



SEEK 470: PUBLIC ECONOMICS FOR BUSINESS LEADERS

Fall Quarter 2008 Syllabus

**Kellogg School of Management
Northwestern University**

**Section 81
Thursday, 6:30 – 9:30 p.m., Evanston Campus**

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Course Overview and Goals:

Consider the following issues:

- ❑ In early February 2007, the Intergovernmental Panel on Climate Change of the United Nations issued a report concluding unequivocally that global warming was occurring. The panel further stated that it was 90 percent certain that global warming was being driven by human activity resulting in heat-trapping greenhouse gases. Given this background, why then have power plants and other heavy industrial facilities located in the European Union been allocated permits to emit carbon dioxide (the most important greenhouse gas)? And why have the owners of these power plants and factories been given the right to profit from these permits by selling them in an open market?
- ❑ The U.S. Social Security program faces an impending fiscal crisis, with unfunded liabilities estimated to be on the order of \$11 trillion. Why is the federal government involved in providing pensions at all? In what ways should the program be reformed to deal with the fiscal crisis?
- ❑ In 2006, the U.S. Congress seemed poised to adopt comprehensive immigration reform. However, these efforts collapsed due to irreconcilable differences between the House and Senate bills that, in many ways, reflected the profound differences among the American public over issues relating to undocumented immigration and border security. Why has immigration become such a divisive issue? Why, indeed, is the government involved in regulating immigration: why not simply permit labor to flow across borders within the context of free, unimpaired labor markets? To what extent, if any, does immigration benefit the U.S. economy? To what extent does immigration benefit source countries such as Mexico?

Leaders in business firms, not-for-profit organizations, and government agencies need to be able to speak knowledgeably and intelligently about these and other key issues in public policy in order to be effective. It may seem obvious that this would be a requirement for leaders in the public sector, and it is plausible that leaders of not-for-profits or NGOs would also need to be well informed on the public policy issues of the day. But why do business leaders need to know anything about public policy?

Public policy choices, whether in the area of environmental policy, health insurance, social security, or taxation can have an important impact on a firm's shareholders and its employees. Some of these impacts are fairly clear, sometimes they are more subtle. When firms are directly affected by a particular public policy, well-informed leaders are able to frame the issues that will affect their business within the broader context to more productively educate the public and Congress. Even if firms are not directly affected, the opinions of business leaders are often solicited. In light of this, an ability to discuss public policy with intelligence and clarity is an essential part of leadership training. Having a framework to think about public policy questions can give you an important leg up in doing your job.

The public policies we will study in this course involve government interventions in private markets. In this course, we will argue that government intervention can sometimes --- though not always --- be driven by the failure of private markets to maximize social welfare. These circumstances are known as market failures. By the time you complete this course, you will

- ☐ have a comprehensive framework for understanding why markets may fail to maximize social welfare and why government intervention may be needed.
- ☐ be able to identify possible public solutions to market failures.
- ☐ be able to identify opportunities where private action can substitute for public policy responses to market failures.

This course draws from the branch of economics known as **public finance**. The term “public finance” may suggest a narrow focus on taxation, or perhaps government debt. But in fact, public finance is a broad subject area, built upon the foundations of microeconomics, that deals with the questions of when and how government should intervene in the private marketplace and how government interventions affect economic outcomes.

Prerequisites

MECN 430 (Microeconomic Analysis) is a prerequisite for this course. Public finance requires an understanding of the material you studied in MECN 430. Much of the economics you will study in this course will be familiar from MECN 430. However, there will also be new microeconomic theory taught in the class.

Textbook and Readings

- ☐ Gruber, Jonathan, *Public Finance and Public Policy*, 2nd edition (New York, NY: Worth Publishers), 2007.
- ☐ Case packet of readings.
- ☐ Additional required readings may be handed out in class, or posted to the course Blackboard web site.

