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UST 603/PAD 603/PDD603/NAL 603

PUBLIC FINANCE AND ECONOMICS

FALL 2009

WEDNESDAY SESSION

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. Ninth Edition (2008) or Eighth Edition (2005). Thompson.

Steven Landsburg. The Armchair Economist. Free Press. 1993

Ansel Sharp, Charles Register, and Paul W. Grimes. Economics of Social Issues. Eighteenth Edition (2008) or Seventeenth Edition. (2005). Irwin.

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2. Reserve reading (CSU library website)

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

Michael Crawford. "Analyzing the Cost Effectiveness of Managed Competition." Government Finance Review, October 2002: 32-36.

John Mikesell. "Cost Estimation" in Fiscal Administration: Analysis and Applications in the Public Sector. Wadsworth.

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

Michael Spicer and Richard Bingham. "Public Finance and Budgeting." In Richard Bingham et al. Public Administration in Practice. Newbury Park: Sage, 1991.

XiaoHu Wang. "Incremental Cost Analysis" in Financial Management in the Public Sector (2006). M.E. Sharpe.

III. COURSE REQUIREMENTS

1. Three Midterms, September 23, October 21, November 25, (25% each for two highest scores)
2. Final Comprehensive Examination, December 9 (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 and also articles on reserve, 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. PAGE NUMBERS FOR THE NEW EDITIONS OF THE TEXTS ARE LISTED IN BRACKETS. PAGE NUMBERS FOR THE EARLIER EDITIONS ARE LISTED IN PARENTHESES. 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 or historical data.

Session 1: Introduction. Course overview.

Session 2: Scarcity and the Need to Choose; Opportunity Cost; the Nature of Economic Theory; Economic Efficiency.

Assignments: Sharp et al., Chapter 1, 11 [324-327] or 13 (358-363); Hyman, Chapter 1 [2-29] (3-28), 2 [52-59] (52-59)

Session 3: Supply and Demand.

Assignments: Sharp et al., Chapter 2

Session 4: Supply and Demand (cont'd); Markets, Efficiency, and The Role of Government; The Effects of Subsidies on Efficiency; Efficiency versus equity.

Assignments: Sharp et al., Chapter 14 [414-418] 14 (387-391). Hyman, Chapters 1 [41, 51] (41, 50-51), 2 [59-76] (59-75); Landsburg, Chapters 1, 4, 5, 6, 7, 8.

Session 5: Midterm I

Session 6: Rationale for Government Action: Externalities.

Assignments: Sharp et al., Chapters 4, 6; Hyman, Chapter 3, Landsburg, Chapters 9, 17, 24.

Session 7: Rationale for Government Action, Public Goods; Budgetary Process; Cost Analysis

Assignments: Sharp et al. Chapter 5; Hyman, Chapter 4 [141-154, 165-169] (139-152, 162-167)

Michael Spicer and Richard Bingham. "Public Finance and Budgeting." In Richard Bingham et al. Public Administration in Practice (Reserve Reading).

XiaoHu Wang. "Incremental Cost Analysis" in Financial Management in the Public Sector (Reserve Reading).

Michael Crawford. "Analyzing the Cost Effectiveness of Managed Competition." Government Finance Review (Reserve Reading)

John Mikesell. "Cost Estimation" in Fiscal Administration: Analysis and Applications in the Public Sector (Reserve Reading).

Session 8: Methods of Expenditure Analysis

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 9: Midterm II.

Session 10: Income Distribution and Redistribution.

Assignments: Sharp et al, Chapters 7, 3, 15 [437-442] (408-413); Hyman, Chapter 7 [255-268, 270-277, 287-301] (251-263, 265-273, 283-298); Landsburg, Chapter 13.

Session 11: Principles of Taxation.

Assignments: Sharp et al. Chapter 14; Hyman, Chapter 1 [18-20] (19-21), 10 [402-419] (395-412), Landsburg, Chapter 7.

Session 12: Principles of taxation (contd.).

Assignments: Hyman, Chapter 11 [63-65] (63-65), 14 [542-553] (536-547), 16 [623-630, 641-650] (610-617, 624-631), 17 [654-658, 663-667, 671-683] (641-645, 650-654, 658-670),

Session 13. Midterm III

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

Assignments: Hyman, Chapter 5 [173-216] (170-213); Landsburg, Chapter 6.

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

Session 15. 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 below prepared to both provide an answer to the question for that session and also to explain your reasoning for the answer, drawing graphs where appropriate. Your exams will take the form of questions of this type.

