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Economics of Taxation  
(E512)

Fall 2011  
M-W 3:00-4:50  
223 DKH

**Office Hours:** Mondays and Wednesdays 1:45-2:45.  
Other times by appointment.

**Prerequisite:** Econ 500.

Public economics studies the role of the government in a market economy and the implications of its actions for the citizenry. The underlying structure is one of a decentralized economy wherein economic decisions are coordinated through prices (which in turn are determined by free, but sometimes regulated, markets). Additionally, the public sector itself typically plays a significant role in these market economies. Public economics examines why the government may have to supplement the market mechanism. It evaluates the efficiency and equity justifications for an intervention and their ramifications for individuals' incentives and welfare. It also studies what form the interventions should take and how policies ought to be designed.

This particular course is devoted to different issues in taxation from a public economics perspective. However, because E511 (Public goods theory) is not offered, I shall also cover the basic material for the study of public goods theory and externalities. In taxation, we first study topics framed in static settings. They include: theory and measurement of efficiency costs of taxation, tax incidence, optimal commodity taxation, optimal income taxation, the theory of tax design, in-kind transfers, taxation of externalities, taxation and labor supply, and tax evasion. Then we turn to dynamic settings and study the effects of taxation on savings and capital accumulation as well as revisiting incidence and optimal tax issues. In this context, the competing frameworks of dynastic families and overlapping-generations will both be studied.

I will cover a good deal of classical material as you need to know the foundation. But I shall also cover some more recent developments for you to appreciate some of the contemporary research in taxation. Similarly, I shall combine methodological with more applied issues.

**Readings:** There is no required text for this course. The readings include a number of surveys, and some classic articles as well as more recent contributions

**Course grade:** There will be four sets of homeworks and a final. Each homework counts for 12.5% and the final for 50% of your final grade. The final is scheduled for 1:30-4:30 pm on Monday December 12 (the regular campus schedule).

### **Undergraduate textbooks:**

H. Rosen and T. Gayer, Public Finance, 9<sup>th</sup> edition, McGraw-Hill Higher Education, 2009.

J. Stiglitz, Economics of the Public Sector 3<sup>rd</sup> edition, Norton, 1999.

J. Gruber, Public Finance and Public Policy, 3<sup>rd</sup> Edition, Worth Publishers, New York, 2009.

**An in-between textbook:** J Hindriks and G Myles, Intermediate Public Economics, the MIT Press, 2006.

### **Graduate textbooks and surveys:**

A. J. Auerbach and M. S. Feldstein (eds), Handbook of Public Economics, Volumes 1, 2, 3, and 4, North Holland: Amsterdam, 1985, 1987, 2002 and 2003.

James Mirrlees, Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba (eds), Dimensions of Tax Design: the Mirrlees Review, Oxford University Press: April 2010.

James Mirrlees, Stuart Adam, Tim Besley, Richard Blundell, Stephen Bond, Robert Chote, Malcolm Gammie, Paul Johnson, Gareth Myles, and James Poterba, Tax by Design: the Mirrlees Review, Oxford University Press: 2011, forthcoming

B. Salanie, The Economics of Taxation, MIT Press: Cambridge, 2003.

G. D. Myles, Public Economics, Cambridge University Press: Cambridge, 1995.

A. B. Atkinson and J. E. Stiglitz, Lectures on Public Economics, McGraw Hill: New York, 1980.

J. J. Laffont, Fundamentals of Public Economics, MIT Press: Cambridge, 1988.

R. Jha, Modern Public Economics, 2<sup>nd</sup> edition, Rutledge: London and New York, 2009.

D. A. Starret, Foundations of Public Economics, Cambridge University Press: Cambridge, 1988.

R. W. Tresch, Public Finance, 2<sup>nd</sup> edition, Academic Press, 2002.

Roger Guesnerie, A Contribution to Pure Theory of Taxation, Cambridge University Press, 1998.

### **A useful and informative book on taxation:**

J Slemrod and J Bakija, Taxing Ourselves, fourth edition, the MIT Press, Cambridge 2008.

