

Public Finance

Textbook(s): n/a

Book(s) on Reserve: Public Finance in Canada, 4th edition (Rosen, Wen, and Snoddon, 2012).

Course Outline:

This is a course on Public Economics, with a particular focus on the ideas and methods most relevant for understanding the economics of expenditure programs that are designed to redistribute income or to provide social insurance against risks faced by households. These programs include employment insurance, health care, pensions, subsidized housing, and progressive taxation. Such “welfare state” programs comprise a very substantial part of government activities. Understanding the efficiency and equity rationales for the welfare state is therefore fundamental to understanding the economic role of government in the modern economy.

The theoretical concepts to be covered include Pareto efficiency, excess burden, social welfare functions, inequality measures, public goods, insurance market failures, optimal income taxation, in-kind transfers, and social insurance. We will discuss how these topics relate to actual welfare states programs.

Most of the following listed articles will be discussed; many are regarded as seminal contributions. (An asterisk means that reading the full paper is indispensable. Where there is no asterisk, the paper may contain considerably more material than will be discussed in class; in those cases, my lecture notes are sufficient and reading the paper, though recommended, is regarded as optional.)

Topics and Reading List

A. Pareto Efficiency and Competitive Equilibrium

1. Pareto Efficiency (1/2 lecture)

Reading: Economics 651 (01) Course Outline continued Page 2

Musgrave, R.M. (1996) The Role of the State in Fiscal Theory, *International Tax and Public Finance* 3: 247—258.

Bator, F.M. (1957) The Simple Analytics of Welfare Maximization, *American Economic Review* 47: 22—59.

2. Competitive Equilibrium and the Welfare Theorems (1 lecture)

Reading:

Bator, F.M. (1957) The Simple Analytics of Welfare Maximization, *American Economic Review* 47: 22—59.

Rosen, H., J.-F. Wen, and T. Snoddon (2012) *Public Finance in Canada*, 4rd edition, McGraw-Hill, chapters 2 (Fundamentals of Welfare Economics) and 3 (Economic Roles of Government). The book is on reserve at the library.

B. Income Distribution as a Public Good

3. Public Goods (3 lectures)

Reading:

Samuelson, P. (1955) Diagrammatic Exposition of a Theory of Public Expenditures, *Review of Economics and Statistics* 37: 350—6.

Warr, P. (1963) The Private Provision of a Public Good is Independent of the Distribution of Income, *Economic Letters* 13: 207—211.

Rosen, H., J.-F. Wen, and T. Snoddon (2012) *Public Finance in Canada*, 4rd edition, McGraw-Hill, chapters 4 (Public Goods) (on reserve).

4. Pareto Optimal Redistribution (1 lecture)

Reading:

Thurrow, L. (1971) Income Distribution as a Pure Public Good, *Quarterly Journal of Economics* 85: 327—36.

Von Furstenburg, G.M. and D.C. Mueller (1971) The Pareto Optimal Approach to Income Redistribution: a Fiscal Application, *American Economic Review* 61: 628—637.

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Hochman, H.M. and J.D. Rodgers (1969) Pareto Optimal Redistribution, *American Economic Review* 59(4): 542—557.

C. Income Inequality and Income Instability

5. Measures of Social Welfare and Inequality (1.5 lectures)

Reading:

Barr, N. (1998) Problems of Definition and Measurement, Chapter 6 in *The Economics of the Welfare State*, 3rd edition, Stanford University Press. On reserve at the library. (*)

Atkinson, A.B. (1970) On the Measurement of Inequality, *Journal of Economic Theory* 3: 244--263.

Economics 651 (01) Course Outline continued Page 3

6. Income Distribution in Canada (3 lectures)

Reading:

The Conference Board of Canada (2012) “Hot Topic: Canadian Income Inequality: Is Canada Becoming More Unequal?”, <http://www.conferenceboard.ca/hcp/hot-topics/caninequality.aspx> (*)

Veall, M.R. (2012) Top Income Shares in Canada: Recent Trends and Policy Implications, Department of Economics Working Paper, McMaster University, <http://www.economics.mcmaster.ca/documents/departments-working-papers/2012-11.pdf>

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Gonzalez, F. and J.-F. Wen (2013) A Theory of Top Income Taxation and Social Insurance, *The Economic Journal*, forthcoming.

Beach, C., R. Finnie, and D. Gray (2010) Long-Run Inequality and Short-Run Instability of Men's and Women's Earnings in Canada, *Review of Income and Wealth* 56: 572—596.