Pedagogy

The course relies on a combination of lectures, in-class discussions, and exercises to develop the key learning points that will emerge from the course. Each class will typically be focused on a set of case discussion questions or an extended exercise. The exercises that will be the focus of particular classes are listed on the course outline below and are contained in the case packet. The exercises are not to be turned in, but students should make the attempt to complete them before hand. The case discussion questions that will serve as the focus of class discussion will be included in a “weekly assignment reminder” that will be distributed each class for the upcoming week. The class will typically begin with a discussion of the case or exercise, and key concepts

that arise in the case or exercise will be developed through short lectures that are interspersed with the discussion.

Grading

Grades will be based on a midterm exam, a final exam, team-based policy-situation reports, and class participation:

1. Class attendance and participation8%
2. Team Policy Position Reports (**October 16 and November 20**).. (8.5% per report) 17%
3. Midterm Exam (**October 30**).....35%
4. Final Exam (**December 11**)40%

Team Policy Position Reports

You will be assigned to a team of 5 or 6 students. Each team will be asked to prepare a Policy Position Report that takes a clear position on a specific public policy question. The reports must not exceed 1,200 words.

- **First Policy Position Report (due Thursday, October 16):** *Of the countries around the world that have reformed their publicly supported pension systems, which one should provide a model for how the U.S. should reform Social Security?*
- **Second Policy Position Report (due Thursday, November 20):** *Should the U.S. increase the gasoline tax, decrease it, or keep it the same?*

The reports are due at the beginning of the class on both of these evenings.

During the class session to which the reports relate, students can expect to be cold called and asked to describe and defend their position on the public policy question. I am expecting that by virtue of having written these reports, you will be especially engaged in the class and will contribute to a rich classroom discussion.

There is no restriction on the sources that you can use for the reports. However, please be sure to footnote the sources that you draw from, being especially careful to note the URL and date of access of any sources you find on the web.

I assign students to teams for this exercise for two important reasons: first (and most importantly) to infuse an international perspective into as many teams as possible; secondly, to mitigate logistical issues that can arise in a Section 81 class that involves both full-time and part-time students.

I will make team assignments after the first class in order to allow the course drop-add to fully resolve itself. I will post the team assignments to the course Blackboard site by 5 p.m. on

Monday, September 29.

Midterm and Final Examinations

The exams will be closed-book/closed-notes in-class exams.

The midterm examination will be 90 minutes long and will consist of true-false questions and problems. It will emphasize understanding of economic analytics. The midterm will take place in the first half of class on **Thursday, October 30** and will cover all material from the first five weeks of class.

The final examination will be two-hours long and will take place during finals week on **Thursday, December 11 from 6:30 to 8:30**. The final exam will be cumulative, and will emphasize your ability to synthesize and integrate your knowledge of the material in the course to provide a coherent analysis of public policy issues. As such it will consist of a set (5 to 7) essay and short answer questions.

More information about the midterm and final exams will be made available as the dates approach.

Class Attendance and Participation

Attendance, preparation, and participation are essential for this class to be value adding. Attendance is expected, and a student who misses class for any reason other than a serious illness or a death in the family can impair his or her participation grade. Much of the learning in this course comes from in-class discussion of cases or exercises. Learning opportunities are maximized when a student is actively engaged in the class discussion. Active engagement means that you are listening carefully to the comments of other students and seeking opportunities to make comments that move the class discussion forward. Some of the key characteristics of valuable class participation are as follows:

- **Relevance:** Are your comments clearly related to the case and to the comments of others? Does your comment stick to a subject or does it wander?
- **Advancement:** Does your comment move the class discussion forward? Does it take the discussion farther or deeper than previous comments?
- **Fact-based:** Have you used specific data from the case, from readings, or from personal experience to support the assertions that you are making?
- **Logical:** Is your reasoning consistent and logical? Do you use concepts from the readings or lectures correctly?
- **Originality:** Do your comments go beyond the mundane and commonplace and bring fresh analytic perspectives to bear on the problems under consideration?

