

## States and Markets (U4)

Alastair McFarlane

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#### 1. General Information

Meeting time:	Thursday 14-16
Location:	00.19
Convener:	Alastair McFarlane
Email:	<a href="mailto:mcfarlane@hertie-school.org">mcfarlane@hertie-school.org</a>
Telephone:	
Office hours:	
Office:	
Lab session:	
Tutors:	Joachim Schmitz
Email:	<a href="mailto:j.schmitz@mpp.hertie-school.org">j.schmitz@mpp.hertie-school.org</a>

#### 2. Aim and structure of the course

The description of “States and Markets” in the Master of Public Policy brochure is that it “serves as an introduction to the fundamentals of national and international political economy. The main focus of this course will be on the interplay between the economy and regulatory policies and mechanisms.” In short, U4 is a course in the field of public economics. The course builds on the foundation of U3 and further develops the tools of analysis for policy problems. In addition, we will explore specific policy issues to a greater extent than in U3. This more in-depth approach will be enhanced by students’ opportunity to write an economic analysis of a public policy and present their opinions to fellow participants of the course.

The first part of the course addresses the efficiency and equity justifications for government intervention in the economy. We will start with cost-benefit analysis, which is a method of evaluating the impact of government action on social welfare. Even if you never have to perform a cost-benefit analysis, you will probably have to read and evaluate one if you pursue a career in public policy. Although theories of market failure were analyzed extensively in U3 (specifically those arising from externalities and market power), there are some failures that we omitted (such as income inequality and information asymmetries) and others that deserve further treatment (such as negative externalities and macroeconomic stabilization policy). We will also investigate to what extent there may be “government failure” in providing the optimal public policy.

The second part of the course investigates issues in public finance. Three central questions will be explored: what are the economic rationale for government provision of goods and

services; what are the desirable aspects of a tax system; and what are the impacts of deficit finance on a macro economy.

The third part of the course covers explicitly international issues in economic policy: international economic development, globalization, tax competition, and environmental policy. These issues were chosen because of the intersection of their importance and the controversy surrounding the best policy.

### *3. Teaching, Requirements & Grading*

The teaching is composed of three elements:

- 1) The purpose of the weekly two-hour lectures is for students to hold debates on public policy questions; allow the professor to present economic theory relevant to the debate; to provide illustrations of applied public economics; and respond to questions from the students. See the detailed lecture plan for more information on the lectures.
- 2) During the one-hour lab, the teaching assistant (Joachim Schmidt) will lead the discussion of the weekly review questions and written assignments.
- 3) During office hours, the lecturer will be present to answer all questions on the course material.

Grading will be based on the following: two take-home questions (15% each); an in-class presentation (15%); a research paper on a public policy issue (45%); and participation in class (5%) and labs (5%).

### *4. General recommended readings:*

The following books will serve as general references for this course and are available in the library:

- William J. Baumol and Alan S. Blinder, Macroeconomics: Principles and Policy, 10<sup>th</sup> edition, South-Western College Publishers, 2005.
- Robert S. Pindyck and Daniel L. Rubinfeld, Microeconomics, 6<sup>th</sup> edition, Prentice-Hall, 2005.
- Harvey S. Rosen, Public Finance, 7<sup>th</sup> Edition, McGraw-Hill, 2005.
- Joseph Stiglitz, Economics of the Public Sector, 3<sup>rd</sup> Edition, W.W. Norton, 2000.

Another text that shall be used frequently and is available on-line is:

- Clifford Winston, Government Failure vs. Market Failure: Microeconomics Policy Research and Government Performance, AEI-Brookings Joint Center for Regulatory Studies ([www.aei.brookings.org](http://www.aei.brookings.org)), Books and Monographs 06-05. Sep 2006.

## 5. Overview of the Course

### **Part I: Market Failures and Rationale for Government Intervention**

1. Principles of Cost-Benefit Analysis
2. Asymmetric Information
3. Negative Externalities and the Tragedy of the Commons
4. Market Power and Regulation of Industry
5. Income Inequality and Redistribution
6. Macroeconomic Stabilization Policy

### **Part II: Public Finance**

7. Public Goods and Government Expenditures
8. Tax Reform
9. Budget Deficits

### **Part III: International Issues**

10. Trade Policy
11. Economic Development
12. Tax Competition and Harmonization
13. International Public Goods and Environmental Policy

## 6. Description of Assignments

Review Exercises (30%): There will be a total of three take-home exercises on class material throughout the semester (approximately every three weeks). Only the two assignments with the best scores will count. Each one will be worth 15% of the total grade.

Presentation (15%): Students will be asked to present one side of a policy debate. Both the topic and position will be assigned. (Debate questions are listed below in Section 7 of the syllabus.) Students will be evaluated based on how well they use economic reasoning to argue their position.

