

Arnaud Dellis  
Spring 2007

## **Tentative Syllabus for Economics 651 Theory of Public Finance - Revenue**

### **Course Outline**

This is the first semester of a two-semester course in Public Economics. This course focuses on the revenue side of the public sector budget. The prerequisite for the course is graduate microeconomic theory. The course contains four parts. The first one covers the public economy of taxation and explores both its positive and normative aspects. The second part goes over fiscal federalism; that is, the allocation of fiscal instruments and transfers between the different levels of government. The third part introduces the political constraint. The last part provides an introduction to behavioral public finance. A reading list for each topic is provided below. Note however that it is intended to serve as a reference since not all sections will be covered this semester.

The course will be organized as follows. During the first part of the semester I will be lecturing, mainly on part I and on some topics from parts II-IV. The second part of the semester will consist of presentations by students.

### **Grading**

Your grade will be based on a class presentation and the writing of two referee reports.

Each student enrolled in the class must choose one paper from the reading list part II-IV and present it in class. The presentation format will be similar to a seminar, so a full lecture will be devoted to one presentation. A list of presentations as well as the order of presentations will be established by the beginning of February. The presentation will determine 40% of your grade.

Each student enrolled in the class must write two reports. One report will be on a paper I will assign. The second referee report will be on a paper from the reading list chosen by the student. Both reports will be due by May 8<sup>th</sup>, 2007 at 12.00 pm. Each report will determine 30% of the final grade.

## Texts and Reading

I have ordered four books for the course. They are:

Myles, G., 1995. *Public Economics*. Cambridge University Press, Cambridge. (**M**)

Salanie, B., 2003. *The Economics of Taxation*. MIT Press, Cambridge, MA. (**S**)

Slemrod, J. and J. Bakija, 2004. *Taxing Ourselves. A Citizen's Guide to the Debate over Taxes*. Third edition. MIT Press, Cambridge, MA. (**S & B**)

Thomson, W., 2001. *A Guide for the Young Economist. Writing and Speaking Effectively about Economics*. MIT Press, Cambridge, MA (**Th**)

**M** is a graduate textbook covering the field of Public Economics. It covers all the material discussed in part I. It is the reference graduate textbook in the field. **S** is a graduate textbook, focused on the public economy of taxation. **M** and **S** will serve as the main textbooks for the first part of the class. **Th** is a book that you may find useful in order to prepare for the presentation and the writing of the referee reports. Finally, **S & B** is an optional reading for this class. It provides an overview of the U.S. tax system as well as a discussion of the main issues in taxation. People who are not familiar with the tax system should read it.

In addition, the reading list below contains journal articles and working papers. The articles marked (B) are background papers that layout the basics of a topic. The articles marked (E) are empirical papers. Finally, the articles marked (S) are survey papers that provide a summary of the literature on a specific topic.

For those who are not familiar with undergraduate-level Public Economics, I strongly recommend reading

Hindriks, J. and G. Myles, 2006. *Intermediate Public Economics*. MIT Press, Cambridge, MA. (**H&M**).

## Reading List

### Introduction: The Size of Government

H&M – Ch. 3-4;

(E) Husted, T. and L. Kenny, 1997. The effect of the expansion of the voting franchise on the size of government. *Journal of Political Economy* 105, 54-82.

Meltzer, A. and S. Richard, 1981. A rational theory of the size of government. *Journal of Political Economy* 89, 914-927.

Mueller, D., 2003. *Public Choice III*. Cambridge University Press, Cambridge, Chapter 21.

### Part I: The Public Economy of Taxation

#### 1. Effects of Taxation

S – Ch. 1-2;

(S) Auerbach, A. and J. Hines, 2002. Taxation and economic efficiency. In: *Handbook of Public Economics: vol. 3*, A. Auerbach and M. Feldstein (eds), North-Holland, Amsterdam.

##### 1.1. Tax Incidence

(S) Fullerton, D. and G. Metcalf, 2002. Tax incidence. In: *Handbook of Public Economics: vol. 4*, A. Auerbach and M. Feldstein (eds), North-Holland, Amsterdam.

Harberger, A.C., 1962. The incidence of the corporation income tax. *Journal of Political Economy* 70(3), 215-240.

Hines, J.R. Jr., 1999. Three sides of Harberger triangles. *Journal of Economic Perspectives* 13(2), 167-188.

