

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

Fall 2011

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Office hours:  
Tues. 1:30-3:30PM,  
and by appointment  
Class meets 11am-12:15pm MW  
CDE Classroom

### 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 care, 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. 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 practical steps can be taken to improve the delivery of basic services? For example, how might one address problems of corruption and absenteeism? When is it better to have the government own and produce things, and when is it better to privatize?

Throughout the course, we consider examples of empirical research, and to facilitate this, we will occasionally introduce empirical tools that are particularly useful for microeconomic policy evaluation.

### Course materials

There is one required text for the course: *Public Finance and Public Policy*, by Jonathan Gruber (3rd edition, Worth Publishers, 2011), which can be purchased at Water Street Books or online. The 1st and 2<sup>nd</sup> editions are acceptable substitutes (the reading list below includes page references for all three editions). Additional required readings, with many applications to policy issues in developing and transitional countries, will be made available in course reading packets. The initial course reading packet is available now for you to pick up in the course packet room in the basement of Hollander Hall (room #026). Another course reading packet will be made available a little later in the term, once the initial rush at office services is over and we have a better idea of the enrollment in the class. 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. I will not expect you to memorize names of authors or to address points in the reading that were never mentioned in class.

### Class meeting time

Class meets 11:00am – 12:15pm in the CDE classroom. During the first week of classes, we will meet on Friday. After that, class normally meets Mondays and Wednesdays.

### Course requirements

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

	CDE fellows	Undergraduates
CDE orientation exam and homework	10%	-
Econ 503 writing assignment	-	10%
Econ 503 homework assignments	15%	15%
Econ 503 class participation	5%	5%
Econ 503 midterm exam	35%	35%
Econ 503 final exam	35%	35%

- For CDE fellows, scores on the CDE orientation exam and homework on microeconomics, regression, and writing together account for 10% of the Econ 503 grade.
- Writing Assignment for Undergraduates. In lieu of the CDE orientation, undergraduates will be required to submit a writing assignment of approximately seven pages, due

Monday, December 5th at 4:00pm. It will count for 10% of the final grade. (For CDE fellows, that 10% of the grade will come from the CDE orientation instead). Further information on the writing assignment will be provided later in the term.

- There will also be approximately five homework assignments which together count for 15 percent of your grade. Due dates for these will be announced as the semester progresses. Most homework assignments will be graded by the teaching assistant for the class (Colin Killick), although one or more homework assignments may include short writing assignments that I will grade. 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. Unless otherwise specified, you may hand-write your homework if you want, it is not necessary to type it.
- Class participation counts for 5 percent of your grade. You should attend class regularly, come to class having done the assigned readings, and be prepared to discuss the questions about the reading that I pose to you in advance by e-mail. I reserve the right to call on people to provide their thoughts on the e-mailed discussion questions. It is also important that you not be distracted by electronic equipment. Students may use a computer to take notes if they like, but must use the computer for that purpose only. Smart phones and other electronic devices must be turned off and stowed.
- The midterm exam counts for 35 percent of your grade. The midterm is scheduled for Thursday October 20<sup>th</sup> from 7:00pm to 9:30pm, location to be announced. The exam will be in the evening so that you can have extra time. In exchange, one regular class meeting (tentatively Wednesday October 19<sup>th</sup>) will be canceled and replaced with an optional review session for the exam. 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.
- The final exam counts for 35 percent of your grade. The final exam is *tentatively* scheduled for Friday December 16<sup>th</sup> from 9:30am to Noon, location to be announced.

### **Teaching Assistant**

Colin Killick <Colin.J.Killick@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 reading 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 1<sup>st</sup>, 2<sup>nd</sup>, and 3<sup>rd</sup> 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, and come to class prepared to discuss the questions about the readings that I will pose to you by e-mail.

### 1. Friday, September 9.

#### Introduction;

#### Theoretical Tools of Public Economics: Efficiency, Equity, and Social Welfare I

{27 pages}

- Gruber, Ch. 1, "The Four Questions of Public Finance" (pp. 3-10 in 3<sup>rd</sup> ed., pp. 3-11 in 2<sup>nd</sup> ed., pp. 2-9 in 1<sup>st</sup> ed.)
- Gruber, Ch. 2, "Equilibrium and Social Welfare" (pp. 43-55 in 3<sup>rd</sup> ed., pp. 43-55 in 2<sup>nd</sup> ed., pp. 41-52 in 1<sup>st</sup> ed.)
- Mankiw, N. Gregory. 2007. "The Political Philosophy of Redistributing Income," from *Principles of Microeconomics, 4th Edition*. Thomson-Southwestern, pp. 439-442.

