

ECON 7395: Intranational Macroeconomics

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WEB-page: to come (the class WEB-page will be accessible from www.uh.edu/~bsorensen)

Hours: By appointment, or just drop by.

Course Requirements: Write a Research Paper. We will discuss this in more detail. But since the class is exploratory for us, we plan to write a paper. You can participate with us, or construct your own with or without other student or professor co-authors. Since this class is rather large, we anticipate at least three papers.

Course Description

This class is intended as an advanced course on the how and why puzzle about macroeconomic management from a microeconomic understanding of private market failures. In part, it is a microeconomic public economics class for macroeconomists, as we will focus on the interaction between macroeconomics and governments, which includes macro models as well as such related areas as public finance, political economy, and public choice. Further, we will focus on regional or state data, which has significant advantages from a theoretical perspective, and an econometric perspective. While pooling country data is possible, on average there are too few observations to fully control for all differences. This is much less a problem for states, both because the institutional environment is similar, and because there are 50 states per year. Data for U.S. states are readily available from the Bureau of Economic Analysis and the Census of Governments (Note that the BEA has recently put out GDP numbers for big cities, you are encouraged to try to use those as well).

The course is exploratory and the format "experimental"- think of it as a seminar. We will read articles of interest and/or background articles, but will also give a few lectures. We will discuss the precise requirements in the first class, but the professors' goal is to learn from each other, which should result in a research paper. Thus your goal should be a research paper. We may require some intermediate steps, but we believe that any progress we make here will be of interest to the profession as a whole. The primary expression of interest is to understand how (and why) governments interact with business cycles. Our previous papers from this class generally address the overall problem of what in macro has been called "risk sharing," and in micro is called private insurance market failure. Neither the market failure motivation, nor the impact of institutions on behavior in government institutions, is yet sufficiently developed in our view, so there are a lot of open questions. We are currently concerned with how governments respond to business cycle fluctuations, and the set of mechanisms to help smooth government consumption (which is consistent with the prevailing view of government as an agent of the population). This intersects with much of the new research on behavioral economics. The list of papers below includes work on understanding government behavior, on understanding governmental response to business cycles, and other work we found pertinent.

INTRODUCTION

- Sorensen, Bent E., Lisa Wu, and Oved Yosha, "Output Fluctuations and Fiscal policy: U.S. state and local governments 1978-1994," *European Economic Review*, 45, 2001, pp. 1271-1310.
- Craig, Steven and Edward Hoang, "State Government Response to Income Fluctuations: Consumption, Insurance, and Capital Expenditures," *Regional Science and Urban Economics*, 41, July, 2011, 343-51.
- Craig, Steven, Wided Hemissi, Satadru Mukherjee, and Bent Sorensen "Consumption Smoothing or Buffer Stock Saving: States' Management of Unemployment Insurance Finance," U of H working paper, 2014.

BACKGROUND

I. The Goal of Government

A. Collective Goods

- P. Samuelson, "The Pure Theory of Public Expenditure," REStat, Nov 1954
- _____, "The Diagrammatic Exposition of the Theory of Public Expenditures," REStat, Nov 1955
- S. Craig, "The Impact of Congestion on Local Public Good Production," JPubE, 32, April, 1987.

B. Market Failures

1. Externalities
 - J. Kohlhase, "Toxic Waste Sites and Property Values," JUE, July, 1991
2. Information and Uncertainty
 - G. Akerlof, "The Market for Lemons: Qualitative Uncertainty and Market Mechanisms," QJE, Aug 1970
 - M. Rothschild and J. Stiglitz, "Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information," QJE, Nov 1976
3. (Re)Distribution, Externalities vs. Social Welfare
 - J. Rawls, Theory of Justice, pp. 60-108.
 - J. Behrman and S. Craig, "The Distribution of Public Services: An Exploration of Local Government Preferences," AER, March, 1987