Because the course consists of 10 three-hour sessions, there is ample opportunity for you to participate. Do not be discouraged if, after the first few classes, you have yet to participate. To increase opportunities for effective participation, I will often cold call a student to open the class discussion. I will also occasionally cold call students during the course of a discussion. If you

feel that you are preparing well but that I am not calling on you often enough, please let me know so that I can address the problem. Chances are that if you have invested quality time to prepare for class, you will have something valuable to say during the course of the class discussion.

I am sometimes asked whether student questions (e.g., during a lecture) “count” toward effective class participation. ***Sometimes they do and sometimes they do not.*** An incisive question that moves the class forward will enhance your participation grade. Questions that are beside the point or that reveal a lack of preparation can detract from your participation grade.

Class Etiquette

Students are expected to adhere to the general principles of Kellogg’s Classroom Etiquette Policy, as described on page 21 of the *Policies and Procedures* manual for Kellogg students: http://www.kellogg.northwestern.edu/stu_aff/images/PoliciesProcedures08.pdf.

Specific adjustments to this policy for this class are listed below:

- ☐ If other commitments cause you to arrive late or leave early, please let me know ahead of time by sending an e-mail.
- ☐ To minimize distractions and facilitate discussion, please do not use personal digital assistants, cellular phones, and iPods during class sessions. Skypeing, texting, and twittering during class are not permitted.
- ☐ At the beginning of each class session, I will indicate whether laptops can be opened or closed.

Yom Kippur

The Yom Kippur holiday takes place on October 9. Please let me know if you must be absent from class to observe this holiday.

Course Outline

Week 1: Thursday, September 25

1.1 Introduction to the Course; Microeconomics Primer: Social Efficiency, Markets, and Market Failures

Reading:

- Gruber, Chapter 1 and Chapter 2, pp. 49-55 (start with section on “Social Efficiency” and read through the section “From Efficiency to Social Welfare”)

Exercises:

- “Social Efficiency in Competitive Markets.”
- “Deadweight Loss Due to Subsidies.”

1.2 Public Policy Application #1: Ethanol Subsidies

Readings:

- “Biofuels Boom: Can Ethanol Satisfy America’s Thirst for Foreign Oil?” *CQResearcher* 16(34) (September 29, 2006), pp. 793-816.
- Chapter 3 of “Biofuels --- At What Cost: Government Support for Ethanol and Biodiesel in the United States,” Global Subsidies Initiative of the International Institute for Sustainable Development (October 2006)
- “Europe, Cutting Biofuel Subsidies, Redirects Aid to Stress Greenest Options,” *New York Times* (January 22, 2008).
- “Obama Camp Closely Linked with Ethanol,” *New York Times* (June 23, 2008).
- “Weather Risks Cloud Promise of Biofuel,” *New York Times* (July 1, 2008).
- “High Corn Prices Cast Shadow Over Ethanol Plants,” *NPR All Things Considered* (July 15, 2008), on-line at <http://www.npr.org/templates/story/story.php?storyId=92559699>

Exercise:

- “U.S. Ethanol Subsidies.”

Week 2: Thursday, October 2

2.1 Public Goods: Theory

Reading:

- Gruber, Chapter 7, section 7.1 and Chapter 9, section 9.1.
- Layton, L., “Business Groups Fill the Breach; Improvement Districts

- Springing Up All Over,” *The Washington Post* (September 14, 2006).
- Mac Donald, H., “Why Business Improvement Districts Work,” *Civic Bulletin* No. 4 (May 1996).
- Wilson, J. Q., and G.L. Kelling, “Broken Windows,” *Atlantic Monthly* (March 1982).

Exercise:

- “Mosquito Abatement in Blaney Park.”

