consultations with writing instructor Betsy Burris on September 24<sup>th</sup> through September 26<sup>th</sup> to go over their first drafts, and Prof. Bakija will read 2<sup>nd</sup> draft.
- Second empirical writing assignment (approximately 8 pages). The assignment will ask you to carefully read an empirical journal article on a public economics topic that we will discuss in class, to explain the article, discuss the strengths and weaknesses of the evidence provided, explore how the lessons from this article fit into the broader economic literature on the topic, suggest a new related research idea, and/or consider the policy implications. A first draft will be due to your tutor from the writing workshop by 11am Monday December 1<sup>st</sup>, and the final draft to be read by Prof. Bakija will be due on 11am Monday December 8.

There will also be approximately 7 homework assignments. Due dates for these will be announced as the semester progresses. The first assignment (a writing exercise) will be graded by me, and the remaining homework assignments will be graded by your teaching assistant. Except for the first assignment, working on the homework assignments in groups is encouraged. However, if you work out an answer as part of a study group, be sure you understand exactly how to arrive at the answer. You must write up the answer to the problem on your own, in your own words, and of course you must each turn in your own individual problem set. Turning in an identical problem set answer to a classmate is a violation of the honor code. Late homework assignments will not be accepted, because I will be making the answers available shortly after they are handed in. I will, however, drop the lowest homework grade from your grade calculation. Except for homework #1, you may hand-write your homework if you want.

### **Teaching Assistant**

Zoe Xie <Leiyu.Xie@williams.edu> is the teaching assistant for this course. She will grade most of your homework, and will run a review session before each homework is due. Mamadou Barry <[Mamadou.D.Barry@williams.edu](mailto:Mamadou.D.Barry@williams.edu)> will also be available to provide some assistance with the course.

### **Course web page**

The course web page is available through the site: <http://blackboard.williams.edu>

### **Course schedule and reading assignments**

The schedule below lists the topics and assignments for Economics 503. Some readings come from the textbook for the course: *Public Finance and Public Policy* by Jonathan Gruber. These readings are listed as "Gruber." I have provided page references for both the 1st and 2nd editions. Other readings will be made available in printed reading packets, and in electronic format on the class Blackboard web page. You should do the assigned reading before the date that we cover the topic in class. You are required to attend 24 class sessions; you are relieved of one session in exchange for the out-of-class midterm exam.

#### **1. Friday, September 11. Economic efficiency, equity, and social welfare.**

- Gruber, Ch. 1, "The Four Questions of Public Finance" (pp. 3-11 in 2nd ed., pp. 2-9 in 1st ed.)
- Gruber, Ch. 2, "Equilibrium and Social Welfare" (pp. 43-55 in 2nd ed., pp. 41-52 in 1st ed.)
- Mankiw, N. Gregory. 2007. "The Political Philosophy of Redistributing Income," from *Principles of Microeconomics, 4th Edition*. Thomson-Southwestern, pp. 439-442.
- Weisbach, David. 2003. "Redistribution," from "Should Legal Rules be used to Redistribute Income?" *University of Chicago Law Review*. Vol. 70, pp. 440-446.

#### **2. Monday, September 14. Economic efficiency, equity, and social welfare.**

- Olken, Benjamin A. 2006. "Corruption and the Costs of Redistribution: Micro Evidence from Indonesia." *Journal of Public Economics*, Vol. 90, pp. 853-870 [Excerpt].
- Meier, Gerald M., and James E. Rauch. 2005. "Income Poverty" and "Measurement of Income Inequality," from *Leading Issues in Economic Development*, 8th ed., by, New York: Oxford University Press, pp. 27-30 and 437-439.

*Monday, September 14, 11am: Homework #1 (writing) is due. Submit electronically via Blackboard.*

#### **3. Wednesday, September 16. Empirical evidence.**

- Gruber, Ch. 3, "Empirical Tools of Public Finance"
- Ayres, Ian. 2007. "The World of Chance," from *Supercrunchers*. New York: Bantam Dell, pp. 73-80.