##### 1.2. Labor Supply

M – Ch. 5

(E) Gruber, J. and E. Saez, 2002. The elasticity of taxable income: evidence and implications. *Journal of Public Economics* 84, 1-32.

Hausman, J., 1981. Exact consumers surplus and deadweight loss. *American Economic Review* 81, 622-676.

### **1.3. Savings**

(S) Bernheim, D., 2002. Taxation of saving. In: *Handbook of Public Economics: vol. 3*, A. Auerbach and M. Feldstein (eds), North-Holland, Amsterdam.

Summers, L., 1981. Capital taxation and accumulation in a life cycle model. *American Economic Review* 71, 533-544.

### **1.4. Risk-bearing and Portfolio Choice**

M – Ch. 7

(S) Poterba, J., 2002. Taxation, risk taking and household portfolio behaviour. In: *Handbook of Public Economics: vol. 3*, A. Auerbach and M. Feldstein (eds), North-Holland, Amsterdam.

## **2. Optimal Taxation**

Mirrlees, J.A., 1986. The theory of optimal taxation. In: *Handbook of Mathematical Economics: Volume III*, K.J. Arrow and M.D. Intriligator (eds), Elsevier, 1197-1249.

(B) Slemrod, J., 1990. Optimal taxation and optimal tax systems. *Journal of Economic Perspectives* 4(1), 157-178.

### **2.1. Indirect Taxation**

S – Ch. 3; M – Ch. 4;

Diamond, P.A. and J.A. Mirrlees, 1971. Optimal taxation and public production. I: Production efficiency and II: Tax rules. *American Economic Review* 61, 8-27 and 261-278.

Ramsey, F., 1927. A contribution to the theory of taxation. *Economic Journal* 37, 47-61.

### **2.2. Direct Taxation**

S – Ch. 4; M – Ch. 5

Diamond, P., 1998. Optimal income taxation: An example with a U-shaped pattern of optimal marginal tax rates. *American Economic Review* 88, 83-95.

Kremer, M., 2001. *Should Taxes be Independent of Age?*. Mimeo.

Mirrlees, J.A., 1971. An exploration in the theory of optimum income taxation. *Review of Economic Studies* 38(2), 175-208.

Saez, E., 2001. Using elasticities to derive optimal income tax rates. *Review of Economic Studies* 68, 205-229.

Sheshinski, E., 1972. The optimal linear income tax. *Review of Economic Studies* 39, 297-302.

### **2.3. Direct vs. Indirect Taxation**

S – Ch. 5; M – Ch. 5

Atkinson, A. and J. Stiglitz, 1976. The design of tax structure: direct versus indirect taxation. *Journal of Public Economics* 6, 55-75.

Boadway, R., M. Marchand and P. Pestieau, 1994. Towards a theory of the direct-indirect tax mix. *Journal of Public Economics* 55, 71-88.

### **2.4. Dynamic Optimal Taxation**

M – Ch. 15

Aiyogari, R., A. Marcet, T. Sargent and J. Seppala, 2002. Optimal taxation without state-contingent debt. *Journal of Political Economy* 110, 1220-1254.

Barro, R., 1979. On the determination of public debt. *Journal of Political Economy* 87, 940-947.

Golosov, M. and A. Tsyvinski, 2006. Designing optimal disability insurance: A case for asset testing. *Journal of Political Economy* 114, 257-279.

## **3. Social Security**

M – Ch. 14;

Cremer, H., J-M. Lozachmeur and P. Pestieau, 2004. Social security and variable retirement schemes. An optimal income taxation approach. *Journal of Public Economics* 88, 2259-2281.

Diamond, P., 1977. A framework for social security analysis. *Journal of Public Economics* 8, 275-298.

Diamond, P., 2003. *Taxation, Incomplete Markets, and Social Security*. MIT Press, Cambridge, MA.

Diamond, P. and J.A. Mirrlees, 1978. A model of social insurance with variable retirement. *Journal of Public Economics* 10, 295-336.

Samuelson, P., 1975. Optimum social security in a life-cycle growth model. *International Economic Review* 16(3), 539-544.

Sheshinski, E. and Y. Weiss, 1981. Uncertainty and optimal social security systems. *Quarterly Journal of Economics* 96(2), 189-206.

Van Groezen, B., T. Leers and L. Meijdam, 2003. Social security and endogenous fertility: pensions and child allowances as Siamese twins. *Journal of Public Economics* 87, 233-51.