## Topics of Discussion

### 0. **Overview of the field**

Articles by Peter Diamond, Martin Feldstein, Jean-Jacques Laffont, Nicholas Stern and Joseph Stiglitz in the Journal of Public Economics 86, December 2002.

### 1. **"Welfare Economics" and efficiency loss of taxation**

#### 1.1 *Background*

- A. Mas-Colell, M. Whinston and J. Green, Microeconomic Theory, Oxford University Press, 1995, pp. 80-91; 116-123; 325-334; Chapter 16, 817-831.
- B. Salanie, The Economics of Taxation, Appendices.

#### 1.2 *Theory*

- A. J. Auerbach, "The Theory of Excess Burden and Optimal Taxation," in Auerbach and Feldstein, eds., Handbook of Public Economics, Vol. 1, pp. 61-86.
- A. J. Auerbach and J.R. Hines, "Taxation and Economic Efficiency," in Auerbach and Feldstein, eds., Handbook of Public Economics, Vol. 3, pp. 1347-1360.
- B. Salanie, The Economics of Taxation, Chapter 2.
- P. Diamond and D. McFadden, "Some Uses of the Expenditure Function in Public Finance," Journal of Public Economics 3, 1974, pp. 3-21.

#### 1.3 *Measurement*

- D. T. Slesnick, "Empirical Approaches to the Measurement of Welfare," Journal of Economic Literature, Volume 36, Dec. 1998, pp. 2108-2165.

### 2. **Tax Incidence**

#### 2.1 *Competitive Markets*

- B. Salanie, The Economics of Taxation, Chapter 1.
- D. Fullerton and G. Metcalf, "Tax Incidence," in A. Auerbach and M. Feldstein, eds, Handbook of Public Economics, Volume 4, 2003, Chapter 26, Sections 1-2.
- L. Kotlikoff and L. Summers, "Tax Incidence," in A. Auerbach and M. Feldstein, eds, Handbook of Public Economics, Volume 2, 1987, pp. 1043-1092.
- Atkinson and Stiglitz, Lectures on Public Economics, Lecture 6.
- G. D. Myles, Public Economics, pp. 231-246.
- A. Harberger, "The Incidence of the Corporation Income Tax," Journal of Political Economy, June 1962.

## 1.2 *Imperfect Competition*

D. Fullerton and G. Metcalf, "Tax Incidence," in A. Auerbach and M. Feldstein, eds, Handbook of Public Economics, Volume 4, 2003, Chapter 26, Section 3.

## 3. **Optimal Taxation**

### 3.1. *Optimal Commodity Taxation*

Ian Crawford, Michael Keen, and Stephen Smith, Value-added taxes, and excises, Dimensions of Tax Design: the Mirrlees Review.

B. Salanie, The Economics of Taxation, Chapter 3.

A. J. Auerbach, "The Theory of Excess Burden and Optimal Taxation," in Auerbach and Feldstein, eds., Handbook of Public Economics, Vol. 1, pp. 86-110.

A. J. Auerbach and J.R. Hines, "Taxation and Economic Efficiency," in Auerbach and Feldstein, eds., Handbook of Public Economics, Vol. 3, pp. 1361-1371.

A. B. Atkinson and J. E. Stiglitz, Lectures on Public Economics, Lecture 12.

G. D. Myles, Public Economics, Chapter 4.

### 3.2 *Optimal Income Taxation*

B. Salanie, The Economics of Taxation, Chapter 4.

Mike Brewer, Emmanuel Saez, and Andrew Shephard, Means testing and tax rates on earnings, Dimensions of Tax Design: the Mirrlees Review.

A. J. Auerbach and J.R. Hines, "Taxation and Economic Efficiency," in Auerbach and Feldstein, eds., Handbook of Public Economics, Vol. 3, pp. 1372-1383.

J. Stiglitz, "Pareto Efficient and Optimal Taxation and the New New Welfare Economics," in A. Auerbach and M. Feldstein, Eds., Handbook of Public Economics, Volume 2, Amsterdam: North Holland, 1987, pp. 991-1041.

P. A. Diamond, "Optimal Income Taxation: An Example with a U-Shaped Pattern of Optimal Marginal Tax Rates," American Economic Review, Volume 88, March 1998, pp. 83-95.