**4. Friday, September 18. Empirical example: does education increase productivity?**

- Gruber, Section 11.4 of Ch. 11: "Measuring the Returns to Education" (pp. 302-306 in 2<sup>nd</sup> ed., pp. 290-295 in 1<sup>st</sup> ed.).
- Psacharopoulos, George. 1991. "Economic Impact of Education" excerpted from *The Economic Impact of Education: Lessons for Policymakers*. San Francisco: ICS Press.
- Duflo, Esther. 2001. "Schooling and Labor Market Consequences of School Construction in Indonesia: Evidence from an Unusual Policy Experiment." *American Economic Review*. Vol. 91, No. 4.

[Psacharopoulos and Duflo readings are excerpts reprinted in Meier, Gerald M., and James E. Rauch, eds. 2005. *Leading Issues in Economic Development*, 8<sup>th</sup> ed., by, New York: Oxford]

*Monday, September 21: class meeting is cancelled due to Eid.*

*Monday, September 21, 4pm. Homework #2 (efficiency, equity, evidence) is due. Please submit to the main office of the CDE. We will have covered what you need to know to do this homework by Wednesday Sept. 16<sup>th</sup>, so you should be able to complete the assignment well before the due date if you want to keep your schedule free for Eid.*

**5. Wednesday, September 23. Empirical example: does education increase productivity? (continued)**

- Easterly, William. 2001. "Educated for What?" excerpted from *The Elusive Quest for Growth*, Cambridge: MIT Press, 2001, pp. 71-78 and 82-84.
- "Education Matters," by David Card, *Milken Institute Quarterly*, 4<sup>th</sup> Quarter 2002, pp. 73-77. [Excerpt]

*Thursday, September 24, 9:00am. First draft of empirical writing assignment #1, to be used in meeting with Betsy Burris, is due.*

*Thursday September 24 – Saturday September 26: individual writing consultations with Betsy Burris (for CDE fellows only).*

**6. Monday, September 28. Externalities and public goods**

- Gruber, "Externalities: Problems and Solutions," Ch. 5, Sections 5.1 to 5.3 only. (pp. 120-138 in 2<sup>nd</sup> ed., pp. 115-132 in 1<sup>st</sup> edition).
- Gruber, "Public Goods: Problems and Solutions" Ch. 7, Section 7.1 and part of 7.2 only (pp. 177-185 in 2<sup>nd</sup> ed., pp. 169-177 in 1<sup>st</sup> ed.)

*Monday, September 28, 11am. Final draft of empirical writing assignment #1, to be read by Prof. Bakija, is due.*

**7. Wednesday, September 30. Public goods; imperfect competition**

- Besley, Timothy and Maitreesh Ghatak. 2006. "Public Goods and Economic Development" from *Understanding Poverty*, Abhijit Banerjee, Roland Benabou, and Dilip Mookherjee, eds., Oxford University Press, [Excerpt, pp. 285-292].
- Stiglitz, Joseph. 2000. "Failure of Competition," "Natural Monopoly: Public Production of Private Goods," and "Regulation and Taxation (Subsidies)" from *Economics of the Public Sector*, 3rd ed., New York: W.W. Norton, 2000, pp. 77-79 and 190-198.
- *The Economist*. 2002. "The Road to Hell is Unpaved." Dec. 19.

**8. Monday, October 5. Externalities, public goods, and imperfect competition: some examples and evidence**

- Easterly, William. 2001. "Tales of Increasing Returns: Leaks, Matches, and Traps" from *The Elusive Quest for Growth*, by William Easterly, Cambridge: MIT Press, pp. 145-169.
- Miguel, Edward and Michael Kremer. 2004. "'Worms: Identifying Impacts of Intestinal Worms on Health in the Presence of Treatment Externalities.'" *Econometrica*, Vol 72, No. 1 (January). [Excerpt reprinted in Meier, Gerald M., and James E. Rauch, eds. 2005. *Leading Issues in Economic Development*, 8<sup>th</sup> ed., by, New York: Oxford University Press, pp. 225-230]

**9. Wednesday, October 7. Insurance and asymmetric information**

- Gruber, "Social Insurance," Ch. 12, Sections 12.1, 12.2, 12.5, 12.6, 12.7 and Appendix only (pp. 316-328, 337-341, 345-347 in 2<sup>nd</sup> ed., pp. 303-314, 321-325, 328-329 in 1<sup>st</sup> ed.).
- Gruber, "Moral Hazard Costs of Health Insurance for Patients" (Ch. 15 pp. 426-429 in 2<sup>nd</sup> ed., pp. 405-408 in 1<sup>st</sup> ed.).

