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UST 603/PAD 603/PDD603

PUBLIC FINANCE AND ECONOMICS

FALL 2005

TUESDAY SECTION

I. COURSE OBJECTIVES

1. To provide an understanding of basic economic concepts and tools used by economists and show how economists use these in thinking, talking, and writing about issues of government spending, taxing, and regulation.
2. To provide an understanding of the economist's view of how the world works and the contributions of this view to thinking about public policy and budgeting issues.

II. REQUIRED TEXTS

1. Texts

David Hyman. Public Finance. Eighth Edition. Dryden Press. 2005.
Steven Landsburg. The Armchair Economist. Free Press. 1993

Ansel Sharp, Charles Register, and Paul W. Grimes. Economics of Social Issues. Seventeenth Edition. Irwin, 2005.

2. Reserve reading

Robert Anthony and David Young. "Program Analysis" in Management Control in Nonprofit Organizations. Irwin, 1988 or 1994.

Steven Rhoads, "Do Economists Overemphasize Monetary Benefits." Public Administration Review, Volume 45, Number 2, 1985: 815-819

III. COURSE REQUIREMENTS

1. Three Midterms, September 20, October 18, November 15 (16.67% each)
2. Final Comprehensive Examination, December 13 (50%)

All of these examinations are designed to assess your knowledge of economic and public finance concepts and your ability to apply them to concrete real-world situations. The purpose of holding exams so frequently is to provide you with timely feedback on how well you are grasping the material so that you can improve your work on later exams. Exams will include questions on some arguments in the Hyman and Landsburg texts, but not covered in class. All exams will be open-book, but please come as well prepared as you would be for a regular exam. Make-up exams will be granted only in cases of a documented emergency and, whenever possible, you should notify me prior to the scheduled exam. Any make-up exams must be taken by appointment during regular office hours (9am-5pm) and no later than 48 hours after the normally scheduled exam.

3. Class Participation

IV. GRADING POLICY

Final grades will be assessed on an A-B-C-F scale. Pluses and minuses will be shown on graded assignments for advisory purposes only.

V. COURSE OUTLINE

Reading assignments should be completed prior to coming to class. Please read the Sharp assignments before the Hyman assignments where both are assigned. In the Sharp text, please try to understand the basic economic arguments advanced and don't dwell on the institutional data.

Session 1: Introduction. Scarcity and the need to choose; Opportunity cost; The Nature of Economic Theory; Economic Efficiency.

Assignments: Sharp et al., Chapter 1, 13(358-363); Hyman, Chapter 1 (3-28), 2 (52-59)

Session 2: Supply and Demand.

Assignments: Sharp et al., Chapter 2.

Session 3: Supply and Demand (cont'd); Markets, Efficiency, and The Role of Government; The Effects of Subsidies on Efficiency; Efficiency versus equity.

Assignments: Hyman, Chapters 1 (41, 50-51), 2 (59-75); Landsburg, Chapters 1, 4, 5, 7, 8.

Session 4: Midterm I

Session 5: Rationale for Government Action: Monopoly; Negative Externalities.

Assignments: Sharp et al., Chapters 8, 4; Hyman, Chapter 3 (96-101, 104-110, 112-134)
Landsburg, Chapters 9, 17, 24.

Session 6: Rationale for Government Action: Positive Externalities; Public Goods.

Assignments: Sharp et al. Chapters 6, 5; Hyman, Chapters 3 (101-104, 110-111), 4 (139-152, 162-167)

Session 7: Methods of expenditure analysis and Budgeting.

Assignments: Hyman, Chapter 6; Landsburg, Chapter 10

Anthony and Young. "Program Analysis" in Management Control in Nonprofit Organizations. Irwin, 1988 or 1994 (Reserve Reading).

Session 8: Midterm II.

Session 9: Income Distribution and Redistribution.

Assignments: Sharp et al, Chapters 7, 3, 15 (407-412); Hyman, Chapter 7 (251-263, 265-273, 283-298); Landsburg, Chapter 13.

Session 10: Principles of Taxation.

Assignments: Sharp et al. Chapter 14; Hyman, Chapter 1(19-21), 10 (395-412)

Session 11: Buchanan video

Session 12: Midterm III

Session 13: Principles of taxation (contd.).

