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OR by appointment

UST 603/PAD 603/PDD603/NAL 603

## PUBLIC FINANCE AND ECONOMICS

SPRING 2008

### 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

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, February 13, March 19, April 16 (16.67% each)
2. Final Comprehensive Examination, May 7 (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. 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], 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] (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: Monopoly; Negative Externalities.

Assignments: Sharp et al., Chapters 8, 4; Hyman, Chapter 3 [96-101, 104-110, 112-137] (96-101, 104-110, 112-134) Landsburg, Chapters 9, 17, 24.

Session 7: Rationale for Government Action: Positive Externalities; Public Goods.

Assignments: Sharp et al. Chapters 6, 5; Hyman, Chapters 3 [101-104, 110-111] (101-104, 110-111), 4 [141-154, 165-169] (139-152, 162-167)

Session 8: 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 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.

Assignments: Hyman, Chapter 5 [173-212] (170-209): Landsburg, Chapter 6.

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

Assignments: Hyman, Chapters 5, [213-216] (209-213), 18 [688-709, 713-720] (675-697, 701-708)

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

#### 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 would occur if there were:
  - a. A major recession such as occurred in the 1980's
  - b. A terrorist attack
  - c. A major hurricane
  - d. b. or c.
  - e. Any of the above events
2. Given the events of September 11, we should:
  - a. seek to make air travel safety perfectly safe
  - b. provide air travel safety at a level where its marginal benefits to society equal its marginal costs to society
  - c. increase investment in air travel safety so long as such increases yield a positive marginal social benefit to society
  - d. b. and c.
  - e. all of the above

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 third unit of job training is:

- a. \$135,000
- b. \$30,000
- c. \$40,000
- d. \$35,000
- e. we cannot determine this from the information given

4. The economically efficient level of job training is:

- a. 2 units
- b. 4 units
- c. 5 units
- d. 6 units
- e. 7 units

#### Session 4

1. There is currently a shortage of abortion services. This suggests that:

- a. the price of abortion services is above the equilibrium price
- b. the price of abortion services is below the equilibrium price
- c. the price of abortion services will fall
- d. a. and c.
- e. b. and c

2. All but one of the following is likely to cause the demand curve for prescription drugs to shift to the right. Which is this?

- a. an aging population
  - b. a reduction in the price of prescription drugs
  - c. coverage of prescription drugs by Medicare
  - d. an increase in income
3. According to supply and demand, government regulations on mortgage lenders mandating more restrictive requirements for making mortgage loans will lead to all of the following EXCEPT:
- a. a reduction in the supply of mortgage loans
  - b. a reduction in the quantity demanded of loans
  - c. higher interest rates for mortgage loans
  - d. a reduction in home ownership
  - e. higher housing prices
4. According to supply and demand, an increase in public school teachers' wages and 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. federal subsidies to school districts to hire new teachers
  - c. allowing college graduates without education certificates to teach
  - d. tougher standards for teaching certification
  - e. b. or c.

#### Session 5

1. The demand for health care is inelastic. This means that, when price increases by a given percentage:
- a. the quantity demanded of health care will increase by a smaller percentage
  - b. the quantity demanded of health care will decrease by a larger percentage
  - c. the quantity demanded of health care will remain unchanged
  - d. the quantity demanded of health care will decrease by a smaller percentage
  - e. none of the above
2. In the mid-1980s, the state of Texas raised the price of personalized automobile license plates from \$25 to \$70. The state's revenue from the personalized license plates then fell. From this information, what can you say about the price elasticity of demand for personalized plates?
- a. elasticity is greater than one
  - b. elasticity is less than one
  - c. elasticity is equal to one
  - d. Not enough information to answer the question

3. Assuming that, in the absence of government intervention, the market for food operates efficiently, it follows then that the subsidies to food buyers:
  - a. lead to economic inefficiency because such subsidies will result in marginal social benefit exceeding marginal social cost for food
  - b. result in a smaller than efficient output of food
  - c. lead to an increase in the price of food
  - d. a. and c.
  - e. none of the above
  