Garcia Medina, C. and J.-F. Wen (2014) Income Instability and Residual Income Progression, mimeo.

Fortin, N., D. Green, T. Lemieux, K. Milligan, and C. Riddell (2012) Canadian Inequality: Recent Developments and Policy Options, *Canadian Public Policy* 38(2): 121—145.

D. Redistribution in Cash and Kind

7. Progressive Income Taxation (4 lectures)

Reading:

Stern, H.N. (1976) On the Specification of Models of Optimum Income Taxation, *Journal of Public Economics* 6: 123—62. (*)

Stiglitz, J. (1982) Self-Selection Pareto Efficient Taxation, *Journal of Public Economics* 17: 213—40.

Slemrod, J., S. Yitzhaki, J. Mayshar, and M. Lundholm (1994) The Optimal Two-Bracket Linear Income Tax, *Journal of Public Economics* 53: 269—290. (*)

Kaplow, L. (2007) Optimal Income Transfers, *International Tax and Public Finance* 14: 295—325.

8. In-Kind Transfers (1 lecture)

Reading:

Blackorby, C. and D. Donaldson (1988) Cash versus Kind, Self-Selection, and Efficient Transfers, *American Economic Review* 78: 691—700. (*)

E. Risk and Insurance

9. Insurance Against Illness and Unemployment (4 lectures)

Reading:

Arrow, K. (1963) Uncertainty and the Welfare Economics of Health Care, *American Economic Review* 53: 941—973 (*)

Economics 651 (01) Course Outline continued Page 4

Pauly, M.V. (1974) Overinsurance and Public Provision of Insurance: The Roles of Moral Hazard and Adverse Selection, *Quarterly Journal of Economics* 88: 44—62.

Rothschild, M. and J.E. Stiglitz (1976) Equilibrium in Competitive Insurance Markets, *Quarterly Journal of Economics* 90: 629—650. (*)

Dahlby, B. (1981) Adverse Selection and Pareto Improvement through Compulsory Insurance, *Public Choice* 37: 547—58.

Pauly, M.V. (1968) The Economics of Moral Hazard: Comment, *American Economic Review* 58: 531—537. (*)

Cohen, Alma, and Peter Siegelman. Testing for Adverse Selection in Insurance Markets, *Journal of Risk and Insurance* 77(1) (2010): 39—84.

Thomasson, Melissa A. Early Evidence of An Adverse Selection Death Spiral? The Case of Blue Cross and Blue Shield, *Explorations in Economic History*, 2004, 41(4), 313—328.

Rosen, H., J.-F. Wen, and T. Snoddon (2012) *Public Finance in Canada*, 4rd edition, McGraw-Hill, chapter 9 (Health Care) (on reserve).

F. Redistribution as Social Insurance

10. Social Insurance and Risk-Taking (2 lectures)

Reading:

Sinn, H.-W. (1996) Social Insurance and Risk Taking, *International Tax and Public Finance* 3: 259—280. (*)

Meyer, J. (1987) Two-Moment Decision Models and Expected Utility Maximization, *American Economic Review* 77: 421—430.

11. Entrepreneurship (3 lectures)

Reading:

Bird, E.J. (2001) Does the Welfare State Induce Risk-Taking? *Journal of Public Economics* 80: 357—383.

Kanbur, S.M. (1981). Risk Taking and Taxation: An Alternative Perspective, *Journal of Public Economics* 15, 163—184.

Penalosa-Garcia, C., and J.-F. Wen (2008) Redistribution and Entrepreneurship with Schumpeterian Growth, *Journal of Economic Growth* 13: 57—80.

Gordon, D.V. and J.-F. Wen (2013) An Empirical Model of Tax Convexity and Self-Employment, *Review of Economics and Statistics* 96: 471—482.

Grade Determination and Final Examination Details:

There will be three assignments, worth 10 percent each; a mid-term exam worth 30 percent; and a final exam worth 40 percent. The tentative date for the midterm exam is Tuesday, October 21, in class. In addition, with each assignment, (only) PhD students (not MA students) will be required to provide an adequate written answer to a question based on a journal article reading in the course outline. (Failure to meet this requirement will result in a 20% penalty on the assignment grade.)

All work will be marked on a numerical basis, then aggregated, and converted to letter grades. The following *grade conversion chart* is an approximate guide to letter grade equivalents.

A+	96 – 100	B	76 – 80	C-	56 – 60
A	91 – 95	B-	71 – 75	D+	51 – 55
A-	86 – 90	C+	66 – 70	D	46 – 50
B+	81 – 85	C	61 – 65	F	<45