

Economics 750

Public Economics

Hanming Fang and Andrew Postlewaite

Fall, 2011

- This is a graduate course in public economics. Economics 701 and 703 are prerequisites; you cannot take the course for credit if you have not taken these courses. 750A is taught by Professor Andrew Postlewaite and 750B is taught by Professor Hanming Fang. The class will meet Tuesdays and Thursdays 1:30 - 3:00 in McNeil 285. There will be an additional meeting scheduled for student presentations.
- **Requirements:**
 - Students will present an empirical or theoretical research paper. At the end of this syllabus, there is a list of papers that you can choose from to present. Presentations will be by pairs of students with presentations being approximately 1 hour. Students are expected to attend all presentations. More details will be given the first class.
 - You are required to write a short research paper. For the paper, you are expected to pursue a topic covered in class or other related issues (subject to the approval of the instructors). The paper may consist of an empirical and/or theoretical analysis, but should contain original work. Before the end of the semester, you are to complete a two-page research proposal. The paper will be due in the beginning of the Spring semester. Please speak to us if you have difficulty developing a topic, and we will work on it together. The goal is to get you started on your first research project that can potentially be turned into the third-year paper later.

Part I

Econ 750A Postlewaite

- Room 456 McNeil building, phone: 898-7350, office hours: Friday 1:30-2:30 or by appointment
- There will be several problem sets for 750A.
- The topics we will cover are listed below in more or less the order in which we will cover them.
- Much of the reading will be journal articles. There are also notes on Blackboard mostly due to Hanming Fang.
- The following books contain material that is useful background for some topics and may be referred to.

(S) Salanie, B., *Microeconomics of Market Failures*, Cambridge MA: MIT Press, 2000.

(CS) Cornes, R., and T. Sandler, *The Theory of Externalities, Public Goods and Club Goods*, Cambridge, McGraw-Hill, 1986.

(FT) Fudenberg, D. and J. Tirole, *Game Theory*, MIT Press 1991.

(L) Laffont, J.J. *Fundamentals in Public Economics*, Cambridge, MIT Press, 1996.

(MWG) Mas-Colell A., M. D. Whinston, and J. R. Green, *Microeconomic Theory*, New York & Oxford, Oxford University Press, 1995.

Required reading is marked as **(R)**.

My papers can be downloaded from my webpage.

Papers marked with **(B)** can be downloaded from the Blackboard site for this course.

1. Public Goods

Reading:

Public Economics Notes, Sections 1-3

(MWG) Chapter 11.C and example 16.G.3

2. Implementation and Mechanism Design

In our first look at public goods, we discussed the problems with relying entirely on markets for decisions within society. In this section we develop tools that are useful in analyzing how well societies can determine public decisions according to fixed criteria.

2.1. Implementation with Complete Information

Reading:

(R)(B) Jackson, M. “A Crash Course in Implementation”, *Journal of Social Choice and Welfare*, 2001; Section 1-3.

(S) Chapter 4

Moore, J., “Implementation, contracts, and renegotiation in environments with complete information,” in *Advances in Economic Theory*, ed, J-J Laffont, Cambridge, 1992, pp. 182-282.

Hurwicz, L., E. Maskin and A. Postlewaite, “Feasible Implementation of Social Choice Correspondences by Nash Equilibria,” in *Essays in Honor of Stanley Reiter*, Kluwer Academic Publishers, 1995; pp 367-433. This paper deals primarily with questions of feasibility when the set of alternatives is not presumed to be known at the time the mechanism is chosen.

2.2. Implementation with Incomplete Information

Reading:

(R) MWG, Chapter 23.

(R)(B) Jackson, M. “Mechanism Theory” .

Palfrey, T. (1990), “Implementation in Bayesian Equilibrium,” in *Advances in Economic Theory: Sixth World Congress*, vol. I, edited by J.-J. Laffont. Cambridge, U.K.: Cambridge University Press.

