

Economics 503: Public Economics for Developing and Transitional Countries

Fall 2010

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

Course description

Public economics (also known as “public finance”) is the branch of economics concerned with government expenditure and taxation, focusing primarily on microeconomic aspects of these activities. In this class, we will mainly 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 by laying out a general theoretical and empirical framework for thinking about public economics issues. Among the questions we address in this part of the course include: what should the goals of government be? What do “economic efficiency,” “equity,” and “social welfare” mean, how can these concepts help us think clearly about policy issues, and what are the philosophical disputes over these concepts? Why it is so challenging to find convincing empirical evidence on questions of public policy, and how can one learn to think critically about empirical evidence and to begin 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? How can we get good evidence on the benefits and costs of proposed government policies, in order to help government better allocate its scarce resources? What are the incentives of politicians and government employees, and how does the design of political 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 (3rd edition, Worth Publishers, 2010), which can be purchased at Water Street Books or online. The 1st and 2nd editions are acceptable substitutes (the reading list below includes page references for all three editions). 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 "Glow" 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. Each week I will e-mail you a guide to the next week's readings, including a set of discussion questions to help you prepare for class. Depending on how things go, as the semester progresses, I may modify when we cover certain readings, or skip some, or tell you to emphasize some parts of the reading and skim others -- I will make this clear in the weekly e-mail guides. All readings represent testable material; my e-mail guides to the readings and what I cover in class will be good guides to what you need to know about the readings for the exam.

Class meeting time

During the first week of classes, our class will meet on Wednesday September 8th, 9:55AM-11:10AM; after the first week, our regular class meeting time is Tuesday and Thursday, 9:55AM-11:10 AM. I may need to re-schedule the class meeting currently scheduled for Thursday October 28th; if this becomes necessary, I will address it later in the semester.

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, Tuesday October 26	30%	35%
Final exam (day and time to be announced)	30%	35%

- Midterm exam. The midterm will be held on Tuesday October 26th, in the evening so that you can have extra time (I currently plan to cancel the regular class meeting that day in exchange). The exact 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 some time between December 13th and December 20th. Further details will be provided later.
- Empirical writing assignment #1 (approximately 5 double-spaced 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 9:55am Thursday September 23rd, and the final draft will be due by 9:55am Tuesday September 28th. CDE fellows will have 30 minute individual consultations with writing instructor Betsy Burriss some time on September 23rd, 24th or 25th to go over their first drafts (undergraduates should arrange to have a tutor at the Writing Workshop go over their first draft). Prof. Bakija will read the final draft.
- Empirical writing assignment #2 (approximately 8 double-spaced pages). The assignment will ask you to choose one of three empirical journal articles on public economics topics that I will make available to you, read the article carefully, attend a small discussion group meeting on the article (which will replace one regular class period), and then write a paper that discusses the strengths and weaknesses of the evidence provided in the paper, explores how the lessons from this article fit into the broader economic literature and policy debate on the topic, suggest a new related research idea, and/or consider the policy implications. You will submit a first draft through Glow, and another copy to your tutor from the writing workshop, by 4:00pm Monday November 29th. The final draft to be read by Prof. Bakija must be submitted through Glow by 4:00pm Monday December 6th.

- There will also be approximately six homework assignments. Due dates for these will be announced as the semester progresses. The homework assignments will be graded by your teaching assistant. 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 completely on your own, in your own words, and of course you must each turn in your own individual homework. Turning in an identical homework assignment as 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 drop the lowest homework grade from your grade calculation, which should take care of legitimate excuses. You may hand-write your homework if you want, it is not necessary to type it.

Teaching Assistant

Diego Ontaneda <Diego.M.Flores@williams.edu> is the teaching assistant for this course. He will grade most of your homework, and will run a review session before each homework is due.

Course web page

The course web page is available through the site: <http://glow.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 the 1st, 2nd, and 3rd editions. Other readings will be made available in printed reading packets, and in electronic format on the class "Glow" web page. You should do the assigned reading before the date that we cover the topic in class.