R. Boadway and Laurence Jacquet, Optimal marginal and average income taxation under maximin, Journal of Economic Theory 143, 2008, 425-441.

G. D. Myles, Public Economics, Chapter 5.

M. Feldstein, The effect of marginal tax rates on taxable income: a panel study of the 1986 tax reform act, Journal of Political Economy 103, 1995, 551-572.

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

E Saez, Optimal income transfer programs: intensive versus extensive labor supply responses, Quarterly Journal of Economics, August 2002 1039-1073.

### 3.3. *Optimal Tax Design*

James Banks and Peter Diamond, The base for direct taxation, Dimensions of Tax Design: the Mirrlees Review.

- B. Salanie, The Economics of Taxation, Chapter 5.
- A. B. Atkinson, and J. E. Stiglitz, "The Design of Tax Structure: Direct Versus Indirect Taxation," Journal of Public Economics, 1976, 6, pp. 55-75.
- J. Stiglitz, "Pareto Efficient and Optimal Taxation and the New New Welfare Economics," in A. Auerbach and M. Feldstein, Eds., Handbook of Public Economics, Volume 2, Amsterdam: North Holland, 1987, pp. 991-1041.
- N. Stern, The Theory of Optimal Commodity and Income Taxation: An Introduction, in Newbery and Stern (eds), The Theory of Taxation For Developing Countries, World Bank, 1987.
- H. Naito, Re-examination of uniform commodity taxes under a non-linear income tax system and its implication for production efficiency, Journal of Public Economics 71, 1999, 165-188.

### 3.4. *Nontax instruments*

J Currie and F. Gahvari, "Transfers in cash and in-kind: Theory meets the data," Journal of Economic Literature, 46, 2008, 333-383.

## 4. **Public Goods**

- A. Mas-Colell, M. Whinston and J. Green, Microeconomic Theory, Oxford University Press, 1995, Chapter 11.
- G. D. Myles, Public Economics, Chapter 9.
- R Cornes and T Sandler, The theory of externalities, public goods and club goods, second edition, Cambridge University Press, 1996.
- Atkinson and Stiglitz, Lectures on Public Economics, Lecture 16.
- Bergstrom, T., L. Blume and H. Varian. On the private provision of public goods, Journal of Public Economics 29, 25-49.

## 5. **Externalities**

- A. Mas-Colell, M. Whinston and J. Green, Microeconomic Theory, Oxford University Press, 1995, Chapter 11.
- J-J Laffont, Fundamentals of Public Economics, Chapter 1.
- P. S. Dasgupta and G. M. Heal, Economic Theory and Exhaustible Resources, Cambridge University Press, 1979, Chapter 3.
- G. D. Myles, Public Economics, Chapter 10.
- R. H. Coase, "The Problem of Social Cost," Journal of Law and Economics, 1960, Vol 3, pp. 1-44.

### 5.1 *Optimal Taxation and Environmental taxation*

- B. Salanie, The Economics of Taxation, Chapter 10.
- Don Fullerton, Andrew Leicester, and Stephen Smith, Environmental taxes, Dimensions of Tax Design: the Mirrlees Review.

A.L. Bovenberg and L. Goulder, "Environmental taxation and regulation," in Auerbach and Feldstein, eds., Handbook of Public Economics, Vol. 3, pp. 1471-1540.

## 6. Taxation and Labor Supply

Costas Meghir and David Phillips, Labor supply and taxes, Dimensions of Tax Design: the Mirrlees Review.

R. A. Moffit, "Welfare programs and labor supply," in A. Auerbach and M. Feldstein, eds, Handbook of Public Economics, Volume 4, 2003, Chapter 34.

R. Blundell and T. MaCurdy, "Labor Supply: A Review of Alternative Approaches," in A. Ashenfelter and D. Card, eds., Handbook of Labor Economics, Vol 3, Amsterdam: Elsevier, 1999, 1569-1695.

## 7. Tax Evasion

Jonathan Shaw, Joel Slemrod, and John Whiting, Administration and Compliance, Dimensions of Tax Design: the Mirrlees Review.