4. A decision to change the level and/or mix of services provided by government so as to achieve economic efficiency:
  - a. will lead to a Pareto-optimal outcome
  - b. will result in a situation where the winners from the change could compensate the losers
  - c. will provoke no opposition by citizens
  - d. a. and b.
  - e. all of the above

#### Session 7

The following data should be used for questions 1 and 2. The table below shows the demand curve and marginal cost curve facing an oil monopoly:

Output (Barrels)	Price (\$)	Marginal Cost (\$)
1	90	29
2	80	39
3	70	49
4	60	59
5	50	69

1. If the monopoly firm wishes to maximize profits, the firm will:
  - a. produce 1 barrel at a price of \$90
  - b. produce 2 barrels at a price of \$80 per barrel
  - c. produce 3 barrels at a price of \$70 per barrel
  - d. produce 4 barrels at a price of \$60 per barrel
  - e. produce 5 barrels at a price of \$50 per barrel
  
2. If this were a perfectly competitive industry, the firms would:
  - a. produce 5 barrels at a price of \$50 per barrel
  - b. produce 4 barrels at a price of \$60 per barrel

- c. produce 3 barrels at a price of \$70 per barrel
  - d. produce 2 barrels at a price of \$80 per barrel
  - e. produce 1 barrel at a price of \$90 per barrel
3. An external cost arises from the use of fossil fuels because of global warming. If fossil fuels are sold in a competitive market:
- a. The marginal social cost of fossil fuels is less than their marginal private cost
  - b. the marginal social cost of fossil fuels will exceed their marginal private cost
  - c. the marginal social benefit of fossil fuels will be less than their marginal social cost
  - d. a. and c.
  - e. b. and c.
4. The marginal cost per unit of a pollutant discharged into a river by a competitive chemical industry is estimated at \$70 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 \$60 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
  - c. the firm will clean up more of the discharge and this is the correct decision from the point of view of economic efficiency
  - c. 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 8

1. An external benefit results from the purchase of smoke detectors. If smoke detectors are sold in a competitive market, it follows that:
- a. too many smoke detectors will be produced unless a subsidy is provided for smoke detectors
  - b. too few smoke detectors will be produced unless a subsidy is provided for smoke detectors
  - c. too many smoke detectors will be produced unless a tax is imposed on smoke detectors
  - d. too few smoke detectors will be produced unless a tax is imposed on smoke detectors
2. An external benefit results from garbage collection. If garbage collection services are sold in a competitive market:
- a. the marginal social benefit of garbage collection is less than the marginal private benefit received by any consumer
  - b. the marginal social benefit of garbage collection will exceed the marginal private benefit received by any consumer

- c. in equilibrium the marginal social cost of garbage collection equals the marginal social benefit
  - d. In equilibrium the marginal social benefit of garbage collection is zero
3. The following actions can save lives. All of these are public goods except:
- a. the provision of clean air
  - b. the control of communicable diseases
  - c. the treatment of heart disease
  - d. a reduction in gun ownership by criminals
  - e. none of the above
4. A good would be classified as a public good if:
- a. one person's consumption of a unit of the good does not exclude others from consuming that unit
  - b. a majority of citizens want government to provide the good
  - c. the market makes it difficult for those who cannot afford the good to obtain the amount they need
  - d. government finances the good and provides it at a zero price to consumers
  - e. all of the above

#### Session 9

1. Two government projects each have an investment cost of \$1,600,000. Project A yields \$200,000 per year for the first four years and then yields \$300,000 per year for four years after that. Project B yields \$250,000 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 B will be greater than the net present value of Project A
  - c. The net present value of Project A will be greater than the net present value of Project B.
  - d. b. or c. may be true depending on the discount rate selected
2. A city is considering whether or not to build a parking garage. The front-end investment cost to acquire the land and build the garage is \$6 million. The garage is expected to yield a net annual income of \$500,000 for 40 years. Assuming a discount rate of 10%, on the basis of a cost-benefit analysis using these figures, the garage has:
- a. a net present value of about minus \$1.1 million and should not be built
  - b. a net present value of about \$4.9 million and should be built
  - c. a net present value of about \$14 million and should be built
  - d. a net present value of about minus \$6 million and should not be built.
  - e. a net present value of about \$4.8 million and should be built.