Assignments: Hyman, Chapters 2 (63-65), 14 (536-547), 16(610-617 624-629, 630-631), 17 (641-645, 650-654, 658-670),

Session 14: Public choice and the Politics of Budgeting and Taxation.

Assignments: Hyman, Chapter 5 (170-209): Landsburg, Chapter 6.

Session 15: Public Choice (cont'd); Public Finance and Federalism. Limitations of Economics

Assignments: Hyman, Chapters 5 (209-213), 18 (675-697, 701-708)

Steven Rhoads, "Do Economists Overemphasize Monetary Benefits." Public Administration Review, Volume 45, Number 2, 1985: 815-819 (Reserve reading).

Session 16: Final.

IV. HOMEWORK QUESTIONS

The following questions are designed to help you test your understanding of and ability to apply course material. You should come to the session indicated prepared to both provide an answer to the question and also explain your reasoning for the answer, drawing graphs where appropriate. Your exams will take the form of questions of this type.

Session 2

1. If the economy is currently operating on the production-possibilities curve for government goods and services versus private goods and services:
 - a. an increase in government goods and services can be obtained without any sacrifice of private goods and services
 - b. it will be impossible to increase the output of government goods and services
 - c. a decrease in the output of government goods and services will have no effect on the output of private goods and services
 - d. a decrease in the output of government goods and services will allow an increase in the output of private goods and service
 - e. the economy will be able to provide all of the government and private goods and services that people want
2. A command or government-run economy is characterized by:
 - a. an absence of shortages and surpluses

- b. an absence of opportunity costs
- c. a responsiveness of production to consumer preferences
- d. non-price rationing

Questions 3-4 are based on the following information:

A study has been instituted to determine the benefits of a wellness education program at different levels and the results are listed in the following table. Figures for costs of the program are also included:

Units of wellness education	Total Social Benefits (\$)	Total Social Costs (\$)
1	80,000	60,000
2	150,000	120,000
3	210,000	180,000
4	260,000	240,000
5	300,000	300,000
6	330,000	360,000

3. The estimated marginal social benefit of the second unit of wellness education is:
 - a. \$150,000
 - b. \$30,000
 - c. \$70,000
 - d. \$60,000

4. The economically efficient level of wellness education is:
 - a. 3 units
 - b. 5 units
 - c. 4 units
 - d. 6 units
 - e. 0 units

Session 3

1. If cable and satellite television are substitutes, a decrease in the price of satellite services will:
 - a. lead to a decrease in the demand for cable television services
 - b. lead to a decrease in the demand for satellite television services
 - c. lead to an increase in the price of cable television services
 - d. lead to an increase in the supply of cable television services

- e. none of the above
2. Computer programming experts are finding it difficult to secure employment. It follows that:
 - a. the quantity supplied of computer programming services exceeds the quantity demanded
 - b. the wages paid to computer experts can be expected to rise
 - c. this is an example of market failure and an indication that government ought to finance the employment of more computer experts
 - d. a and b
 - e. all of the above
 3. According to supply and demand theory, government regulations requiring that health insurance companies provide more generous coverage of medical treatment for their customers can be expected to lead to all of the following EXCEPT :
 - a. a reduced supply of health care insurance policies
 - b. higher insurance premiums or prices
 - c. an increase in the number of households covered by health care insurance policies
 - d. a reduction in the number of households covered by health care insurance policies
 - e. higher prices for medical care
 4. According to supply and demand, an increase in nursing salaries and a reduction in the quantity of nursing services offered can be expected to result from:
 - a. entry of more males into the nursing profession
 - b. an increase in the demand for hospital care
 - c. more stringent licensure requirements for nurses
 - d. increased subsidies for nursing education
 - e. b. or c.