2.2 Public Policy Application #2: International Cooperation in the Provision of Global Public Goods

Reading:

- Chapter 2 “Global Public Goods: What They Are and Why Many Are in Short Supply,” of the Final Report of the International Task Force on Global Public Goods, *Meeting Global Challenges: International Cooperation in the National Interest*, available on-line at <http://www.gpgtaskforce.org/bazment.aspx>

Week 3: Thursday, October 9

3.1 Externalities: Theory

Reading:

- Gruber, Chapter 5, pp. 120-138.
- Besanko, D., “Notes on the Theory of Cap & Trade Systems in Environmental Regulation.”

Exercise:

- “The Market for Flu Inoculations.”

3.2 Public Policy Application #3: Market-Based Approaches to Global Warming

Readings:

- Gruber, Chapter 6, pp.150-163.
- Senate Greenhouse Gas Cap-and-Trade Proposals, Pew Center for Global Climate Change.
- “Climate Change: Is Tougher Action Needed to Slow Rising Temperatures?”

- CQ Researcher* 16(4) (January 27, 2006), pp. 73-96.
- “Quick Facts on Cap-and-Trade Policies to Reduce Carbon Emissions,” Tax Policy Center, available on-line at http://www.taxpolicycenter.org/taxtopics/quickfacts_cap-and-trade.cfm
 - McKibbin, W. J., and P.J. Wilcoxon, “The Role of Economics in Climate Change Policy,” *Journal of Economic Perspectives* Vol. 16 No. 2 (Spring 2002), pp.107-129.
 - “Global Warming Talks Leave Few Concrete Goals,” *New York Times* (July 10, 2008).

Week 4: Thursday, October 16

☹ **First Policy Position Report Due:** *Of the countries around the world that have reformed their publicly supported pension systems, which one should provide a model for how the U.S. should reform Social Security?*

4.1 Insurance Market Failures: Theory

Reading:

- Gruber, Chapter 12.

Exercise:

- “The Market for Retirement Annuities.”

4.2 Public Policy Application #4: Social Security

Reading:

- Gruber, Chapter 13.
- “Social Security Reform: How Should America’s Retirement System Be Saved, *CQ Researcher* 14(33) (September 24, 2004), pp. 781-804.
- U.S. General Accountability Office, “Social Security Reform: Other Countries’ Experiences Provide Lessons for the United States,” (October 2005).
- Social Security and Medicare Boards of Trustees, “Summary of the 2008 Annual Report on the Financial Condition of the Social Security and Medicare Trust Funds,” on line at <http://www.ssa.gov/OACT/TRSUM/index.html>

Exercise:

- “Reforming Social Security with an Aging Population” (to be passed out in class)

Week 5: Thursday, October 23

5.1 Credit Market Failures: Theory

Reading:

- Chapter 2 of Armendariz, Beatriz and Jonathan Morduch, *The Economics of Microfinance*, “Why Intervene in Credit Markets” (Cambridge, MA: MIT Press), 2007.

Exercise:

- “Market Failure in Rural Credit Markets.”

5.2 Public Policy Application #6: Rural Credit Markets in Developing Countries

Readings:

- Hoff, Karla, and Joseph Stiglitz, “Imperfect Information and Rural Credit Markets --- Puzzles and Policy Perspectives,” *The World Bank Economic Review*,” 4(3) (September 1990), pp. 235-250.
- Chapter VII of Meyer, Richard and Geetha Nagarajan, *Rural Financial Markets in Asia: Policies, Paradigms, and Performance*, “Rural Financial Market Development in Bangladesh: Failing Banks, Thriving Microfinance,” (Oxford: Oxford University Press)

Week 6: Thursday, October 30

6.1 MIDTERM EXAM

6.2 Public Policy Application #6: Health Care Policy

Readings:

- Gruber, Chapters 15 & 16.
- “Universal Coverage: Will All Americans Finally Get Health Insurance,” *CQ Researcher* 17(12) (March 30, 2007), pp. 265-288.