McLean, R. and A. Postlewaite, “Informational Size and Efficient Auctions,” *Review of Economic Studies* 71, 2004: 809-827.

(B) Moulin, Herve, “Serial Cost-Sharing of Excludable Public Goods,” *Review of Economic Studies*, 61(2), April 1994, pages 305-325.

(B) Cremer, Jacques and Richard P. McLean, “Optimal Selling Strategies under Uncertainty for a Discriminating Monopolist When Demands Are Interdependent”, *Econometrica*; 53(2), March 1985, pages 345-61.

(B) Cremer, Jacques and Richard P. McLean, “Full Extraction of the Surplus in Bayesian and Dominant Strategy Auctions”, *Econometrica*; 56(6), November 1988, pages 1247-57.

Olszewski, Wojciech, “Serial Mechanisms for Provision of Excludable Public Goods”, mimeo, Princeton University, December 1999.

Gul, F. and A. Postlewaite, “Asymptotic Efficiency in Large Exchange Economies with Asymmetric Information,” *Econometrica*, 1992, Vol. 60, pp. 1273-1292.

McLean, R. and A. Postlewaite, “Informational Size and Incentive Compatibility,” *Econometrica* 70, 2002, 2421-2454.

Postlewaite, A. and D. Schmeidler, “Implementation in Differential Information Economies,” *Journal of Economic Theory*, June 1986, Vol. 39, No. 1, pp. 14-33.

3. Positive Models of Public Good Provision

3.1. Positive Models of Private Provision of Public Goods

3.1.1. Static Models of Private Provision

Public Goods Notes, Section 4.1

(R) Bergstrom, T., L. Blume and H. Varian (1986), “On the Private Provision of Public Goods,” *Journal of Public Economics*, 29, 25-49. (I list this as required but the notes cover nearly all the relevant material.)

(B) Morgan, J. (2000), "Financing Public Goods by Means of Lotteries," *Review of Economic Studies* 67:761-784.

Bernheim, D., “On the Voluntary and Involuntary Provision of Public Goods,” *American Economic Review*, 76, pp.789-793.

3.1.2. Dynamic Models of Voluntary Provision

(R) Admati, A. and M. Perry (1991), “Joint Projects without Commitment,” *Review of Economic Studies* 58, pp. 259-276.

(R) Marx, L. and S. Matthews, “Dynamic Voluntary Contributions to a Public Project,” *Review of Economic Studies*, v 62(2), 2000, 327-58.

3.2. Provision of Public Goods with Private Information

Public Goods Notes Section 5

(R) Mailath, G. and A. Postlewaite, "Asymmetric Information Bargaining Problems with Many Agents," *Review of Economic Studies*, 1990. (I list this as required but the notes cover nearly all the relevant material.)

3.3. Voting

MWG, Chapter 21D. This section deals with the median voter model and its limitations.

(R)(B) Jackson, M. "Mechanism Theory" Sections 1,2 and 3.4.

4. Social Arrangements

(R) Postlewaite, A., "Social Norms and Preferences," in *Handbook for Social Economics, Vol. 1A*, ed J. Benhabib, A. Bisin and M. Jackson, The Netherlands: North-Holland, 2011, pp 31-67.

(R) Postlewaite, A., "Social Norms and Social Assets," *Annual Reviews*, (2011) pp 239-259.

(R) Postlewaite, A., "The Social Basis of Interdependent Preferences," *European Economic Review*, 1998, v42; easy reading.

(R) Mailath and Postlewaite, 2002 "The Social Context of Economic Decisions," *Journal of the European Economic Association* (April-May 2003), 354-362.

(R) Postlewaite, A., "Social Arrangements and Economic Behavior," *Annales d' Economie et de Statistique*, 63-64, 2001, pp. 67-87; easy reading.

(R) Cole, Mailath and Postlewaite "Social Norms, Savings Behavior and Growth," *Journal of Political Economy*, 1992, Vol. 100, pp. 1092-1126. First real paper.