Session 4

1. The price of physician services rises by 10% and, as a result, the number of visits to physicians falls by 2%. This indicates that
 - a. the demand for physicians services is relatively inelastic with respect to price
 - b. the demand for physician services is relatively elastic with respect to price
 - c. the demand for physician services is perfectly inelastic with respect to price
 - d. the coefficient of elasticity is 5
 - e. a. and d
2. Assume that the supply of nurses is increased while the supply of physicians is decreased. According to supply and demand, given an elastic demand for nursing services and an inelastic demand for physicians' services, we would predict which of the following:

- a. a decrease in the total revenues of both nurses and physicians.
 - b. an increase in the total revenues of both nurses and physicians
 - c. nurses' revenues would rise but physicians revenues would fall
 - d. nurses' revenues would fall but physicians revenues would rise
 - e. no predictions are possible because we have no information about elasticities of supply for the services of either nurses or physicians
3. Assuming that, in the absence of government intervention, the market for housing operates efficiently, it follows then that a subsidy provided to housing suppliers will:
- a. lead to economic inefficiency because it will result in marginal social cost exceeding marginal social benefit for housing
 - b. result in a smaller than efficient output of housing
 - c. lead to a reduction in the price of housing
 - d. a. and c.
 - e. all of the above
4. If the output of education is Pareto-optimal, this means that:
- a. the marginal social benefit of education equals its marginal social cost
 - b. it is impossible, in changing the output of education, to make someone better off without making someone else worse off
 - c. equity in the availability of education is secured
 - d. a. and b.

Session 6.

1. A monopoly firm in an industry is a source of economic efficiency because:
- a. it seeks to maximize profits
 - b. it uses too few resources
 - c. it produces where marginal revenue exceeds marginal cost
 - d. all of the above
 - e. none of the above
2. Which of the following government policies dealing with monopolies will not promote economic efficiency:
- a. reducing barriers to entry into monopolized industries
 - b. breaking up monopolies so as to create more competition
 - c. reducing monopolists' profits by imposing a tax on their outputs
 - d. regulating the price charged by natural monopolies
 - e. none of the above
3. An external cost results from the use of cell phone calls because of auto accidents. If cell phone call services are sold in a competitive market, it follows that:

- a. too many cell phone calls will be made unless a subsidy is provided for cell phone calls
 - b. too few cell phone calls will be made unless a subsidy is provided for cell phone calls
 - c. too many cell phone calls will be made unless a tax is imposed on cell phone calls
 - d. too few cell phone calls will be made unless a tax is imposed on cell phone calls
4. The marginal cost per unit of a pollutant discharged into a river by a competitive chemical industry is estimated at \$30 per ton. A pollution tax of \$50 per ton is in effect. The marginal cost to the firm of cleaning up a ton of discharge is \$49 at current clean-up levels. Given these conditions:
- a. the firm will not clean up any more of the discharge and this is the correct decision from the point of view of economic efficiency
 - b. the firm will not clean up any more of the discharge but this is not the correct decision from the point of view of economic efficiency because pollution is not reduced.
 - c. the firm will clean up more of the discharge and this is the correct decision from the point of view of economic efficiency because pollution is reduced
 - d. the firm will clean up more of the discharge but this is not the correct decision from the point of view of economic efficiency

Session 7

1. When the consumption of vaccine generates significant external benefits, firms producing vaccine:
- a. produce too little of it unless they are subsidized
 - b. produce too little of it unless they are taxed
 - c. produce too much of it unless they are subsidized
 - d. produce too much of it unless they are taxed
2. The provision of higher education generates external benefits. The output of higher education is likely then to be inefficient because:
- a. the marginal social costs of higher education exceed its marginal social benefits
 - b. the marginal social costs of higher education exceed its marginal private costs
 - c. the marginal social benefits of higher education exceed its marginal social costs
 - d. the marginal social costs of higher education exceed its marginal private benefits
 - e. none of the above
3. All of the following are examples of public goods except:
- a. a lighthouse
 - b. national defense
 - c. education
 - d. a flood control system

- e. the maintenance of law and order
4. If energy conservation were a public good then the most efficient response by government would be:
 - a. educational programs that alert energy users to the social benefits of conservation
 - b. government regulations on the use of energy
 - c. a tax on the users of energy
 - d. a subsidy to energy producers for each unit of energy produced
 - e. government ownership of energy producers

Session 8.