1. Wednesday, September 8.

Introduction; Theoretical tools of public economics. {23 pages}

- Gruber, Ch. 1, "The Four Questions of Public Finance" (pp. 3-10 in 3rd ed., pp. 3-11 in 2nd ed., pp. 2-9 in 1st ed.)
- Gruber, Ch. 2, "Equilibrium and Social Welfare" (pp. 43-55 in 3rd ed., pp. 43-55 in 2nd ed., pp. 41-52 in 1st ed.)

2. Tuesday, September 14.

Empirical tools of public economics. {34 pages}

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

3. **Thursday, September 16.**

Empirical example: does education increase productivity? {13 pages}

- Gruber, Section 11.4 of Ch. 11: "Measuring the Returns to Education" (pp. 307-311 in 3rd ed., pp. 302-306 in 2nd ed., pp. 290-295 in 1st ed.). [Note: Gruber does a better job of explaining Duflo's study in the 3rd edition; I've posted a scan of the 3rd edition version of his explanation on Glow].
- Psacharopoulos, George. 1991. "Economic Impact of Education" from *The Economic Impact of Education: Lessons for Policymakers*. San Francisco: ICS Press. [Excerpt reprinted in Meier, Gerald M., and James E. Rauch, eds. 2005. *Leading Issues in Economic Development*, 8th ed., New York: Oxford, pp. 189-193.]
- 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. [Excerpt reprinted in Meier, Gerald M., and James E. Rauch, eds. 2005. *Leading Issues in Economic Development*, 8th ed., New York: Oxford, pp. 198-200.]

4. **Tuesday, September 21.**

Empirical example: does education increase productivity? (continued) {16 pages}

- 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*, 4th Quarter 2002, pp. 73-77. [Excerpt]

5. **Thursday, September 23.**

Social welfare, theories of distributive justice, and the equity-efficiency tradeoff {25 pages}

- 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.
- Olken, Benjamin A. 2006. "Corruption and the Costs of Redistribution: Micro Evidence from Indonesia." *Journal of Public Economics*, Vol. 90 [Excerpt, pp. 853-862 and 864-867]. Note: you can skim pp. 853-862; focus mainly on 864-867.

Thursday, September 23. First draft of empirical writing assignment #1 is due through Glow by the beginning of class. This will be used in your meeting with Betsy Burris.

Thursday September 23 – Saturday September 25: individual writing consultations with Betsy Burris (for CDE fellows only). Undergraduates should arrange for a writing tutor at the Writing Workshop to look over their initial draft.

6. Tuesday, September 28.

Externalities and public goods {25 pages}

- Gruber, "Externalities: Problems and Solutions," Ch. 5, Sections 5.1 to 5.3 only. (pp. 121-137 in 3rd ed., pp. 120-138 in 2nd ed., pp. 115-132 in 1st ed.).
- Gruber, "Public Goods: Problems and Solutions" Ch. 7, Section 7.1 and "Free Rider" part of 7.2 only (pp. 181-189 in 3rd ed., pp. 181-185 in 2nd ed., pp. 169-177 in 1st ed.)

Tuesday, September 28. Final draft of empirical writing assignment #1, to be read by Prof. Bakija, is due at the beginning of class.

7. Thursday, September 30.

Externalities and public goods: examples {32 pages}

- 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. 285-288].
- Gruber, "Why Should the Government Be Involved in Education?" Ch. 11, Section 11.1 only (pp. 292-294 in 3rd ed., pp. 287-289 in 2nd ed., pp. 275-277 in 1st ed.)
- 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.

8. Tuesday, October 5.

Imperfect competition {18 pages}

- 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.

9. Thursday, October 7.

Insurance and asymmetric information {20 pages}

- Gruber, "Social Insurance," Ch. 12, Sections 12.1-12.3, 12.5-12.7 and Appendix only (pp. 321-337, 342-347, 350-352 in 3rd ed., pp. 316-331, 337-341, 345-347 in 2nd ed., pp. 303-316, 321-325, 328-329 in 1st ed.).
- Gruber, "Moral Hazard Costs of Health Insurance for Patients" (Ch. 15, p. 433-436 in 3rd ed., pp. 426-429 in 2nd ed., pp. 405-408 in 1st ed.).