II. Public Choice Mechanisms

- T. Bergstrom and R. Goodman, "Private Demands for Public Goods," AER, June 1973
- T. Borcharding and R. Deacon, "The Demand for the Services of Non-Federal Governments," AER, Dec 1972
- C. Tiebout, "A Pure Theory of Local Expenditures," JPE, Oct, 1956
- E. Gramlich and D. Rubinfeld, "Micro Estimates of Public Spending Demand Functions and Test of the Tiebout and Median Voter Hypothesis," JPE, June, 1982

III. The Effects of Federalism as an Institution

W. Oates, Fiscal Federalism, 1972.

W. Oates, "Fiscal Federalism," JEL, Sept, 99, p. 1120.

S. Craig and R. Inman, "Federal Aid and Public Education: An Empirical Look at the New Fiscal Federalism," REStat, Nov, 1982

Baicker, Katherine, "Extensive or Intensive Generosity? The Price and Income Effects of Federal Grants," REStat, May, 2005, p. 371

Arzaghi M. and Henderson J.V., "Why countries are fiscally decentralizing," p. 1157, JPubE, July, 2005

Barankay and Lockwood, "Decentralization and the Productive Efficiency of Swiss Cantons," JPubE, June, 07

Robert P. Inman; Daniel L. Rubinfeld, "Rethinking Federalism," Journal of Economic Perspectives Vol. 11, No. 4 (Autumn, 1997), pp. 43-64

A. Other Governmental Institutions

Case, Ann, Harvey Rosen, and James Hines, "Budget Spillovers and Fiscal Policy Interdependence," JPubE, 1993, pp285-307.

Glaeser, Ed, David Laibson, J. Scheinkman, and Christine Soutter, "Measuring Trust," QJE, Aug, 2000, pp. 811-846.

IV. Political Economy: Endogenous Borders

Alesina and Spalatore, "On the Size and Number of Nations", QJE, 1997.

Alesina, Baqir, and Hoxby, "Political Jurisdictions in Heterogenous Communities", QJE 2003.

Brasington, "Joint Provision of Public Goods: The Consolidation of School Districts", JPubE, 1999.

Knight, Brian and Nora Gordon, "A Spatial Merger Estimator with an Application to School District Consolidation," *Journal of Public Economics*, 93, June 2009, pp 752-765

V. The Role of Government Debt

Poterba, James, "Balanced Budget Rules and Fiscal Policy: Evidence from the States," NTJ, Sept, 1995, p. 329.

Poterba, J, "Budget Rules and Fiscal Policy in US States," AER, 1996

Poterba, J. "State Response to Fiscal Crises: The Effect of Budgetary Institutions and Politics," JPE, 1994

Robert Inman and H. Bohm, "Balanced Budget Rules and Public Deficits: Evidence from the US States," in *Carnegie-Rochester Conference Series on Public Policy*, 1996, Elsevier.

Schaltegger and Torgler, "Government Accountability and Fiscal Discipline," JPubE, Feb, 07

VI. Political Economy Applications to Macroeconomics

A list of papers from our own work (Sorensen) using intranational data is listed here (you can have the programs and data for all of these):

“Financial Integration within EU Countries: The Role of Institutions, Confidence, and Trust.” in *NBER International Seminar on Macroeconomics 2007*.

“What Can Explain Excess Smoothness and Sensitivity of State-Level Consumption?” *Review of Economics & Statistics* January 2008.

“U.S. Banking Deregulation, Small Businesses, and Interstate Insurance of Personal Income.” *Journal of Finance*, November 2007.

“Producer Prices versus Consumer Prices in the Measurement of Risk Sharing.” *Applied Economics Quarterly*, Vol. 53, January 2007, 3-17.

“Risk Sharing and Industrial Specialization: Regional and International Evidence,” *American Economic Review*, 93, June 2003, 903-18.