1. A city is considering whether or not to build a sports stadium. The front-end investment cost to acquire the land and build the stadium is \$15 million. The stadium is expected to yield a net annual income of \$2 million for 40 years. Assuming a discount rate of 8%, on the basis of a cost-benefit analysis using these figures, the stadium has:
 - a. a net present value of about \$9 million and should be built
 - b. a net present value of about \$ 24 million and should be built
 - c. a net present value of about \$65 million and should be built
 - d. a net present value of about minus \$15 million and should not be built.
 - e. a net present value of about \$ 22 million and should be built.

2. Benefits received in the future from a public investment made today should be discounted because:
 - a. they are uncertain
 - b. inflation will occur
 - c. people want to be compensated for postponing the receipt of benefits
 - d. all of the above
 - e. none of the above

3. When cost-benefit analysis is used for evaluating capital projects, using a lower discount rate:
 - a. will lead to the adoption of less projects since it indicates a lower expected return
 - b. will lead to the adoption of more projects
 - c. a. or b. depending upon the magnitude of future benefits from particular projects
 - d. will not affect the number of projects adopted because both costs and benefits must be discounted in a cost-benefit analysis.

3. Assuming a discount rate of 10%, what is the maximum you should pay for a computer system that will save you \$40,000 per year in staff costs for the next five years and can be traded in at the end of this time for a lump sum of \$5000?

- a. \$151,600
- b. \$154,700
- c. \$27,900
- d. \$170,600

Session 10.

1. According to supply and demand, placing price ceilings or caps on electricity prices below market equilibrium prices can be expected to lead to:
 - a. an increase in the quantity of electricity available
 - b. a shortage of electricity
 - c. reduced quantity of electricity demanded
 - d. b. and c.
 - e. all of the above
2. Families of four are to be supported at a minimum income of \$ 16,000 per year by a negative income tax program with a tax rate of 40% A family of four earns an income of \$10,000. Its total income, including the earned income and the negative tax payment, will be:
 - a. \$1,600
 - b. \$11, 600
 - c. \$40,000
 - d.. \$12,000
 - e. \$22,000
3. It is known that some stores illegally purchase food stamps from low-income households at a discount for cash and then receive reimbursement from government for the full value of these food stamps. A legal crackdown on this market would:
 - a. reduce the economic welfare of these stores
 - b. improve the economic welfare of low-income households
 - c. reduce the economic welfare of low-income households
 - d. a. and b.
 - e. a. and c.
4. According to supply and demand, the beneficiaries from rental subsidies provided to low-income tenants include:
 - a. landlords
 - b. low-income tenants
 - c. all tenants
 - d. a. and b.
 - e. all of the above

Session 12

1. An income tax taxes all income up to \$20,000 at 20% and income in excess of \$20,000 at 30%. A household earning \$40,000 faces:
 - a. an average tax rate and marginal tax rate of 30%
 - b. an average tax rate and marginal tax rate of 25%
 - c. an average tax rate of 20% and a marginal tax rate of 25%
 - d. an average tax rate of 25% and a marginal tax rate of 30%
 - e. an average tax rate of 17.5% and a marginal tax rate of 30%

2. Horizontal tax equity means that;
 - a. all people should pay equal taxes
 - b. the "rich" should pay more taxes than the "poor"
 - c. people in the same economic circumstances should pay equal taxes
 - d. the distribution of income after taxes should be equal

3. A progressive tax rate means that the ratio of tax payments to income:
 - a. falls as income rises
 - b. rises as income rises
 - c. remains the same as income rises
 - d. b. or c.

4. According to supply and demand, which of the following is true in regard to the effects of increasing the cigarette tax imposed on cigarette sellers:
 - a. the increase in the tax burden on smokers and the reduction in smoking will be smaller, the less elastic is demand with respect to price.
 - b. the increase in the tax burden on smokers will be smaller and the reduction in smoking will be larger, the less elastic is demand with respect to price
 - c. the increase in the tax burden on smokers will be larger and the reduction in smoking will be smaller, the less elastic is demand with respect to price
 - d. the increase in the tax burden on smokers and the reduction in smoking will be larger, the less elastic is demand with respect to price

Session 14

1. Tax efficiency means that:
 - a. the excess burden from taxes is minimized
 - b. taxes should generally have a neutral effect on economic decisions
 - c. taxes should be levied at progressive rates
 - d. a. and b.