Session 3

1. An inward shift (shift to the left) in the production possibility frontier for a country would occur in all of the following cases below EXCEPT:
 - a. a deadly bird-flu epidemic
 - b. layoffs of workers from a major automobile plant
 - c. terrorist bombing of subways
 - d. a major hurricane
 - e. none of the above (i.e. they all shift the frontier inward)

2. 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 private goods and services will allow an increase in the output of government goods and services
 - d. a decrease in the output of government goods and services will have no effect on the output of private goods and services

Questions 3-4 are based on the following information. A study has been instituted to determine the benefits and costs of a job-training program at different levels and the results are listed in the following table. Figures for costs of job training are also included:

Units of Job training	Total Social Benefits (\$)	Total Social Costs (\$)
1	50,000	35,000
2	95,000	70,000
3	135,000	105,000
4	170,000	140,000
5	200,000	175,000
6	225,000	210,000
7	245,000	245,000
8	260,000	280,000

3. The estimated marginal social benefit of the fifth unit of job training is:
 - a. \$200,000
 - b. \$30,000

- c. \$25,000
 - d. \$35,000
 - e. we cannot determine this from the information given
4. The economically efficient level of job training is:
- a. 7 units
 - b. 6 units
 - c. 5 units
 - d. 4 units
 - e. 2 units

Session 4

1. Schools are having difficulty finding mathematics teachers. This suggests that the wage paid for the services of mathematics teachers is:
- a. currently higher than the equilibrium wage
 - b. currently lower than the equilibrium wage
 - c. can be expected to rise
 - d. a. and c.
 - e. b. and c.
2. All but one of the following may cause the demand curve for health care to shift to the right. Which is this?
- a. government subsidies to buyers of health insurance
 - b. an aging population
 - c. an increase in income
 - d. a decrease in the price of health care
 - e. none of the above (i.e. any of the above will shift the demand curve to the right)
3. According to supply and demand, a decrease in public school teachers' wages and an increase in the quantity of public school teaching services offered can be expected to result from:
- a. the provision of vouchers to parents for private schools
 - b. tougher standards for teaching certification
 - c. federal subsidies to school districts to hire new teachers
 - d. relaxing licensure requirements by allowing college graduates without education certificates to teach
4. Ethanol is a substitute for gasoline. An increase in subsidies to ethanol producers can be expected to lead to:

- a. an increased demand for ethanol (rightward shift in the demand curve)
- b. an increased supply of ethanol (rightward shift in the supply curve)
- c. lower gasoline prices
- d. a. and c,
- e. b. and c.

Session 5

1. You need to increase the revenue generated by a local swimming pool in order to meet expenses. The mayor advises you to reduce the price of pool passes. The city manager recommends increasing the price of pool passes. You realize that
 - a. the mayor thinks demand is elastic and the city manager thinks demand is inelastic
 - b. both the mayor and the city manager think that demand is elastic
 - c. both the mayor and the city manager think that demand is inelastic
 - d. the mayor thinks demand is inelastic and the city manager thinks demand is elastic

2. Assuming that the demand for gasoline is inelastic with respect to price, the effect of a decrease in gasoline refining capacity from a major hurricane will lead to:
 - a. higher gasoline prices
 - b. a reduced quantity of gasoline demanded
 - c. increased revenues for gasoline producers
 - d. a. and c.
 - e. all of the above

3. Suppose that the price elasticity of supply of lawn mowers is 1.5. If the price of lawn mowers rises 5 percent, the quantity supplied of lawn mowers would
 - a. decline 7.5 percent.
 - b. rise 7.5 percent.
 - c. rise 1.5 percent.
 - d. rise 0.3 percent.

4. Assuming that, in the absence of government intervention, the market for day care operates efficiently, then subsidies to day care users will:
 - a. lead to economic inefficiency because such subsidies will result in marginal social benefit exceeding marginal social benefit for day care
 - b. result in a larger than efficient output of day care
 - c. lead to an decrease in the price of day care
 - d. a. and b.
 - e. all of the above

Session 7

1. An external cost results from the use of cell phone services. If cell phone services are sold in a competitive market, it follows that:
 - a. too few cell phone services will be purchased unless a subsidy is provided for these services
 - b. too few cell phone services will be purchased unless a tax is imposed on these services
 - c. too many cell phone services will be purchased unless a subsidy is provided for these services
 - d. too many cell phone services will be purchased unless a tax is imposed on these services

2. The marginal cost per unit of a pollutant discharged into a lake by a competitive chemical industry is estimated at \$200 per ton. A pollution tax of \$200 per ton is in effect. The marginal cost to the firm of cleaning up a ton of discharge is \$300 at current clean-up levels. Given these conditions:
 - a. 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
 - b. the firm will clean up more of the discharge but this is not the correct decision from the point of view of economic efficiency .
 - c. 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
 - d. 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.