(R) Mailath and Postlewaite "Social Assets," *International Economic Review*, 47 (November 2006), 1057-1091.

(B) Charles, Kerwin, Erik Hurst and Nick Roussanov (2007), "Conspicuous Consumption and Race," mimeo, University of Chicago.

(B) Corneo, G. and Olivier Jeanne "Social Organization in an Endogenous Growth Model," *International Economic Review* 40 (3), 711-726. This paper incorporates relative wealth concerns in a more manageable model than that in Cole et al. (1992).

(B) Corneo, G. and Olivier Jeanne "Conspicuous consumption, snobbism and conformism," *Journal of Public Economics* Volume 66, Issue 1, October 1997,

Pages 55-71. This paper presents a model generating conspicuous consumption similar to the model in Cole et al. in the *Quarterly Review* listed above.

(B) Corneo, G. and Olivier Jeanne "Status, the Distribution of Wealth, and Growth," *Scand. J. of Economics* 103(2), 283-293, 2001. This paper takes a fairly standard endogenous growth model and incorporates relative wealth concerns.

(B) Corneo, G. and Hans Gruner, "Social Limits to Redistribution," *American Economic Review*, Vol. 90, No. 5. (Dec., 2000), pp. 1491-1507. This is a nice application of a model in which a concern for relative ranking is taken to data.

(B) DellaVigna, Stefano, "Psychology and Economics: Evidence from the Field," *Journal of Economic Literature* 47:2, 315-372, 2009. This is a nice survey of behavioral economics that discusses deviations from standard models in the preferences, beliefs and decision making process employed by individuals.

(B) Dufwenberg, M., P. Heidhues, G. Kirchsteiger, F. Riedel and J. Sobel, "Other-Regarding Preferences in General Equilibrium," mimeo, 2008. This is a recent paper that incorporates preferences that take into account other people's welfare (other-regarding preferences) and addresses the question of when one can identify other-regarding preferences from market behavior, and when the conclusion of the First Welfare Theorem continues to be true.

(B) Heller, D. "Insuring Against Risk through Social Assets", mimeo, undated. A variant of the Social Asset paper we discussed in class.

(B) Hopkins, E. and Tatiana Kornienko, "Running to Keep in the Same Place: Consumer Choice as a Game of Status", *American Economic Review*, September, 2004, 94(4), 1085-1107.

(B) Hopkins, E. and Tatiana Kornienko, "Inequality and Growth in the Presence of Competition for Status," *Economics Letters* 93 (2006) 291-296. This is a short note that integrates a concern for relative position into a simple endogenous growth model. The authors show that redistribution to reduce inequality may increase inefficient conspicuous consumption.

(R) Persico, Postlewaite and Silverman, "The Effect of Adolescent Experience on Labor Market Outcomes: The Case of Height", 112, 2004: 1019-1053.

(B) Postlewaite and Silverman, "Noncognitive Skills, Social Success, and Labor Market Outcomes," mimeo, 2006.

(B) Cole, Mailath and Postlewaite "Class Systems and the Enforcement of Social Norms," *Journal of Public Economics*.70, 1998, pp. 5-35.

(B) Neumark and Postlewaite, "Relative Income Concerns and the Rise in Married Women's Employment," *Journal of Public Economics* 70, 1998, pp. 157-183.

(B) Okuno-Fujiwara, M. and A. Postlewaite, "Social Norms in Matching Games," *Games and Economic Behavior*, 1995, Vol. 9, pp79-109. This paper examines the role of status in supporting cooperation in a repeated game with random matching.

(B) Sobel, J. "Interdependent Preferences and Reciprocity," *JEL* 93, 2005, pp 392-436. This is a very nice survey of work that aims at understanding the limits of the joint assumptions of rationality and individual greed in economics models.