- e. all of the above
2. Assuming that wage levels are higher for those households who possess university degrees, a large increase in income tax rates can be expected to lead to (Hint: What happens to the after-tax income differential between occupations that require a degree and those that do not?):
- a. reduced demand for higher education
 - b. lower tuition
 - c. lower pre-tax wages in occupations not requiring a university degree
 - d. a and b
 - e. all of the above
3. A selective tax on luxury boats:
- a. imposes an economic burden on both the buyers and builders of boats
 - b. promotes greater horizontal equity in taxation
 - c. is likely to impose an excess burden on the economy
 - d. a. and c.
 - e. all of the above
4. Assuming real estate buyers seek to maximise their returns on their investments, raising the local property tax rates in a particular jurisdiction is likely to lead to:
- a. reduced demand and lower prices for real estate in that jurisdiction
 - b. increased demand and higher prices for real estate in surrounding jurisdictions
 - c. reduced demand and higher prices for real estate in that jurisdiction
 - d. a. and b.
 - e. b. and c.

Session 15

1. Public choice theory:
- a. assumes that individuals working in the public sector are motivated by public-interest rather than self-interest
 - b. seeks to provide an explanation of the outcomes of the political process
 - c. seeks to provide guidance to government decision-makers in selecting public policies efficiently.
 - d. all of the above
2. Suppose three equal size groups, X, Y, and Z are voting on how to share a given tax burden. Tax proposal A would divide the burden equally among the three groups. Tax proposal B would impose 20% of the burden on X, 80% of the burden on Y and none of the burden on Z. Tax proposal C would impose 10% of the burden on X, 40% of the tax burden on Y, and 50% of the tax burden on Z. Given these alternatives and assuming

each group wishes to keep its tax burden as low as possible, which tax proposal will win if the proposals are voted on using majority rule:

- a. tax proposal A
 - b. tax proposal B
 - c. tax proposal C
 - d. there is no clear winner
3. Three equal size groups, A, B, and C, are voting on the building of a public day-care facility. The facility will provide \$10,000 of annual benefits per head to members of group A, \$12,000 of benefits per head to group B, and \$5000 of benefits per head to group C. The annual cost to be shared equally will be \$8,000 per head. According to economic theory:
- a. majority rule will result in building the facility
 - b. the facility should be built on efficiency grounds
 - c. the facility should not be built on efficiency grounds
 - d. a. and b.
 - e. a. and c.
4. According to public choice theory, educational policy-makers are most likely to be subject to organized political pressure exerted by groups of:
- a. teachers
 - b. taxpayers
 - c. parents
 - d. voters

Session 16

1. Examine again the data for the wellness education program used above in the homework for Session 2 in questions 3 and 4. Assuming that the program was delivered by a budget-maximizing bureaucracy:
 1. the bureaucracy will produce 5 units and this is the efficient amount
 - b. the bureaucracy will produce 3 units and this is the efficient amount
 - c. the bureaucracy will produce 5 units and this exceeds the efficient amount
 - d. the bureaucracy will produce 5 units and this is less than the efficient amount
 - e. the bureaucracy will produce 6 units and this is more than the efficient amount
2. A decentralized system of government:
 - a. tends to result in uniformity in the level and mix of government services between jurisdictions
 - b. allows diversity in the level and mix of government services

- c. makes it easier to reach national goals for government services
 - d. is undemocratic
3. According to most economists, the redistribution of income is most effectively carried out by:
- a. a national government
 - b. a local government
 - c. a state government
 - d. a regional government
4. Suppose investment in crime control by a local jurisdictions in urban areas leads to increased public safety for both the local and surrounding jurisdictions. In this case, a national or state government could best improve economic efficiency by:
- a. providing an unconditional or general-purpose grant to the jurisdiction to enable it to afford more crime control
 - b. providing a block grant that pays for the full cost of investments in crime control
 - c. providing a matching categorical grant that pays for the spillover or interjurisdictional benefits of crime control
 - d. not providing any aid since citizens can always move to jurisdictions which maximize their economic well-being