No class on Tuesday, October 12 (Fall Reading Period)

10. Thursday, October 14.

Insurance (and lack thereof) in developing and transition economies {25 pages}

- Pauly, Mark V., 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, pp. 369-379.
- Lavoie, Amy. 2009. "Mexican Program Successful at Reducing Crippling Health Care Costs." *Harvard Science*, April 7.
<<http://harvardscience.harvard.edu/medicine-health/articles/mexican-program-successful-reducing-crippling-health-care-costs>>
- Dercon, Stefan. 2003. "Risk and Poverty Traps," Excerpted from "The Microeconomics of Poverty and Inequality: The Equity-Efficiency Trade-Off Revisited." in *Poverty, Inequality and Growth: Proceedings of the AFD-EUDN Conference*, [pp. 152-160]
- Maccini, Sharon, and Dean Yang. 2009. "Under the Weather: Health, Schooling, and Economic Consequences of Early-Life Rainfall." *American Economic Review* Vol. 99, no. 3. [Excerpt, pp. 1006-1007].

11. Tuesday, October 19.

Credit market failure {29 pages}

- Besley, Timothy. 1994. "How Do Market Failures Justify Interventions in Rural Credit Markets?" *World Bank Research Observer*, Vol. 9, No. 1 (January) [Excerpt, selected portions of pp. 31-36 and 37-40]
- Banerjee, Abhijit, and Esther Duflo. 2010. "Giving Credit Where It Is Due." *Journal of Economic Perspectives*. Vol. 24, No. 3 (Summer). [Excerpt, pp. 62-74]
- Dercon, Stefan. 2003. "Credit Market Failure and the Poor," Excerpted from "The Microeconomics of Poverty and Inequality: The Equity-Efficiency Trade-Off Revisited." in *Poverty, Inequality and Growth: Proceedings of the AFD-EUDN Conference*, [pp. 139-147].

12. Thursday, October 21.

Behavioral economics and public policy. {21 pages}

- Gruber, "The Economics of Smoking," Ch. 6, Section 6.3 (pp. 165-172 in 3rd ed., pp. 163-171 in 2nd ed., pp. 156-164 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].

13. Tuesday, October 26. (Evening)

MIDERM EXAM

14. Thursday, October 28*

Design of aid to the poor {22 pages}

- van de Walle, Dominique. 1998. "Targeting Revisited" by *World Bank Research Observer*, Vol. 13, No. 2 (August), pp. 231-246.
- Hanlon, Joseph, Armando Barrientos, and David Hulme. 2010. "Cash Does Not Make People Lazy" Excerpted from *Just Give Money to the Poor*, Kumarian Press, pp. 73-78.

*** Note: I might need to re-schedule the Oct. 28th class meeting to another day. If so, I will let you know in advance and will work to find an alternative time and day, probably outside the normal class meeting time, to meet.**

15. Tuesday, November 2.

Fixed effects {24 pages}

- Stock, James and Mark Watson. 2007. "Regression with Panel Data." Ch. 10 from *Introduction to Econometrics*, 2nd ed. Boston: Pearson Education, pp. 349-372.

16. Thursday, November 4.

Government production vs. private production. {27 pages}

- Shleifer, Andrei. 1998. "State vs. Private Ownership." *Journal of Economic Perspectives*, Vol. 12, No. 4 (Autumn), [Excerpt, pp. 135-144.]
- 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*, 8th ed., by, New York: Oxford University Press, pp. 343-352.]
- Nellis, John, Rachel Menezes, and Sarah Lucas. 2004. "Privatization in Latin America: The Rapid Rise, Recent Fall, and Continuing Puzzle of a Contentious Economic Policy." *Center for Global Development Policy Brief*. Vol. 3, Issue 1 (January), pp. 1-7.