*No class on Monday, October 12 (Fall Reading Period)*

**10. Wednesday, October 14. Applications: health insurance, credit market failure**

- Mark V. Pauly, Peter Zweifel, Richard M. Scheffler, Alexander S. Preker, and Mark Bassett. 2006. "Private Health Insurance in Developing Countries." *Health Affairs*. Vol. 25, No. 2, March / April.
- Besley, Timothy. 1994. "How Do Market Failures Justify Interventions in Rural Credit Markets?" *World Bank Research Observer*, Vol. 9, No. 1 (January) [Excerpt, pp. 29-40]
- Boudreaux, Carol, and Tyler Cowen. 2008. "The Micromagic of Microcredit." *The Wilson Quarterly*.

**11. Monday, October 19. Poverty and market failure.**

- Dercon, Stefan. 2003. "The Microeconomics of Poverty and Inequality: The Equity-Efficiency Trade-Off Revisited." in *Poverty, Inequality and Growth: Proceedings of the AFD-EUDN Conference*, pp. 135-162.
- Gruber, "Why Should the Government Be Involved in Education?" Ch. 11, Section 11.1 only (pp. 287-289 in 2nd ed., pp. 275-277 in 1st ed.)
- Aghion, Philippe, Eve Caroli, and Cecilia Garcia-Penalosa. 1999. "Inequality and Economic Growth: The Perspective of New Growth Theories." *Journal of Economic Literature*, Vol. 38, December 1999. (Excerpt pp. 1615-1619 only).

**12. Wednesday, October 21. Behavioral economics and public policy.**

- Gruber, "The Economics of Smoking," and "The Economics of Other Addictive Behaviors" Ch. 6, Sections 6.3 and 6.4 only (pp. 163-174 in 2nd ed., pp. 156-167 in 1st ed.).
- Mullainathan, Sendhil. 2005. "Development Economics through the Lens of Psychology," in Francois Bourguignon and Boris Pleskovic, eds., *Annual World Bank Conference on Development Economics 2005: Lessons of Experience*. Washington, D.C.: World Bank; Oxford and London: Oxford University Press. [Excerpt, pp. 45-57 and 67].

FRIDAY OCTOBER 23. MIDTERM EXAM.

**13. Monday, October 26. Design of anti-poverty policies.**

- van de Walle, Dominique. 1998. "Targeting Revisited" by *World Bank Research Observer*, Vol. 13, No. 2 (August), pp. 231-248.
- Son, Hyun. 2006. "Cash Transfers in Africa: An Ex-Ante Evaluation" *International Poverty Centre: Poverty in Focus*, June, pp. 11-12.

**14. Wednesday, October 28. Government production vs. private production.**

- Shleifer, Andrei. 1998. "State vs. Private Ownership." *Journal of Economic Perspectives*, Vol. 12, No. 4 (Autumn), pp. 135-150.
- Birdsall, Nancy, and John Nellis. 2003. "Winners and Losers: Assessing the Distributional Impact of Privatization," *World Development* Vol. 31, No. 10, pp. 1617-1633.

**15. Monday, November 2. Fixed effects; empirical evidence on privatization.**

- Stock, James, and Mark Watson. 2002. "Regression with Panel Data" Ch. 8 from *Introduction to Econometrics*. Boston: Addison Wesley, pp. 271-290.
- Galiani, Sebastian, Paul Gertler, and Ernesto Schargrotsky. 2005. "Water for Life: The Impact of Privatization of Water Services on Child Mortality in Argentina." *Journal of Political Economy*. Vol. 113, No. 1. [Excerpt reprinted in Meier, Gerald M., and James E. Rauch, eds. 2005. *Leading Issues in Economic Development*, 8<sup>th</sup> ed., by, New York: Oxford University Press, pp. 343-352.]

**16. Wednesday, November 4. Instrumental variables.**

- Murray, Michael P. 2006. "Avoiding Invalid Instruments and Coping with Weak Instruments." *Journal of Economic Perspectives*. Vol. 20, No. 4 (Fall). [Excerpt, pp. 111-120].
- Fisman, Raymond and Edward Miguel. 2008. "Rainfall" and "Feast, Famine, and Africa's Legacy of Violence," from *Economic Gangsters*, Princeton: Princeton University Press, pp. 120-127.