Policy Brief (45%): Students are allowed to choose any topic that they wish as long as it is somehow related to the assigned presentation question (see above). The final paper will be graded based on the quality of the economic analysis and how well it reflects the lessons learned from U3 and U4. The final version is expected to be 2,000 words long (not including bibliography) and is due at the end of the semester on DATE. The students will also be asked to write a rough draft to be handed in earlier. This gives me (and your fellow students) the chance to provide constructive comments.

Participation (10%): Attendance in class, lab sessions, and the extent to which students constructively contribute to both will be taken into account. Class participation will count for 5% and lab session participation will count for 5%.

## 7. Detailed Schedule of Lectures and Readings

<b>Session #1</b>	<b>31.01.07</b>	<b>Principles of Cost-Benefit Analysis</b>
<i>Concepts</i>	Benefit-cost ratio, social discount rate, certainty equivalent value	
<i>Readings</i>	Rosen Ch 11, Winston	
<i>Debate</i>	Can economists put a price on a human life?	
<b>Session #2</b>	<b>06.02.07</b>	<b>Market Failure: Asymmetric Information</b>
<i>Concepts</i>	Adverse selection, moral hazard, signalling	
<i>Readings</i>	Pindyck and Rubinfeld Ch 17, Rosen Ch 10, Levitt & Dubner Ch 2	
<i>Debate</i>	Should health insurance be universal?	
<b>Session #3</b>	<b>13.02.07</b>	<b>Externalities &amp; the Tragedy of the Commons</b>
<i>Concepts</i>	Tragedy of the Commons, Collective Action, congestion	
<i>Readings</i>	Pindyck and Rubinfeld Ch 18, Garret Hardin	
<i>Debate</i>	Are toll roads the best transportation policy for motorists?	
<b>Session #4</b>	<b>20.02.07</b>	<b>Market Power and Regulation</b>
<i>Concepts</i>	Anti-trust, economic regulation, social regulation	
<i>Readings</i>	Winston, Samuelson and Nordhaus	
<i>Debate</i>	Should advertising be regulated?	
<b>Session #5</b>	<b>27.02.07</b>	<b>Income Inequality and Redistribution</b>
<i>Concepts</i>	Maximin criterion, Okun's leaky bucket, Lorenz curve	
<i>Readings</i>	Rosen Ch 7	
<i>Debate</i>	Are unemployment benefits too generous?	
<b>Session #6</b>	<b>05.03.07</b>	<b>Macroeconomic Stabilization Policy</b>
<i>Concepts</i>	Phillips Curve, rational expectations, rules vs. discretionary policy	
<i>Readings</i>	Baumol and Blinder (14, 16)	
<i>Debate</i>	Should central bankers worry about inflation?	
<b>Session #7</b>	<b>12.03.07</b>	<b>Public Goods and Government Expenditures</b>
<i>Concepts</i>	Public good, merit good	
<i>Readings</i>	Stiglitz Ch 8, 10, Pindyck and Rubinfeld Ch 18	
<i>Debate</i>	Should the government provide education?	
<b>Session #8</b>	<b>19.03.07</b>	<b>Tax Reform</b>
<i>Concepts</i>	Deadweight loss	
<i>Readings</i>	Stiglitz Ch 17, 18, 19, 20, 25	
<i>Debate</i>	Is the flat tax a good idea?	
<b>Session #9</b>	<b>26.03.07</b>	<b>Budget Deficits and National Debts</b>
<i>Concepts</i>	Crowding out, capital budgets, Ricardian equivalence	
<i>Readings</i>	Baumol and Blinder Ch 15, Rosen Ch 18,	
<i>Debate</i>	Should governments be required to run balanced budgets?	
<b>Session #10</b>	<b>02.04.07</b>	<b>International Trade Policy</b>
<i>Concepts</i>	Comparative advantage, increasing returns	
<i>Readings</i>	Krugman, Stiglitz (book on international trade)	
<i>Readings</i>	Should international trade be restricted?	

<b>Session #11</b>	<b>16.04.07</b>	<b>Tax Harmonization and Tax Competition</b>
<i>Concepts</i>	Race to the bottom, capital mobility	
<i>Readings</i>	Assaf and Sadka	
<i>Applications</i>	Is tax competition harmful?	
<b>Session #12</b>	<b>23.04.07</b>	<b>Economic Development</b>
<i>Concepts</i>	Poverty trap, convergence, endogenous growth	
<i>Readings</i>	Baumol and Blinder, Weil, Burda	
<i>Debate</i>	Are the lessons of OECD nations applicable to developing nations?	
<b>Session #13</b>	<b>30.04.07</b>	<b>Global Public Goods and Environmental Policy</b>
<i>Concepts</i>	Marginal cost of abatement, marginal social cost of emissions	
<i>Readings</i>	Nicholas Stern report, Economist articles on emissions trading, Stiglitz 26	
<i>Application</i>	Should pollution be “exported” to poorer nations?	