4.1. Applications

4.1.1. Labor Supply

(R) Cole, Mailath and Postlewaite "Incorporating Status Concerns in Economic Models," *Quarterly Review of the Minneapolis Federal Reserve Bank*, Fall, 1995.

4.1.2. Investment

(R) Cole, Mailath and Postlewaite, "Investment and Concern for Relative Position," *Review of Economic Design* 6, 2001, pp. 241-261.

(B) DeMarzo, P., R. Kraniel and I. Kremer (2004), "Diversification as a Public Good: Community Effects in Portfolio Choice," *Journal of Finance* 54, pp 1677 - 1713.

(B) DeMarzo, P., R. Kraniel and I. Kremer (2007), "Relative Wealth Concerns and Financial Bubbles," *Review of Financial Studies* 21:19-50.

(B) Roussanov, N., "Diversification and its Discontents: Idiosyncratic and Entrepreneurial Risk in the Quest for Social Status," mimeo, 2007.

5. Discrimination

(B) Fang, H. and Andrea Moro (2011). "Theories of Statistical Discrimination and Affirmative Action: A Survey." Chapter 5 in *Handbook of Social Economics*, Vol IA, edited by Jess Benhabib, Alberto Bisin, and Matthew Jackson, North-Holland, 2010, pp. 133-200.

(B) Phelps, E. (1972). "The Statistical Theory of Racism and Sexism," *American Economic Review*, Vol. 62, 659–661.

(B) Coate, S. and Glenn Loury (1993). “Will Affirmative Action Eliminate Negative Stereotypes?” *American Economic Review*, Vol. 83, No. 5, 1220-40.

(B) Fang, H. (2001), “Social Culture and Economic Performance”, *American Economic Review*, Vol. 91, No. 4, 924-937.

(B) Mailath, G., L. Samuelson and A. Shaked (2000), “Endogenous Inequality in Integrated Labor Markets with Two-Sided Search.” *American Economic Review*, Vol. 90, No. 1, 46-72.

(B) Fang, H. and P. Norman (2006), “Government-mandated discriminatory policies”, *International Economic Review*, Vol. 47, No. 2, 361-189.

(B) Chan, J. and E. Eyster (2003), “Does Banning Affirmative Action Lower College Student Quality?” *American Economic Review*, Vol. 93, No. 3, 858-872.

(B) Moro, A. and P. Norman (2004), “A General Equilibrium Model of Statistical Discrimination.” *Journal of Economic Theory*, 114 (1), 1-30.

6. Public Choice

6.1. Models of Political Competition

Reading:

(R) MWG Chapter 21

(R) Notes, Part III Public Choice

(B) Besley, T. and S. Coate (1997), "An Economic Model of Representative Democracy," *QJE* pp 85-114.

(B) Osborne, M and A. Slivinski (1996) “A Model of Political Competition with Citizen-Candidates,” *QJE* pp 65-96.

(B) Lizzeri, Alessandro and Nicola Persico (2001), "The Provision of Public Goods under Alternative Electoral Incentives," *American Economic Review*, XC (2001), 225-239.

(B) Diermeier, D., H. Eraslan and A. Merlo (2003), “A Structural Model of Government Formation,” *Econometrica* 71, pp 27-70.

(B) Aragones, E. and A. Postlewaite, “Ambiguity in Election Games,” *Review of Economic Design* 7(3), 2002: 233-255.

(B) Aragones, E., T. Palfrey and A. Postlewaite, "Reputation and Rhetoric in Elections," *Journal of the European Economic Association*, 5: 846-884.

Downs, A., *An Economic Theory of Democracy*, New York, Harper and Row, 1957.

Part II

Econ 750B Fang

In this part of the course, we will mainly cover two topics:

1. (Section 7) Economics of Discrimination and Affirmative Action: Theory and Empirical Methods;
2. (Section 8) Topics in Social Insurance: Theory and Empirical Methods.

Requirements:

There will be **two problem sets** in this part of the course, one for each topic.