#### **4. Family Taxation**

Cigno, A. and A. Pettini, 2002. Taxing family size and subsidizing child-specific commodities?. *Journal of Public Economics* 84, 75-90.

Cremer, H., A. Dellis and P. Pestieau, 2003. Family size and optimal income taxation. *Journal of Population Economics* 16, 37-54.

Fleurbaey, M. and F. Maniquet, 2004. *Optimal Fiscal Benefits when Children are not Held Responsible for the Wealth of their Parents*. Mimeo.

#### **5. Environmental Taxation**

Cremer, H., F. Gahvari and N. Ladoux, 1998. Externalities and optimal taxation. *Journal of Public Economics* 70, 343-364.

Fullerton, D. and G. Hentel, 2007. The general equilibrium incidence of environmental taxes. *Journal of Public Economics*, forthcoming.

### **Part II: Fiscal Federalism**

#### **1. The Economic Theory of Federalism**

Bewley, T., 1981. A critique of Tiebout's Theory. *Econometrica* 49(3), 713-740.

Epple, D. and A. Zelenitz, 1981. The implications of competition among jurisdictions: Does Tiebout need politics? *Journal of Political Economy* 89(6), 1197-1217.

(E) Faguet, J-P., 2004. Does decentralization increase government responsiveness to local needs? Evidence from Bolivia. *Journal of Public Economics* 88, 867-893.

Gordon, R.H., 1983. An optimal taxation approach to fiscal federalism. *Quarterly Journal of Economics* 98, 567-586.

(B) Musgrave, R., 1999. Fiscal federalism. In: *Public Finance and Public Choice. Two contrasting Visions of the State*, J.M. Buchanan and R.A. Musgrave (eds), MIT Press, Cambridge, MA, 155-175.

(S) Oates, W., 1999. An essay on fiscal federalism. *Journal of Economic Literature* 37, 1120-1149.

(E) Panizza, U., 1999. On the determinant of fiscal centralization: Theory and evidence. *Journal of Public Economics* 74, 97-139.

(E) Strumpf, K. S. and F. Oberholzer-Gee, 2002. Endogenous policy decentralization: Testing the central tenet of Economic federalism. *Journal of Political Economy* 110(1), 1-36.

Tiebout, C., 1956. A pure theory of local expenditures. *Journal of Political Economy* 64(5), 416-424.

Wildasin, D.E., 1991. Income redistribution in a common labor market. *American Economic Review* 81(4), 757-774.

## **2. Intergovernmental Transfers**

Boadway, R., K. Cuff and M. Marchand, 2003. Equalization and the decentralization of revenue-raising in a federation. *Journal of Public Economic Theory* 5(2), 201-228.

Boadway, R. and F. Flatters, 1982. Efficiency and equalization payments in a federal system of government: a synthesis and extension of recent results. *Canadian Journal of Economics* 15(4), 613-633.

Lockwood, B., 1999. Inter-regional insurance. *Journal of Public Economics* 72, 1-37.

Smart, M., 1998. Taxation and deadweight loss in system of intergovernmental transfers. *Canadian Journal of Economics* 31(1), 189-206.

## **3. Commodity Taxation**

Kanbur, R. and M. Keen, 1993. Jeux sans frontieres: Tax competition and tax coordination when countries differ in size. *American Economic Review* 83(4), 877-892.

Mintz, J. and H. Tulkens, 1986. Commodity tax competition between member states of a federation: Equilibrium and efficiency. *Journal of Public Economics* 29, 133-172.

#### **4. Capital Income Taxation**

Edwards, J. and M. Keen, 1996. Tax competition and Leviathan. *European Economic Review* 40, 113-134.

**(E+S)** Hines, J.R., 1999. Lessons from behavioral responses to international taxation. *National Tax Journal* 52, 305-322.

Keen, M. and M. Marchand, 1997. Fiscal competition and the pattern of public spending. *Journal of Public Economics* 66, 33-53.

**(S)** Wilson, J.D., 1999. Theories of tax competition. *National Tax Journal* 52, 269-304.

**(S)** Wilson, J.D. and D.E. Wildasin, 2004. Capital tax competition: bane or boon. *Journal of Public Economics* 88, 1065-1091.