3. Provided the affected parties can negotiate with each other, an efficient voluntary solution to the problem of water pollution by a mining firm may be reached:
 - a. if the mining firm has the legal right to pollute and the victims of pollution can offer to pay the firm to reduce pollution
 - b. if the victims of pollution have the legal right to prevent the mining firm from polluting but the firm can offer to pay the victims to bear some pollution
 - c. only if agreements between the parties actually result in reduced pollution
 - d. a or b
 - e. all of the above

4. An example of external benefits arising from higher education would include:
 - a. increased income of university graduates
 - b. income earned by college professors
 - c. new scientific knowledge
 - d. all of the above
 - e. none of the above

Session 8

20. The most efficient solution to the problem of global warming caused by carbon dioxide would be:
- educational programs that show citizens how they can contribute to the reduction of global warming
 - a tax on those carbon-based energy sources that contribute to global warming
 - to subsidize the output of firms who contribute to global warming so that they can afford to take remedial measures without laying off workers
 - regulatory limits on carbon-dioxide emissions
2. All of the following are examples of public goods except:
- a lighthouse
 - reducing global climate change
 - treatment for diabetes
 - a more effective flood control system for New Orleans
 - prevention of a bird-flu epidemic

The following information is used in questions 3 and 4. A drug rehabilitation program is currently serving 150 clients for a total cost of \$450,000 with fixed costs of \$300,000. Costs are assumed to be a linear function of the number of clients served.

3. If the program adds 50 more clients, total costs will be:
- \$200,000
 - \$500,000
 - \$600,000
 - \$800,000
 - \$900,000
4. Assuming that the program receives \$2,500 per client served, the program can be expected to break even at a service level of:
- 120 clients
 - 150 clients
 - 200 clients
 - 300 clients

Session 9

1. Roadway City is considering building a new asphalt plant to help it maintain its roads. The plant will cost \$8 million to construct, last approximately 20 years, and, in addition, have operating costs of \$1 million per year. If the plant is built, it is estimated that the

city will save \$2 million per year that is currently paid to private asphalt producers. Assuming a discount rate of 8%, on the basis of benefit-cost analysis and criteria, the plant has (Hint: calculate the net savings in annual costs as a result of building the plant to make your present value calculations easier):

- a. A net present value of about \$12 million and should be built
 - b. A net present value of about \$1.8 million and should be built
 - c. A net present value of about \$7.8 million and should be built
 - d. A net present value of about \$9.8 million and should be built
 - e. A net present value of about minus \$ 8 million and should not be built
2. Two government projects each have an investment cost of \$2,400,000. Project X yields \$600,000 per year for the first four years and then yields \$400,000 per year for four years after that. Project Y yields \$500,000 per year for eight years. Assuming a discount rate greater than zero, which of the following statements is accurate?
- a. Since total future benefits exceed the investment cost for both projects, both projects must always have a positive net present value
 - b. The net present value of Project X will be greater than the net present value of Project Y
 - c. The net present value of Project Y will be greater than the net present value of Project X
 - d. The net present value of the two projects will be the same
 - d. b. or c. may be true depending on the discount rate selected
3. Assuming a discount rate of 8%, what is the maximum you should pay for medical testing equipment that will save you \$50,000 in external lab testing fees each year for the next five years and can be traded in at the end of this time for a lump (one-time) sum of \$10, 000?
- a. \$192,840
 - b. \$199,650
 - c. \$206,460
 - d. \$239,580
 - e. \$260,000
4. In cost-benefit analysis of capital projects, using a discount rate which is higher than that which measures the true opportunity cost to society of resources invested in a capital project:
- a. will lead to the rejection of projects which are justifiable on efficiency grounds
 - b. will lead to the adoption of projects which are not justifiable on efficiency grounds
 - c. will not affect investment decisions so long as both costs and benefits are discounted
 - d. will lead to excessively high estimates of the present values of future benefits from the projects
 - e. both a. and b.

Session 11

1. Park rangers at Yellowstone National Park are known to have low wages. This is likely to be partially a result of the fact that
 - a. park rangers are required to be college graduates.
 - b. park rangers don't need much money to live.
 - c. park ranger jobs are perceived to be enjoyable
 - d. park ranger jobs are perceived to be dangerous

2. The effects of a price ceiling imposed on electricity at a level below equilibrium prices in a competitive market would include:
 - a. a decreased quantity of electricity available
 - b. a loss of mutually beneficial trade between electricity buyers and sellers
 - c. increased investment in new electricity plants
 - d. a. and b.
 - e. all of the above

3. Economic problems can arise in our redistributinal programs for the following reasons:
 - a. these programs may reduce work effort among the poor
 - b. many of those receiving benefits may not be poor
 - c. the poor waste their welfare payments on things they do not need
 - d. a. and b.