Office Hours: Friday, 1:00-2:30pm and by appointment

7. Economics of Statistical Discrimination and Affirmative Action

Section 7.1 overlaps with Andy's Section on Discrimination. We will go directly to Section 7.2 if Andy has covered most of the theory papers in I.A.

7.1. Theory

★ Survey: **Hanning Fang and Andrea Moro** (2011). "Theories of Statistical Discrimination and Affirmative Action: A Survey." Chapter 5 in *Handbook of Social Economics*, Vol IA, edited by Jess Benhabib, Alberto Bisin, and Matthew Jackson, North-Holland, 2010, pp. 133-200.

★ **Edmund Phelps** (1972). "The Statistical Theory of Racism and Sexism," *American Economic Review*, Vol. 62, 659-661.

★ **Stephen Coate and Glenn Loury** (1993). "Will Affirmative Action Eliminate Negative Stereotypes?" *American Economic Review*, Vol. 83, No. 5, 1220-40.

Fang, H. (2001), "Social Culture and Economic Performance", *American Economic Review*, Vol. 91, No. 4, 924-937.

Mailath, G., L. Samuelson and A. Shaked (2000), "Endogenous Inequality in Integrated Labor Markets with Two-Sided Search." *American Economic Review*, Vol. 90, No. 1, 46-72.

Fang H. and P. Norman (2006), "Government-mandated discriminatory policies", *International Economic Review*, Vol. 47, No. 2, 361-189.

★ **Chan, J. and E. Eyster** (2003), "Does Banning Affirmative Action Lower College Student Quality?" *American Economic Review*, Vol. 93, No. 3, 858-872.

Moro, A. and P. Norman (2004), "A General Equilibrium Model of Statistical Discrimination." *Journal of Economic Theory*, 114 (1), 1-30.

7.2. Empiric Methods to Distinguish Prejudice from Statistical Discrimination

Becker, Gary S. (1957). *The Economics of Discrimination*. Chicago: University of Chicago Press.

Becker, Gary S. (1993b). "Nobel Lecture: The Economic Way of Looking at Behavior." *Journal of Political Economy*, Vol. 101, 385-409.

★ **Knowles, John, Nicola Persico and Petra Todd** (2001). "Racial Bias in Motor Vehicle Searches: Theory and Evidence." *Journal of Political Economy*, Vol. 109, 203-228.

★ **Anwar, Shamena and Hanming Fang** (2006). "An Alternative Test of Racial Profiling in Motor Vehicle Searches: Theory and Evidence." *American Economic Review*, Vol. 96, No. 1, 127-151.

★ **Anwar, Shamena and Hanming Fang** (2011). "Testing for the Role of Racial Prejudice Using Bounceback Rates in Emergency Departments." NBER Working Paper 16888.

Sahuguet, Nicolas and S. Mechoulan (2011). "Assessing Racial Discrimination in Parole Release." Working Paper.

★ **Fang, Hanming and Nicola Persico** (2010). "Difference-in-Difference Estimators of Prejudice: An Examination of the Existing Test and An Alternative." Working Paper.

Goldin, Claudia and Cecilia Rouse (2000) "Orchestrating Impartiality: The Impact of "Blind" Auditions on Female Musicians" *The American Economic Review*, Vol. 90, No. 4 (Sept., 2000), pp. 715-741.

Altonji, Joseph and Charles R. Pierret (2001). "Employer Learning and Statistical Discrimination." *Quarterly Journal of Economics*, 116(1): 313-350.

8. Selected Issues on Social Insurance: Theory and Evidence

8.1. Asymmetric Information: Theory, Tests and Welfare Analysis

The key reason for the government to be involved in providing insurance is the potential market failure as a result of asymmetric information. Here we review the basic theory of how asymmetric information may lead to market failure; and the tests for asymmetric information that are derived from the theory; and finally some recent empirical methods to examine the welfare effects of asymmetric information. Recently there have been some work emphasizing potential private information in other dimensions, such as risk aversion.