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**17. Monday, November 9. Applications of instrumental variables: evidence on competition, public vs. private production, and school quality**

- Gruber, Ch. 11, "How is the Government Involved in Education" and "Evidence on Competition in Education Markets" (pp. 289-302 in 2nd ed., pp. 277-290 in 1st ed.)
- Bettinger, Eric. 2005. "Lessons from Private-School Vouchers in Colombia." *Federal Reserve Bank of Cleveland Proceedings*, November.
- Hoxby, Caroline. 1998. "What Do America's 'Traditional' Forms of School Choice Teach Us about School Choice Reforms?" *Federal Reserve Board of New York Economic Policy Review*, March 1998 [Excerpt, p. 48 and pp. 51-53]

**18. Wednesday, November 11. Applications of instrumental variables: evidence on competition, public vs. private production, and school quality (continued)**

- Hsieh, Chang-Tai, and Miguel Urquiola. 2006. "The Effects of Generalized School Choice on Achievement and Stratification: Evidence from Chile's Voucher Program." *Journal of Public Economics*. Vol. 90, pp. 1477-1503.

**19. Monday, November 16. Improving basic public service delivery: addressing absenteeism and corruption**

- Banerjee, Abhijit and Esther Duflo. 2006. "Addressing Absence," *Journal of Economic Perspectives*, Vol. 20, No. 1 (Winter) pp. 117-132.
- Fisman, Raymond and Edward Miguel. 2008. "Learning to Fight Economic Gangsters," from *Economic Gangsters*, Princeton: Princeton University Press. [Excerpt, pp. 186-191 and 196-199.]

**20. Wed. Nov. 18, Friday Nov. 20, and Mon. Nov. 23. Discussion of empirical journal articles.**

On each of these dates, we will discuss some empirical journal articles on public economics topics. You must choose to attend at least one of the sessions, and then you will have to complete a writing assignment where you take one of the empirical research papers and explain its identification strategy, consider the strengths and weaknesses of the evidence presented, and then discuss the policy implications or ideas for further research. The exact papers to be discussed on each of these dates will be announced later.

*Wednesday November 25: No class (Thanksgiving Break)*

**21. Monday, November 30. Political economy I**

- Gruber, Ch. 9, "Political Economy" (pp. 223-244 and pp. 249-253 in 2nd ed., pp. 215-237 and pp. 240-244 in 1st ed.).
- *The Economist*. 2000. "Out of Anarchy," Feb. 17.

*Monday, November 30: First draft of empirical writing assignment #2, to be read by writing tutor, is due.*

**22. Wednesday, December 2. Political economy II**

- Rosen, Harvey. 2005. "Log-rolling" and "Rent-Seeking" excerpted from *Public Finance*, 7th ed., New York: McGraw-Hill, pp. 118-120 and 129-132.
- Hoff, Karla, and Joseph Stiglitz. 2001. "Rational Expectations and Political Barriers to Development." Excerpted from "Modern Economic Theory and Development" in *Frontiers of Development Economics*, Oxford: Oxford University Press, pp. 423-425.
- Easterly, William. 2001. "Polarized Peoples," from *The Elusive Quest for Growth*, Cambridge: MIT Press, pp. 255-281.

**23. Monday, December 7. Decentralization**

- Gruber, "Optimal Fiscal Federalism" Ch. 10, Section 10.2 only (pp. 262-270 in 2nd ed., pp. 251-258 in 1st ed.).
- Bardhan, Pranab. 2002. "Decentralization of Governance and Development." *Journal of Economic Perspectives*, Vol. 16, No. 4 (Fall), pp. 185-205.

*Monday, December 7: Second draft of empirical writing assignment #2, to be read by Prof. Bakija, is due.*

**24. Wednesday, December 9. Design of institutions to address political economy problems**

- Von Hagen, Jurgen. 2005. "Budgeting Institutions and Public Spending." in Anwar Shah, ed., *Fiscal Management*. Washington DC: The World Bank, pp. 1-29.
- Beaulier, Scott A., and J. Robert Subrick. 2007. "Mining Institutional Quality: How Botswana Escaped the Natural Resource Curse." *Indian Journal of Economics and Business*, Special Issue, pp. 55-68.