### 2. Monday, September 12.

#### Theoretical Tools of Public Economics: Efficiency, Equity, and Social Welfare II

{30 pages}

- Weisbach, David. 2003. "Redistribution," from "Should Legal Rules be used to Redistribute Income?" *University of Chicago Law Review*. Vol. 70, [Excerpt, pp. 440-446].
- Bakija, Jon. 2011. "Notes on Social Welfare, Redistribution, and the Tradeoff between Efficiency and Equity."
- Kopczuk, Wojciech, Joel Slemrod, and Shlomo Yitzhaki. 2005. "The Limitations of Decentralized World Redistribution: An Optimal Taxation Approach." *European Economic Review*, Vol. 49, no. 4 [Excerpt, pp. 1051-1058, 1065-1067, and 1073-1075].

### 3. Wednesday, 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.

**4. Monday, September 19.**

**Externalities and Public Goods I**

{25 pages}

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

**5. Wednesday, September 21**

**Externalities and Public Goods II**

{28 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].
- 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.

**6. Monday, September 26**

**Imperfect Competition**

{13 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*, 3<sup>rd</sup> ed., New York: W.W. Norton, 2000, pp. 77-79 and selected portions of pp. 190-193 and 195-198.
- *The Economist*. 2002. "Trucking in Cameroon: The Road to Hell is Unpaved." Dec. 19.

**7. Wednesday, September 28.**

**Insurance and Asymmetric Information**

{36 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 3<sup>rd</sup> ed., pp. 316-331, 337-341, 345-347 in 2<sup>nd</sup> ed., pp. 303-316, 321-325, 328-329 in 1<sup>st</sup> ed.).
- Bakija, Jon. 2010. "Handout on the Economics of Risk and Insurance."
- Sherry Glied and Dahlia Remler, 2002, "Medical Complexity and Moral Hazard," excerpted from pp. 774-777 of "What Every Public Finance Economist Needs to Know about Health Economics," *National Tax Journal* Vol. 55, No. 4 (December).

## 8. Monday, October 3.

### Insurance (or Lack Thereof) in Developing Countries

{24 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 [Excerpt, pp. 369-372].
- Banerjee, Abhijit V., and Esther Duflo. 2011. "Barefoot Hedge Fund Managers," from *Poor Economics: A Radical Rethinking of the Way to Fight Global Poverty*. New York: Public Affairs. [Excerpt, pp. 134-136, 141-155].
- 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>
- Fisman, Raymond and Edward Miguel. 2008. *Economic Gangsters*. Princeton: Princeton University Press. [Excerpt on rainfall insurance in Botswana, pp. 152-153].

## 9. Wednesday, October 5.

### Credit Market Failure and Microfinance

{20 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]

No class on Monday, October 10 (Fall Reading Period)

## 10. Wednesday, October 12.

### Behavioral Economics and Public Policy

{21 pages}

- Gruber, "The Economics of Smoking," Ch. 6, Section 6.3 (pp. 165-172 in 3<sup>rd</sup> ed., pp. 163-171 in 2<sup>nd</sup> ed., pp. 156-164 in 1<sup>st</sup> 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].

## 11. Monday, October 17.

### Health Care Policy in Developing Countries

{30 pages}

- Banerjee, Abhijit V., and Esther Duflo. 2011. "Low-Hanging Fruit for Better (Global) Health?" from *Poor Economics: A Radical Rethinking of the Way to Fight Global Poverty*. New York: Public Affairs, pp. 41-70.

**12. Wednesday, October 19.**

Optional review session for midterm.

**Thursday, October 20. Evening midterm exam, 7:00pm – 9:30pm**

**13. Monday, October 24**

**Aid to the Poor I**

{19 pages}

- van de Walle, Dominique. 1998. "Targeting Revisited," *World Bank Research Observer*, Vol. 13, No. 2 (August), pp. 231-246.

**14. Wednesday, October 26.**

**Aid to the Poor II**

{22 pages}

- Atalas, Vivi, Abhijit Banerjee, Rema Hanna, Benjamin A. Olken, and Julia Tobias. 2011. "Targeting the Poor: Evidence from a Field Experiment in Indonesia." Forthcoming, *American Economic Review*. Excerpt, pp. 1-6.
- Hanlon, Joseph, Armando Barrientos, and David Hulme. 2010. "Asking the Community." Excerpted from pp. 113-115 of *Just Give Money to the Poor*, Kumarian Press.
- Cunha, Jesse M. 2011. "Testing Paternalism: Cash vs. In-Kind Transfers." Working Paper, March 15. [Excerpt, pp. 1-5]
- Barrientos, Armando. 2011. "Social Transfers and Growth: What Do We Know? What Do We Need to Find Out?" Forthcoming, *World Development*.