8.1.1. Theory:

George Akerlof (1970). “The Market for ‘Lemons’: Quality Uncertainty and the Market Mechanism,” *Quarterly Journal of Economics* (August 1970).

Michael Rothschild and Joseph Stiglitz (1976). “Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information”, *Quarterly Journal of Economics*, 90 (4), 629-650.

Hemenway, David (1990). “Propitious Selection.” *Quarterly Journal of Economics*, Vol. 105, 1063-1069.

de Meza, David and David C. Webb (2001). “Advantageous Selection in Insurance Markets.” *Rand Journal of Economics*, Vol. 32, No. 2, 249-262.

8.1.2. Empirical Tests of Asymmetric Information

The most well-known empirical tests of asymmetric information is known as the “positive association property” test, first applied in Chiappori and Salanie (2000) for automobile and Chiappori, Jullien, Salanie and Salanie (2005) showed the robustness of this test. Other applications include Cawley & Philipson (1999) for life insurance market, Finkelstein & McGarry (2006) for Long Term Care insurance market, Fang, Keane & Silverman (2008) for Medigap insurance market.

★ **Chiappori, Pierre-André and Bernard Salanié (2000).** “Testing for Asymmetric Information in Insurance Markets.” *Journal of Political Economy*, Vol. 108, No. 1, 56-78.

Chiappori, Pierre-André, Bruno Jullien, Bernard Salanié and Francois Salanié (2006). “Asymmetric Information in Insurance: General Testable

Implications.” *Rand Journal of Economics*, Vol. 37, No. 4.

Cawley, John, and Thomas Philipson (1999). “An Empirical Examination of Information Barriers to Trade in Insurance.” *American Economic Review*, 89(4): 827-846.

Finkelstein, Amy and Kathleen McGarry (2006). “Multiple Dimensions of Private Information: Evidence from the Long-Term Care Insurance Market.” *American Economic Review*, Vol. 96, No. 4, 938-958.

★ **Fang, Hanming, Michael P. Keane and Dan Silverman (2008).** “Sources of Advantageous Selection: Evidence from the Medigap Insurance Market.” *Journal of Political Economy*, Vol. 116, No. 2, 303-350.

However, “positive correlation property” is not the unique implication from the presence of asymmetric information. The following papers use different angles to examine the presence of asymmetric information.

Finkelstein, Amy and James Poterba (2004). “Adverse Selection in Insurance Markets: Policyholder Evidence from the U.K. Annuity Market.” *Journal of Political Economy*, Vol. 112, 183-208.

★ **Cohen, Alma and Liran Einav (2007).** “Estimating Risk Preferences from Deductible Choice.” *American Economic Review*, Vol. 97, No. 3, 745-788.

8.1.3. Welfare Effects of Asymmetric Information

The frontier of this research area lies in welfare analysis of asymmetric information in insurance context. The following list is almost exhaustive about the existing literature.

Finkelstein, Amy, Liran Einav and Paul Schrimpf (2010). “Optimal Mandates and The Welfare Cost of Asymmetric Information: Evidence from The U.K. Annuity Market.” *Econometrica*, 78(3), May 2010, 1031-1092

★ **Einav, Liran, Amy Finkelstein and Mark R. Cullen (2010).** “Estimating Welfare in Insurance Markets using Variation in Prices.” *Quarterly Journal of Economics*, 125(3), August 2010, 877-921.

8.2. Health Care Systems: Theory and Evidence

Health care reform is one of the most important policy issues in the US. There are numerous angles from which one can examine the issues related to the health care system. I will touch upon only two issues, reclassification risk insurance, and dynamic externalities.

8.2.1. Reclassification Risk: Theory and Evidence

Reclassification risk is the risk that consumers face in future insurance premiums. There is no long-term health insurance currently in the U.S. This could lead to significant welfare loss.

