

# Public Economics

Spring term, 2015-2016 academic year

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## About the course

This course deals with economic role of the government. Variations of government performance across the globe explain why nations prosper or fail, and economics provides valuable insights into such matters.

Historically the government was viewed by economists as an institution in charge of preventing market failures by means of regulation and public expenditures. More recently the focus has expanded to consider the government as a supplier, guardian and enforcer of institutions – “rules of the game” in economy and society. Institutions are outcomes of public choice, and reflect politics, culture, and history – hence modern public economics touches upon and overlaps with political economy, law and economics, social economics and anthropology, etc.

This course combines elements of the traditional and modern views of public economics. In accordance with the tradition, it reviews main types and causes of market failures, and includes primers on public goods and taxation. Next the course proceeds to the agency relations between government and society/private sector under different political regimes, most notably democracy and autocracy, and explores the impact of such regimes for public policy and institutions.

How the state should be organized to better serve its economic roles? To answer this question, the course introduces main ideas and tools of constitutional design, which compares different systems of government (mechanisms of accountability, scale and scope, fiscal and regulatory tools etc.) from the point of view of achievable economic outcomes. A part of such analysis is another standard chapter of public economics, i.e. economics of federalism.

The government triad includes, in addition to legislative and executive branches, the judicial branch and hence there is a section in the course covering selected topics from the law and economics. The course also looks inside the government “black box” by studying the incentives of public servants, and explores government pathologies such as rent-seeking, corruption, and patronage.

Since the quality of governance is closely related to norms and values in the society, the course deals with the economic role of civic culture, i.e. the collective ability of the society to hold politicians and bureaucrats accountable, and with the social traits required to discipline and/or substitute for the government.

The concluding part of the course reviews the rapidly growing literature on comparative analysis of governance and institutions worldwide, and presents theoretical and empirical evidence on the significance of governance for social and economic outcomes.

## Prerequisites

Students are expected to have studied intermediate microeconomics. Technical issues, if any, which exceed such level, are explained in class. Knowledge of social and political theories is a plus, but not a requirement. The language of instruction is English.

## Reading

There are no textbooks covering the content of the course. The course is largely self-contained, and good lecture and seminar notes should suffice to get high scores. Students are encouraged to read original journal articles and books recommended at each lecture (selected bibliography is presented below). Some parts of the course material are covered in the following textbooks:

Atkinson, A., and J. Stiglitz. (1980) Lectures in Public Economics. McGraw-Hill  
Hillman, A. (2003) Public Finance and Public Policies. Responsibilities and Limitations of Government. Cambridge University Press  
Hindriks, J. and G.Myles (2013). Intermediate Public Economics. MIT Press

## Grading

There will be four take-home problem sets (10% of the course grade each, and a final open-book test (60% of the grade).

## Course outline

### 1. Market failures

Individual rationality and public interest. Sub-optimality of market equilibria. Economics of externalities. Public goods and commons. The problem of collective action. Voluntary contributions to public goods provision. Asymmetric information: Lindahl equilibrium and Clarke-Groves mechanisms. Private solutions of coordination problem: the Coase Theorem

### 2. Tax theory primer

Taxation and social welfare. How to choose tax bases and schedules? Informational restrictions. Deadweight loss of taxation. Commodity taxes and the Ramsey rule. Income tax theory. Mirrlees economy and optimal income tax. Joint selection of taxes and public expenditures. Credibility of tax regimes: the capital levy problem

### 3. Agency problem between government and society

Principal-agent problem in the public sector. Common agency. Conflict of interest between government and society. Fiscal policies and incentives to supply public goods in democracies and autocracies. Economics of the “stationary bandit”. Political risks of modernization and development. Preference aggregation: direct and representative democracy

#### 4. Government design

Economic analysis of constitution. Economics of checks and balances. Constitutional design under the “veil of ignorance”: choosing a majority rule. Why are reforms delayed: endorsement ex ante and ex post. How to tame the “Leviathan”? Proper scope of government and public-private partnership

#### 5. Economics of federalism

Local public goods. Inter-jurisdictional spillovers. Preference polarization and Oates Decentralization Theorem. Fiscal competition and “the race to the bottom”. Market-preserving federalism. Tiebout model. Economic and political decentralization

#### 6. Economic analysis of law

Economic role of courts and the rule of law. Externalities and dispute resolution. Contract law: efficient breach, damages and enforcement. Economic significance of property rights. Economics of litigation. Legal origins and the rise of regulatory state

#### 7. Government performance and pathologies

Incentives in public sector. Monitoring and career concerns. Societal expectations and bureaucratic performance. Economics of corruption. Centralized and decentralized corruption. Economic costs of corruption. Rent-seeking and influence activities. Government capture. Political and economic transactions between public and private sectors

#### 8. Public economics of civil society

Political collective action problem. Political foundations of democracy and the rule of law. “Civicness” and government performance. Social capital and welfare state. Collective voice vs. collective exit. Institutions and culture: an interplay

#### 9. Comparative institutional analysis

Inclusive and rent-extracting institutions. How to measure institutions and governance? History, geography and culture as factors of government performance and institutional quality. Primacy of institutions: institutional and development hypotheses. Investments in state capacity. Rise and decline of nations

### **Selected bibliography**

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- Dewatripont, M., I. Lewitt, and J. Tirole. (1999) The Economics of Career Concerns, Part II: Application to Mission and Accountability of Government Agencies. *Review of Economic Studies* 66 (1), 199-217
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- Shleifer A. and R. Vishny. (1993) Corruption. *Quarterly Journal of Economics* 108(3): 599-617.
- Weingast, B. (1997) The Political Foundations of Democracy and the Rule of Law. *American Political Science Review*, 91(2), 245-263.