**15. Monday, October 31.**

**Education I**

{20 pages}

- Gruber, "Why Should the Government Be Involved in Education?" and "Measuring the Returns to Education," Ch. 11, Sections 11.1 and 11.4 (pp. 292-294 and 307-311 in 3<sup>rd</sup> ed., pp. 287-289 and 302-306 in 2nd ed., pp. 275-277 and 290-295 in 1st ed.)
- Banerjee, Abhijit V., and Esther Duflo. 2005. "Human Capital: Education" excerpted from pp. 484-489 of "Growth Theory through the Lens of Development Economics." In Philippe Aghion and Steven N. Durlauf., eds. *Handbook of Economic Growth*. Amsterdam and San Diego: Elsevier, North-Holland.
- Bakija, Jon. "Unemployment Rate by Highest Level of Educational Attainment," based on data from World Bank, *World Development Indicators 2011*.
- 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*, 8<sup>th</sup> ed., New York: Oxford University Press, pp. 198-200.]

**16. Wednesday, November 2.**

**Education II**

{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.
- Card, David. 2001. "Education Matters," *Milken Institute Quarterly*, 4<sup>th</sup> Quarter, pp. 73-77. [Excerpt]

**17. Monday, November 7.**

**Education III**

{31 pages}

- Banerjee, Abhijit V., and Esther Duflo. 2011. "Top of the Class" from *Poor Economics: A Radical Rethinking of the Way to Fight Global Poverty*. New York: Public Affairs, pp. 71-101.

**18. Wednesday, November 9.**

**Political economy I**

{29 pages}

- Ferraz, Claudio and Frederico Finan. "Electoral Accountability and Corruption: Evidence from the Audits of Local Governments." *American Economic Review*, Vol. 101, No. 4 (June). [Excerpt, pp. 1-3]
- Gruber, Ch. 9, "Political Economy," Sections 9.1 – 9.3 only (pp. 227-248 in 3<sup>rd</sup> ed., pp. 223-244 in 2nd ed., pp. 215-237 in 1st ed.).
- *The Economist*. 2000. "Out of Anarchy," Feb. 17.

**19. Monday, November 14**

**Political economy II**

{28 pages}

- 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.
- 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]
- Collier, Paul. 2007. *The Bottom Billion*. Oxford: Oxford University Press. [Excerpt on the Natural Resource Trap, pp. 42-50]
- 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. [Excerpt, pp. 61-63]

**20. Wednesday, November 16**

**Fiscal Federalism and Decentralization**

{28 pages}

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

**21. Monday, November 21.**

**Making Government Work Better I**

{30 pages}

- Banerjee, Abhijit V., and Esther Duflo. 2011. "Policies, Politics" from *Poor Economics: A Radical Rethinking of the Way to Fight Global Poverty*. New York: Public Affairs, pp. 235-265.

Wednesday November 23: No class (Thanksgiving Break)

**22. Monday, November 28.**

**Making Government Work Better II**

{15 pages}

- Banerjee, Abhijit and Esther Duflo. 2006. "Addressing Absence," *Journal of Economic Perspectives*, Vol. 20, No. 1 (Winter) pp. 117-131.

**23. Wednesday, November 30.**

**Government vs. Private Ownership and Production I**

{17 pages}

- Shleifer, Andrei. 1998. "State vs. Private Ownership." *Journal of Economic Perspectives*, Vol. 12, No. 4 (Autumn), [Excerpt, pp. 135-144.]
- 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.

#### 24. Monday, December 5.

##### **Government vs. Private Ownership and Production II**

{24 pages}

- 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.]
- Gruber, Ch. "How is the Government Involved in Education?" and "Evidence on Competition in Education Markets" (Ch. 11, pp. 294-307 in 3<sup>rd</sup> ed., pp. 289-302 in 2nd ed., pp. 277-290 in 1st ed.)

*Monday, December 5, 4:00pm: Undergraduate writing assignment is due.*

#### 25. Wednesday, December 7.

##### **Government vs. Private Ownership and Production III**

{22 pages}

- 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.
- Abdulkadiroglu, Atila, Joshua Angrist, Susan Dynarski, Thomas J. Kane, and Parag Pathak. 2011. "Accountability and Flexibility in Public Schools: Evidence from Boston's Charters and Pilots." *Quarterly Journal of Economics*. Vol. 126, No. 2 [Excerpt, pp. 699-703]
- 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. [Excerpts, pp. 1477-1484, 1492-1493, and 1498-1500.]