Peter Diamond (1992). “Organizing the Health Insurance Market,” *Econometrica*, 60, 1233-1254.

John Cochrane (1995). “Time Consistent Health Insurance”, *Journal of Political Economy*, 103 (3), 445-473.

★ **Hendel, Igal and Alessandro Lizzeri (2003).** “The Role of Commitment in Dynamic Contracts: Evidence from Life Insurance.” *Quarterly Journal of Economics*, Vol. 118, No. 1, 299-327.

Fang, Hanming and Edward Kung (2010). “How Does the Life Settlement Market Affect the Primary Life Insurance Market?” NBER Working Paper 15761.

Fang, Hanming and Edward Kung (2011). “Why Do Life Insurance Policyholders lapse? Loss of Bequest Motives vs. Liquidity Shocks”, NBER Working Paper.

8.2.2. Dynamic Externalities

Health insurance in the US is mostly tied to employment. There is neither universal, nor single-payer, health insurance in the US and this leads to dynamic inefficiencies.

★ **Fang, Hanming and Alessandro Gavazza (2011).** “Dynamic Inefficiency in an Employment-Based Health Insurance System: Theory and Evidence.” NBER Working Paper No. 13371; forthcoming, *American Economic Review*.

8.2.3. Demand and Supply of Medical Care, Interacting with Health Insurance

★ **W. Manning et al. (1987).** “Health Insurance and the Demand for Medical Care: Evidence from a Randomized Experiment”, *American Economic Review*, 77(3), 251-177.

★ **Amanda Kowalski (2009).** “Censored Quantile Instrumental Variable Estimates of the Price Elasticity of Expenditure on Medical Care”. NBER Working Paper 15085.

8.2.4. Health Insurance and Labor Market Outcomes

Madrian, Brigitte C. (1994). “Employment-Based Health Insurance and Job Mobility: Is There Evidence of Job Lock?” *Quarterly Journal of Economics*, Vol. 109, No. 1, 27-54.

Dey, M. and C. Flinn (2005). “An Equilibrium Model of Health Insurance Provision and Wage Determination.” *Econometrica* 73, 571-627.

Dey, M. and C. Flinn (2008). “Household Search and Health Insurance Coverage.” *Journal of Econometrics*, 145 July, 43-63.

Brügemann, Björn and Iourii Manovskii (2011). “Fragility: A Quantitative Analysis of the U.S. Health Insurance System.” Working Paper.

8.3. Unemployment Insurance: Theory and Evidence

For the institutional background related to the unemployment insurance system in the US, see:

Katherine Baicker, Claudia Goldin, and Larry Katz (1998). “A Distinctive System: Origins and Impacts of U.S. Unemployment Compensation,” in *The Defining Moment: The Great Depression and the American Economy*, University of Chicago Press, 1998 (NBER Working Paper No. 5889).

8.3.1. Theory and Evidence of Optimal Unemployment Insurance (Static Models)

The static models for optimal unemployment insurance are Baily (1978), extended further by Chetty (2006). Theoretical results on the optimal unemployment insurance are useful only if one has reliable estimates regarding the effect of UI benefit on unemployment duration, and the consumption smoothing from UI. Meyer (1990) and Gruber (1995) are classical studies on these two issues. Meyer (1995) summarizes.

★ **Baily, Martin (1978).** “Some Aspects of Optimal Unemployment Insurance,” *Journal of Public Economics*, 10, 379-402.

★ **Raj Chetty (2006).** “A General Formula for the Optimal Level of Social Insurance.” *Journal of Public Economics*, 90: 1879-1901.

Bruce Meyer (1990). “Unemployment Insurance and Unemployment Spells,” *Econometrica* 58, 757-782.

Jonathan Gruber (1997). “The Consumption Smoothing Benefits of Unemployment Insurance,” *American Economic Review*, 87, 192-205.

Bruce Meyer (1995). “Lessons from the U.S. Unemployment Insurance Experiments,” *Journal of Economic Literature*, 33, 91-131.