“Consumption and Aggregate Constraints: Evidence from US States and Canadian Provinces.” *Journal of Political Economy*, Vol. 110, June 2002, 634-645.

“Economic Integration, Industrial Specialization, and the Asymmetry of Macroeconomic Fluctuations,” *Journal of International Economics*, Vol. 55, September 2001, 107-137.

“Output Fluctuations and Fiscal Policy: U.S. State and Local Governments 1978-1994.” *European Economic Review*, Vol. 45, June 2001, 1271-1310.

“International Risk Sharing and European Monetary Unification,” *Journal of International Economics*, 45, August 1998, 211-38.

“Channels of Interstate Risk Sharing: United States 1963-1990,” *Quarterly Journal of Economics*, 111, November 1996, 1081-1110.

“Is State Fiscal Policy Asymmetric Over the Business Cycle?” Federal Reserve Bank of Kansas City Review Third Quarter 2001.

“Is Risk Sharing in the United States a Regional Phenomenon?” Federal Reserve Bank of Kansas City Review Second Quarter 2000.

“Intranational and International Credit Market Integration: Evidence from Regional Income and Consumption Patterns.” In G. Hess and E. van Wincoop, eds. *Intranational and International Macroeconomics*, Cambridge University Press 2000, New York.

"Federal Insurance for US States: An Empirical Investigation." In A. Razin and E. Sadka, eds. *Globalization: Public Economics Policy Perspectives*, Cambridge University Press 1999, New York.

PAPERS OF CURRENT INTEREST

VII. Public Pensions

Lindbeck, A. & Persson, M. "The Gains from Pension Reform," *Journal of Economic Literature*, 2003, pp. 74-112

Mitchell, O. S. and Smith, R. S. "Pension Funding in the Public Sector," *REStat*, 1994, pp. 278-290.

Bodie, Z.; Marcus, A. J. & Merton, R. C., "Defined Benefit versus Defined Contribution Pension Plans: What are the Real Trade-offs?" *Pensions in the U.S. Economy, National Bureau of Economic Research, Inc*, 1988, 139-162.

Boyce, S. & Ippolito, R. A., "The Cost of Pension Insurance," *The Journal of Risk and Insurance, American Risk and Insurance Association*, 2002, 69, pp. 121-170

Brown, J. R. "Guaranteed Trouble: The Economic Effects of the Pension Benefit Guaranty Corporation," *The Journal of Economic Perspectives, American Economic Association*, 2008, 22, pp. 177-198

D'Arcy, S. P., J. H. Dulebohn, and P. Oh, "Optimal Funding of State Employee Pension Systems," *The Journal of Risk and Insurance, American Risk and Insurance Association*, **1999**, 66, pp. 345-380.

Bodie, Zvi, Mismatch Risk, "Government Guarantees, and Financial Instability: The Case of the U.S. Pension System," September 1, 2011. Working Paper Series

Joshua Rauh, Robert Novy-Marx, "Policy Options for State Pension Systems and Their Impact on Plan Liabilities," NBER Working Paper No. 16453, October **2010**

Wilcox, D. W. "Reforming the Defined-Benefit Pension System," *Brookings Papers on Economic Activity, The Brookings Institution*, **2006**, 2006, pp. 235-285

Unemployment Insurance

Aidt, Toke, Francisco Veiga, and Linda Veiga, "Election Results and Opportunistic Policies: A New Test of the Rational Political Business Cycle Model," *Public Choice*, 148, July, 2011, pp. 21-44.

Asdrubali, Pierfederico, Bent E. Sorensen, and Oved Yosha, "Channels of Interstate Risk Sharing: United States 1963-1990," *Quarterly Journal of Economics*, 111, November, 1996, pp. 1081-1110.

Barro, Robert J., "On the Determination of the Public Debt." *Journal of Political Economy*, 87, October, 1979, pp. 940-971.