### **Part III: Political Economy of Taxation**

Hettich, W. and S. Winer, 1997. The political economy of taxation. In: *Perspectives on Public Choice: A Handbook*. D. Mueller (ed.), Cambridge University Press, Cambridge, 481-505.

#### **1. Voting and Taxation**

Austen-Smith, D., 2003. Majority preference for subsidies over redistribution. *Journal of Public Economics* 87, 1617-1640.

Bernheim, D., A. Rangel and L. Rayo, 2006. The power of the last word in legislative policy-making. *Econometrica* 74, 1161-1190.

Gradstein, M., 1999. Optimal taxation and fiscal constitution. *Journal of Public Economics* 72, 471-485.

Roemer, J., 1999. The democratic political economy of progressive income taxation. *Econometrica* 67(1), 1-19.

#### **2. Electoral Systems and Taxation**

Austen-Smith, D., 2000. Redistributing income under proportional representation. *Journal of Political Economy* 108(6), 1235-1269.

Lizzeri, A. and N. Persico, 2001. The provision of public goods under alternative electoral incentives. *American Economic Review* 91(1), 225-239.

(E) Milesi-Ferretti, G.M., R. Perotti and M. Rostagno, 2002. Electoral systems and public spending. *Quarterly Journal of Economics*, 609-657.

Persson, T. and G. Tabellini, 1999. The size and scope of government: comparative politics with rational politicians. *European Economic Review* 43, 699-735.

### **3. The Political Economy of Debt and Deficit**

Aghion, Ph. and P. Bolton, 1990. Government domestic debt and the risk of default: a political-economic model of the strategic role of debt. In: *Public Debt Management: Theory and History*, Dornbusch, R. and M. Draghi (eds), Cambridge University Press, Cambridge, 315-345.

Alesina, A. and A. Drazen, 1991. Why are stabilizations delayed? *American Economic Review* 81(5), 1170-1188.

Alesina, A. and G. Tabellini, 1990. A positive theory of fiscal deficits and government debt. *Review of Economic Studies* 57, 403-414.

Battaglini, M. and S. Coate, 2006. *A Dynamic Theory of Public Spending, Taxation and Debt*. Mimeo.

Hassler, J., J. Rodriguez Mora, K. Storesletten and F. Zilibotti, 2003. The survival of the welfare state. *American Economic Review* 93, 87-112.

Lizzeri, A., 1999. Budget deficits and redistributive politics. *Review of Economic Studies* 66, 909-928.

(E) Perotti, R. and Y. Kontopoulos, 2002. Fragmented fiscal policy. *Journal of Public Economics* 86, 191-222.

Persson, T. and L.E. Svensson, 1989. Why a stubborn conservative would run a deficit: Policy with time-inconsistent preferences. *Quarterly Journal of Economics* 104(2), 325-345.

(E) Poterba, J.M., 1994. State responses to fiscal crises: The effects of budgetary institutions and politics. *Journal of Political Economy* 102(4), 799-821.

### **4. Political Accountability**

(E) Besley, T. and A. Case, 1995. Incumbent behavior: Vote-seeking, tax-setting, and yardstick competition. *American Economic Review* 85(1), 25-45.

Sand-Zantman, W., 2004. Economic integration and political accountability. *European Economic Review* 48, 1001-1025.

Seabright, P., 1996. Accountability and decentralization in government: An incomplete contracts model. *European Economic Review* 40, 61-89.

#### **Part IV: Behavioral Public Finance**

(E) Adda, J. and F. Cornaglia, 2006. Taxes, cigarette consumption, and smoking intensity. *American Economic Review* 96, 1013-1028.

Benabou, R. and J. Tirole, 2006. Belief in a just world and redistributive politics. *Quarterly Journal of Economics* 121, 699-746.

Gruber, J. and B. Koszegi, 2004. Tax incidence when individuals are time-inconsistent: The case of cigarette excise taxes. *Journal of Public Economics* 88, 1959-1987.

Hines, J.R. and R.H. Thaler, 1995. The Flypaper effect. *Journal of Economic Perspectives* 9(4), 217-226.

O'Donoghue, T. and M. Rabin, 2003. Studying optimal paternalism, illustrated by a model of sin taxes. *American Economic Review Papers and Proceedings* 93(2), 186-1991.

O'Donoghue, T. and M. Rabin, 2006. Optimal sin taxes. *Journal of Public Economics* 90, 1825-1849.

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