3. When cost-benefit analysis is used for evaluating capital projects, using a higher discount rate:
  - a. will lead to the adoption of more projects since it indicates a higher expected return
  - b. will lead to the adoption of less 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.
  
4. Assuming a full employment economy, which of the following should not be included as a benefit of a government project to build a new sports stadium when doing a cost-benefit analysis
  - a. the income of workers employed by the stadium
  - b. revenues from ticket sales
  - c. the increase in income for restaurants close to the stadium
  - d. both (a) and (c)
  - e. all of the above

#### 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 dangerous.
  - d. park ranger jobs are perceived to be enjoyable
  
2. A comparable worth study indicates that day-care workers are relatively underpaid. As a result, government enacts a law requiring that employers pay day-care workers higher wages. According to supply and demand, this will result in all of the following EXCEPT:
  - a. An increase in the quantity of day-care worker services employed
  - b. An increase in the number of workers seeking employment in day-care
  - c. increased unemployment among day-care workers
  - d. higher wages for day-care workers employed
  
3. A cash subsidy designed to replace public housing subsidies and leave recipients just as well off would:
  - a. cost the taxpayer more than housing subsidies
  - b. cost the taxpayer less than housing subsidies
  - c. increase the price for housing
  - d. b. and c.
  - e. a. and c.

4. Families of four are to be supported at a minimum income of \$12,000 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. \$18,000
  - c. \$22,000
  - d. \$14,800
  - e. \$16,000

### Session 12

1. Proposals for a simplified "flat-rate rate tax" call for the abolition of most tax deductions and credits and for the taxation of all income above a certain minimum tax-free level at the same rate. Under such a tax plan, for those paying taxes:
- a. the marginal tax rate would exceed the average tax rate
  - b. the marginal tax rate would be equal to the average tax rate
  - c. the marginal tax rate would be less than the average tax rate
  - d. the tax would be regressive
  - e. c. and d.
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. According to supply and demand, the market wage will rise and employment will fall as a result of:
- a. a tax on labor paid by employers
  - b. a tax on labor paid by employees
  - c. either a. or b.
  - d. none of the above
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 more 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 more 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 more 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 more elastic is demand with respect to price

### Session 13

1. 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. increased purchases and sales of goods and services over the internet
  - 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 on higher income households 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 the supply of luxury boats:
  - a. imposes an economic burden on both the buyers and builders of boats
  - b. is likely to impose a greater deadweight loss when demand is more elastic
  - c. is likely to impose a greater deadweight loss when demand is less elastic
  - d. a. and b.
  - e. a. and c.
  
4. Assuming real estate buyers seek to maximize 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. 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.
2. A County Commission with three members is faced with choosing one of three projects; a housing program (H), a roads program (R), and a parks program (P). Commissioner Gordon prefers H to R and R to P. Commissioner Peters prefers R to P and P to H. Commissioner Schmidt prefers P to H and H to R. Assuming that the programs are voted on two at a time, which is the clear preference of the Commission as expressed through majority rule?
- a. the housing program
  - b. the roads program
  - c. the parks program
  - d. none is the clear preference
3. A community is considering three education budgets. Budget A calls for spending of \$79 million, budget B calls for spending of \$83 million, and budget C calls for spending of \$86 million. Each of these budgets is the most preferred budget for about a third of the community. If they cannot obtain their most preferred budget, voters will choose the budget that is closest to their most preferred budget in terms of dollars spent. Assuming that the budgets are voted on two at a time with two rounds of voting, majority rule would lead to:
- a. adoption of budget A
  - b. adoption of budget B
  - c. adoption of budget C
  - d. no clear winner
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. The efficiency problem with a budget-maximizing bureaucracy arises because it produces at a level where:

- a. total social cost exceeds total social benefit
  - b. marginal social benefit exceeds marginal social cost
  - c. total social cost exceeds the minimum cost of the output provided
  - d. total social benefit equals total social cost
  - e. marginal social benefit equals marginal social cost
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 local jurisdictions in urban areas leads to increased public safety both for their citizens and those of 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 local jurisdictions to enable them 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 inter-jurisdictional benefits of crime control
  - d. not providing any aid since citizens can always move to jurisdictions which maximize their economic well-being.