Guest Speakers: Professor David Dranove and Leemore Dafney, “Comparison of the McCain and Obama Health Care Plans”

Week 7: Thursday, November 6

7.1 Behavioral Economics and Decision Biases: Justifying Government Intervention Based on Paternalism

Reading:

- Camerer, Colin, Samuel Isaaccharoff, George Loewenstein, Ted O'Donoghue, and Matthew Rabin, "Regulation for Conservatives: Behavioral Economics and the Case for Asymmetric Paternalism," *University of Pennsylvania Law Review*, 151 (2003), pp. 1211-1254.

7.2 Public Policy Application #7: The Mortgage Crisis

Readings:

- "Mortgage Crisis: Should the Government Bail Out Borrowers in Trouble," *CQ Researcher* 17(39) (November 2, 2007), pp. 913-936.
- Thaler, Richard and Cass Sunstein, "Economic Policy for Humans," *Boston Globe* (April 17, 2008).
- "Approval is Near for Bill to Help U.S. Homeowners," *New York Times* (June 25, 2008).
- Krugman, Paul, "Fannie, Freddie, and You," *New York Times* (July 14, 2008).

Week 8: Thursday, November 13

8.1 Income Equality and Inequality: Theory and Evidence

Readings:

- Gruber, Chapter 17 (Sections 17.1 and 17.2 only)
- "The Rich, the Poor, and the Growing Gap Between Them," *The Economist* (June 15, 2006).
- Piketty, Thomas, "How the Income Share of Top 1% of Families has Increased Dramatically", *The Wall Street Journal*. (January 11, 2007).
- Porter, Eduardo. "Economic View: If All the Slices are Equal, Will the Pie Shrink?", *The New York Times*. (November 19, 2006).

Exercise:

- “Assessment of Income Distributions.”

8.2 Public Policy Application #8: Social Welfare Policy in the U.S. and the EU

Readings:

- Alesina, Alberto, Edward Glaeser, and Bruce Sacerdote, “Why Doesn’t the United States Have a European-Style Welfare State,” *Brookings Papers on Economic Activity* 2 (2001), pp. 187-277 (only pp. 187-202 will be assigned and will be passed out to you in class).
- “Choose Your Poison: Europe’s Social Policies Offer a Heady and Intoxicating Mixture,” *Economist* (September 29, 2005).

Week 9: Thursday, November 20

☹ **Second Policy Position Report Due:** *Should the U.S. increase the gasoline tax, decrease it, or keep it the same?*

9.1 Tax Incidence and Efficiency --- Theory

Readings:

- Gruber, Chapters 19 and 20 (section 20.1 only)

Exercise:

- “Cigarette Taxes.”

9.2 Public Policy Application #9: The Role of the Gasoline Tax in Energy Policy

Readings:

- Puentes, Robert; Prince, Ryan. “Fueling Transportation Finance: A Primer on the Gas Tax”. *The Brookings Institution*. (March 2003).
- “Energy Efficiency: Is Enough Being Done to Save Energy,” *CQ Researcher* 16(19) (May 19, 2006), pp. 433-456.
- Mufson, Steven. “Talk of Raising Gas Tax is Just That; Analysts Cite Advantages but Concede its Political Improbability”, *The Washington Post*. (October 18, 2006).
- “Unlikely Allies for a Gas-Tax Holiday,” *New York Times* (May 2, 2008).

Week 10: Thursday, December 4

10.1 and 10.2: Public Policy Application #10: Economics and Public Policy Toward Immigration

Readings:

- Chapters 2 & 3 of Hanson, Gordon, *Why Does Immigration Divide America: Public Finance and Political Opposition to Open Borders* (Washington, D.C.: Institute for International Economics), 2005.
- “Immigration Debate,” *CQ Researcher* 18(5) (February 1, 2008), pp. 97-120.
- “States Take a New Tack on Illegal Immigration,” *New York Times* (June 9, 2008).
- “Nafta Should Have Stopped Illegal Immigration, Right?” *New York Times* (February 18, 2007)

Week 11: Thursday, December 11

•→ FINAL EXAM