4. Families of four are to be supported at a minimum income of \$20,000 per year by a negative income tax program with a tax rate of 40%. A family is able to earn \$10,000. Its total income including earned income and the negative tax payment will be:
 - a. \$30,000
 - b. \$26,000
 - c. \$16,000
 - d. \$14,000

Session 12

1. The gasoline tax, used to pay for roads, can be defended on the basis of:
 - a. the benefits-received principle
 - b. the horizontal equity principle
 - c. neutrality in terms of its effects on economic behavior
 - d. the ability-to-pay principle

2. An income tax taxes all income below \$50,000 at 30% and all income in excess of \$50,000 at 50%. A household earning \$80,000 faces:
 - a. an average tax rate of 30% and marginal tax rate of 50%
 - b. an average tax rate of 37.5% and marginal tax rate of 50%
 - c. an average tax rate of 50% and a marginal tax rate of 37.5%
 - d. an average tax rate of 40% and a marginal tax rate of 50%
 - e. an average tax rate of 50% and a marginal tax rate of 30%

3. Although lawmakers legislated a fifty-fifty division in the payment of the FICA (social security) tax, supply and demand theory would suggest that
 - a. the same tax burden on employees would result if the entire tax were levied on only the employees or only on the employers.
 - b. employees would bear less of the tax burden if employers were required to pay a larger share of the tax payment.
 - c. employees would bear more of the tax burden if employees were required to bear a larger share of the tax payment
 - d. employees would bear more of the tax burden if employers were required to bear a larger share of the tax payment
 - e. b. and c,

4. If a tax is imposed on the sellers of airline travel,
 - a. the burden of the tax on buyers will be larger and the reduction in air travel will be smaller when the demand for air travel is more elastic with respect to the price.
 - b. the burden of the tax on buyers and the reduction in air travel will be smaller when the demand for air travel is more elastic with respect to the price.
 - c. the burden of the tax on buyers will be smaller and the reduction in air travel will be larger when the demand for air travel is more elastic with respect to the price.
 - d. the burden of the tax on buyers and the reduction in air travel will be larger when the demand for air travel is more elastic with respect to the price

Session 13

1. Assuming that wage levels are higher for those households who possess university degrees, a large increase in income tax rates on higher income families 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

2. A selective tax on luxury boats:
 - a. imposes an economic burden on both buyers and sellers
 - b. is likely to impose a greater deadweight loss when demand is more price elastic
 - c. is likely to impose a greater deadweight loss when demand is less price elastic
 - d. a. and b.
 - e. a. and c.

3. A tax leads to an excess burden or efficiency loss because
 - a. it induces the government to spend more
 - b. it induces buyers to consume less and sellers to produce less.
 - c. it causes a disequilibrium in the market.
 - d. the loss to buyers is greater than the loss to sellers.

4. At present customer purchases of good and services over the internet are exempt from state sales taxes. Abolishing this exemption would lead to
 - a. greater horizontal equity in sales taxation
 - b. increased state sales tax revenues
 - c. a reduction in the excess burden from sales taxation
 - d. a. and b.
 - e. all of the above

Session 15

1. A County Commission with three members (Brown, Waters, and Smith) is faced with choosing one of three programs; a day-care program (D), a rehabilitation program for substance abusers (R), and a homeless shelter (H). Commissioner Brown prefers D to R and R to H. Commissioner Waters prefers H to D and D to R. The expressed majority preference turns out to be arbitrary and unstable. What are Commissioner Smith's preferences?
 - a. She prefers D to H and H to R
 - b. She prefers H to R and R to D
 - c. She prefers R to H and H to D
 - d. She prefers R to D and D to H
 - e. none of the above

- 2.. Public choice economists argue that voters find it rational to be ignorant about public policy issues because:
 - a. the policy process is controlled by special interests
 - b. elections are rarely decided by one vote

- c. candidates for elected office rarely differ much on policy issues
 - d. candidates for elected office do not have any incentive to provide accurate information to voters
3. A community is going to vote on how much money to spend on education. 10% of voters want to spend \$25 billion, 20% of voters want to spend \$30 billion, 30% of voters want to spend \$35 billion and 40% of voters want to spend \$40 billion. Voting will be done in a pair-wise fashion, that is, only two of the four options will be considered at a time, with the winner of each vote then being paired with a remaining option. According to the Median Voter Theory, the winner
- a. will be \$25 billion.
 - b. will be \$30 billion.
 - c. will be \$35 billion.
 - d. will be \$40 billion
 - e. will be any of the budgets depending on the order in which they are voted on
4. According to public choice theory, health care policy-makers are most likely to be subject to organized political pressure exerted by groups of:
- a. health care providers
 - b. taxpayers
 - c. patients
 - d. voters