Besley, Timothy, and Anne Case, "Incumbent Behavior: Vote-Seeking, Tax-Setting, and Yardstick Competition," *American Economic Review*, 85, March, 1995, pp. 25-45.

Borge, Lars-Erik, and Per Tovmo, "Myopic or Constrained by Balanced-Budget Rules? The Intertemporal Spending Behavior of Norwegian Local Governments," *FinanzArchiv: Public Finance Analysis*, 65, June, 2009, pp. 200-19.

Campbell, John Y., "Does Saving Anticipate Declining Labor Income? An Alternative Test of the Permanent Income Hypothesis," *Econometrica*, 55, November, 1987, 1249-73.

Carroll, Christopher D., "The Buffer-Stock Theory of Saving: Some Macroeconomic Evidence," *Brookings Papers on Economic Activity*, 2, 1992, pp. 61-156.

Carroll, Christopher D. "Buffer-Stock Saving and the Life Cycle/Permanent Income Hypothesis." *Quarterly Journal of Economics*, 112, 1997, pp. 1-56.

Chetty, Raj, and Emmanuel Saez, "Optimal Taxation and Social Insurance with Endogenous Private Insurance," *American Economic Journal: Economic Policy*, 2, May, 2010, pp. 85-114.

Craig, Steven G., and Michael G. Palumbo, "Policy Interaction in the Provision of Unemployment Insurance and Low-Income Assistance by State Governments," *Journal of Regional Science*, 39, May, 1999, pp. 245-74.

Dahlberg, Matz, and Tomas Lindstrom, "Are Local Governments Governed by Forward Looking Decision Makers?" *Journal of Urban Economics*, 44, 1998, pp. 254-71.

Deaton, Angus S., "Saving and Liquidity Constraints," *Econometrica*, 59, 1991, pp. 1221-1248.

Fatas, Antonio, and Ilian Mihov, "The Case for Restricting Fiscal Policy Discretion," *Quarterly Journal of Economics*, 118, Dec, 2003, pp. 1419-47.

Fatas, Antonio, and Ilian Mihov, "The Macroeconomic Effects of Fiscal Rules for US States," *Journal of Public Economics*, 90, Jan, 2006, pp. 101-17.

Gruber, Jonathan, "The Consumption Smoothing Benefits of Unemployment Insurance," *American Economic Review*, 87, March, 1997, pp. 192-205.

Im, Kyung So, M. Hashem Pesaran, and Yongcheol Shin, "Testing for Unit Roots in Heterogeneous Panels," *Journal of Econometrics*, 115, July, 2003, pp. 53-74.

Jappelli, Tullio, Luigi Pistaferri, and Mario Padula, "A Direct Test of the Buffer-Stock Model of Saving," *Journal of the European Economic Association*, 6, 2008, pp. 1186-1210.

Knight, Brian, and Arik Levinson, "Rainy Day Funds and State Government Savings," *National Tax Journal*, 52, Sept, 1999, pp 459-472.

Nicholson, Walter, and Karen Needels, "Unemployment Insurance: Strengthening the Relationship between Theory and Policy," *Journal of Economic Perspectives*, 20, Summer, 2006, pp. 47-70.

Persson, Torsten, and L. Svensson, "Why a Stubborn Conservative Would Run a Deficit: Policy with Time-Inconsistent Preferences," *Quarterly Journal of Economics*, 104, May, 1989, pp. 325-345.

Poterba, James, "Balanced Budget Rules and Fiscal Policy: Evidence from the States," *National Tax Journal*, 48, September, 1995, pp. 329-36.

Rothschild, Michael, and Joseph Stiglitz, "Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect," *Quarterly Journal of Economics*, 90, November, 1976, pp. 629-49.

Wagner, Gary A., and Russell S. Sobel, "State Budget Stabilization Fund Adoption: Preparing for the Next Recession or Circumventing Fiscal Constraints?" *Public Choice*, 126, 2006, pp. 179-99.