17. Tuesday, November 9.

Instrumental variables. {35 pages}

- Stock, James and Mark Watson. 2007. "Instrumental Variables Regression." Ch. 12 from *Introduction to Econometrics*, 2nd ed. Boston: Pearson Education, pp. 421-456.

18. Thursday, November 11.

Applications of instrumental variables: evidence on competition, public vs. private production, and school quality {22 pages}

- Gruber, Ch. "How is the Government Involved in Education?" and "Evidence on Competition in Education Markets" (Ch. 11, pp. 294-307 in 3rd ed., 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 of Conference on Innovation in Education*, November, pp. 5-8.
- 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]

19. Tuesday, November 16 (or thereabouts)

Small group meetings to discuss empirical journal article for writing assignment.

You will be asked to read one of the following articles, and attend one small group meeting to discuss the article, and then will write a paper about this article, with the first draft due Monday November 29, and the final draft due Monday December 6. Some of the small discussion group meetings will be scheduled outside the regular class meeting time.

- 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, no. 8-9: 1477-1503.
- Reinikka, Ritva, and Jakob Svensson. 2009. "The Returns from Reducing Corruption: Evidence from Education in Uganda." Working Paper, December. <http://people.su.se/~jsven/Testing2009.pdf>
- Tran, Anh. 2010. "Which Regulations Reduce Corruption? Evidence from the Internal Records of a Bribe-Paying Firm." Working paper, May. <http://anhtran.web.officelive.com/Documents/Auction%20Regimes%20and%20Corruption%2027.pdf>

20. Thursday, November 18

Improving basic public service delivery: addressing absenteeism and corruption {26 pages}

- Banerjee, Abhijit and Esther Duflo. 2006. "Addressing Absence," *Journal of Economic Perspectives*, Vol. 20, No. 1 (Winter) pp. 117-131.
- Fisman, Raymond and Edward Miguel. 2008. "Learning to Fight Economic Gangsters," from *Economic Gangsters*, Princeton: Princeton University Press. [Excerpt, pp. 186-191 and 195-199.]

21. Tuesday, November 23.

Cost-benefit and cost-effectiveness analysis {30 pages}

- 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*, 8th ed., New York: Oxford University Press, pp. 225-230; plus excerpt from pp. 205-207 of the original article]

- Abdul Latif Jameel Poverty Action Lab. 2010. "Student Attendance." <
<http://www.povertyactionlab.org/policy-lessons/education/student-attendance>>
- Gruber, Ch. 8, "Cost/Benefit Analysis"

Thursday November 25: No class (Thanksgiving Break)

Monday, November 29, 4:00pm: First draft of empirical writing assignment #2, to be read by writing tutor, is due.

22. Tuesday, November 30.

Political economy I {29 pages}

- Ferraz, Claudio and Frederico Finan. "Electoral Accountability and Corruption: Evidence from the Audits of Local Governments." forthcoming, *American Economic Review* [Excerpt, pp. 1-3]
- Gruber, Ch. 9, "Political Economy," Sections 9.1 – 9.3 only (pp. 227-248 in 3rd ed., pp. 223-244 in 2nd ed., pp. 215-237 in 1st ed.).
- *The Economist*. 2000. "Out of Anarchy," Feb. 17.
- 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.

23. Thursday, December 2.

Political economy II {28 pages}

- Rosen, Harvey. 2005. "Log-rolling" and "Rent-Seeking" excerpted from *Public Finance*, 7th ed., New York: McGraw-Hill, pp. 118-120 and 129-132.
- Easterly, William. 2001. "Polarized Peoples," from *The Elusive Quest for Growth*, Cambridge: MIT Press [Excerpt pp. 255-261]
- 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.

Monday, December 6, 4:00pm: Second draft of empirical writing assignment #2, to be read by Prof. Bakija, is due.

24. Tuesday, December 7.

Decentralization {28 pages}

- Gruber, "Optimal Fiscal Federalism" Ch. 10, Section 10.2 only (pp. 267-275 in 3rd ed., 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.

25. Thursday, December 9. Catch-up and conclusion