8.3.2. Theory of Optimal Unemployment Insurance (Dynamic Models)

Dynamic theory of optimal timing and level of unemployment insurance started with Shavell and Weiss (1979). There is also a growing literature dubbed “dynamic public finance” that addresses the mechanism design issues related to unemployment insurance, as well as disability insurance, dynamic optimal taxation etc.

★ **Steven Shavell and Lawrence Weiss (1979).** “The Optimal Payment of Unemployment Insurance Benefits over Time,” *Journal of Political Economy*, 87, 1347-1362.

★ **Hugo Hopenhayn and Juan Niccolini (1997).** “Optimal Unemployment Insurance,” *Journal of Political Economy*, 105 (1997), 412–438.

Cheng Wang and Stephen Williamson (1996). "Unemployment Insurance with Moral Hazard in a Dynamic Economy," *Carnegie-Rochester Conference Series on Public Policy*, 44, 1-41, 1996.

Michael Golosov, Aleh Tsyvinski and Ivan Werning (2006). “New Dynamic Public Finance: A User’s Guide.” *NBER Macroeconomics Annual 2006*.

Robert Shimer and Ivan Werning (2007). “Liquidity and Insurance for the Unemployed” MIT mimeo.

★ **Robert Shimer and Ivan Werning (2007).** “Reservation Wages and Unemployment Insurance,” *Quarterly Journal of Economics*, 2007, 122 (3): 1145-1185.

Robert Shimer and Ivan Werning (2007). “On the Optimal Timing of Benefits with Heterogeneous Workers and Human Capital Depreciation.” mimeo, MIT.

Landais, Camille, Pascal Michaillat, Emmanuel Saez (2011). "Optimal Unemployment Insurance over the Business Cycle", NBER Working Paper No. 16526, November 2010, revised August 2011.

Mitman, Kurt and Stanislav Rabinovich (2011). “Pro-cyclical Unemployment Benefits? Optimal Policy in an Equilibrium Business Cycle Model.” PIER Working Paper 11-023.

8.3.3. Some New Empirical Studies and Empirical Methods for Welfare Analysis

Chetty (2010) proposes using sufficient statistics, estimable using non-structural methods, to conduct welfare analysis.

★ **Raj Chetty (2010)**. “Sufficient Statistics for Welfare Analysis: A Bridge Between Structural and Reduced-Form Methods”, *Annual Review of Economics*.

Part III

Student Presentations

- Presentations will be by pairs. So find another student to be your presentation partner.
- Each pair should pick two papers, one from the theory list and one from the empirical list. Indicate your preference about which of the two papers you prefer to present.
- If you are planning to use this course to satisfy the empirical course requirement, you should indicate this, and you are more likely to be asked to present an empirical paper.
- We will try to accommodate the preference but depending on the overall choices you may not be assigned your first choice.

Theory

- Bhaskar, V., (2011), "Sex Selection and Gender Balance", *A EJ : Micro*, pp 214-244. (See also the corrigendum.)
- Compte, O. and P. Jehiel (2009), "Group Decision Making," mimeo.
- Compte, O. and P. Jehiel (2010), "On the Optimal Majority Rule," mimeo.
- DeMarzo, P., R. Kraniel and I. Kremer (2004), "Diversification as a Public Good: Community Effects in Portfolio Choice," *Journal of Finance* 54, pp 1677 - 1713.
- DeMarzo, P., R. Kraniel and I. Kremer (2007), "Relative Wealth Concerns and Financial Bubbles," *Review of Financial Studies* 21:19-50.
- Esteban, J. and D. Ray (2006), "Inequality, Lobbying and Resource Allocation," *AER* pp 257-279.
- Hopkins, E. and Tatiana Kornienko, "Running to Keep in the Same Place: Consumer Choice as a Game of Status", *American Economic Review*, September, 2004, 94(4), 1085-1107.

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