J. Slemrod and S. Yitzhaki, "Tax avoidance, evasion and administration," in Auerbach and Feldstein, eds., Handbook of Public Economics, Vol. 3, pp. 1423-1465.

J. Andreoni, B. Erard and J. Feinstein, "Tax Compliance," Journal of Economic Literature, Volume 36, June 1998, pp. 818-860.

A. Sandmo, "The Theory of Tax Evasion: A retrospective view, National Tax Journal Vol. LVIII, No. 4 December 2005

J. G. Allingham and A. Sandmo, "Income Tax Evasion: A Theoretical Analysis," Journal of Public Economics 1, 1972, pp. 323-338.

J. Sanchez and J. Sabel, "Hierarchical Design and Enforcement of Income Tax Policies," Journal of Public Economics, Volume 50, 1993, pp. 345-369.

H. Cremer and F. Gahvari, "Tax Evasion and Optimal Commodity Taxation," Journal of Public Economics, 1993, pp. 261-275.

H. Cremer and F. Gahvari, "Tax Evasion and the Optimum General Income Tax," Journal of Public Economics, 609, 1996, pp. 235-249.

## 8. Taxation in Dynamic Settings

### 8.1 Overview

P. A. Samuelson, "An Exact Consumption-Loan Model of Interest With or Without the Social Contrivance of Money," Journal of Political Economy, December 1958, pp. 467-482.

P. A. Diamond, "National Debt in a Neo-classical Growth Model," American Economic Review, 55, 1965, pp. 1125-1150.

R. J. Barro, "Are Government Bonds Net Wealth?" Journal of Political Economy, 1974, pp. 1095-1117.

Weil, Philippe, "Overlapping Generations: The First Jubilee." Journal of Economic Perspectives 2008, 22(4): 115-34.

A. J. Auerbach and J.R. Hines, "Taxation and Economic Efficiency," in Auerbach and Feldstein, eds., Handbook of Public Economics, Vol. 3, pp. 1403-1414.

L. Kotlikoff, "Generational policy," in A. Auerbach and M. Feldstein, eds, Handbook of Public Economics, Volume 4, 2003, Chapter 27.

Blanchard, Olivier. "Debt, Deficits, and Finite Horizons," Journal of Political Economy, 1985.

Chari, V.V. "Time Consistency and Optimal Policy Design," Minneapolis Fed Quarterly Review, 1988.

## 8.2 *Tax Incidence in Dynamic Models*

Orazio P. Attanasio and Matthew Wakefield, The effects on consumption and saving of taxing asset returns, Dimensions of Tax Design: the Mirrlees Review.

A. Auerbach and L. Kotlikoff, Dynamic Fiscal Policy, Cambridge: Cambridge University Press, 1987, Chapters 5, 9.

D. Fullerton and G. Metcalf, "Tax Incidence," in A. Auerbach and M. Feldstein, eds, Handbook of Public Economics, Volume 4, 2003, Chapter 26, Sections 4-7.

## 8.3 *Optimal Taxation of Capital*

B. D. Bernheim, "Taxation and saving," in Auerbach and Feldstein, eds., Handbook of Public Economics, Vol. 3, pp. 1176-1207.

B. Salanie, The Economics of Taxation, Chapter 6.

A. Atkinson and A. Sandmo, "Welfare Implications of the Taxation of Savings," Economic Journal 90, 1980, pp. 529-549.

C. Chamley, "Optimal Taxation of Capital Income in General Equilibrium with Infinite Lives," Econometrica 54, 1986, pp. 607-622.

Conesa, Juan Carlos, Sagiri Kitao, and Dirk Krueger. 2009. "Taxing Capital? Not a Bad Idea after All!" American Economic Review, 99(1): 25-48.

## 8.4 *Tax Policy, Rates of Return, and Saving*

B. D. Bernheim, "Taxation and saving," in Auerbach and Feldstein, eds., Handbook of Public Economics, Vol. 3, pp. 1208-1239.

## 8.5 *New Dynamic Public Finance*

N. R. Kocherlakota. The New Dynamic Public Finance (Toulouse Lectures in Economics), 2010, Princeton University Press.