# Harvard University
# Social Analysis 10
# Microeconomics
# Reading Summery

*Complied by*
*Minhua Zhang*

***"The Impact of Taxes on Internet Commerce," page 186.***

This article reports on the research concerning the possible effects of an imposition of  sales taxes on Internet sales.  Online sales have grown rapidly, and there is debate over whether a sales tax should be applied to this burgeoning field of Internet sales.  Research by Austan Gollsbee suggests that Internet sales are strongly affected by the local taxation; consumers who live in high sales tax areas are not more technically savvy, do not own more computers, and do not use the Internet more, but they are more likely to purchase things on the Internet.  This suggests that they do so in order to save money.  Hence, Gollsbee concludes, imposing sales taxes on Internet purchases would reduce the number of Internet buyers by 25% and online spending by 30%.  Because Internet sales represent a relatively small fraction of total retail sales, states, for which sales taxes are the largest source of revenue, are not losing much money by not having a sales tax.  But if the online sales continue to grow, states may lose large amounts of revenue, and they cannot collect sales taxes from Internet companies.

***"Light on the Shadows," page 187.***

The "shadow economy" is unreported (underground) economic activity; it includes unreported earning from legal work and illicit activities like drug dealing. Research suggests that the shadow economy in wealthy countries has increased three-fold since the 1960s.  The shadow economy in the US in 1994 was estimated to constitute about 10% of the GDP, and that same year Italy's shadow economy made up over 20% of Italy's GDP.  Spain's shadow economy was over 20% of its GDP, and Russia's shadow economy may be as large as the official economy there.   Overall, the shadow economy may equal about one-seventh of the total output of the world's wealthiest countries.

Drawbacks of the shadow economy include making it harder for the government to evaluate the country's economy, and money transferred in the shadow economy is hard to tax.  Workers are also more vulnerable to exploitation.  However, the shadow economy may help provide more flexible labor in areas where the reported workforce has become stuck in its ways.

The main causes of the shadow economy, the article claims, include "excessive regulation of labor and product markets" (i.e., bureaucratic and regulatory hurdles). Another cause if high effective tax rates that, like regulations, give employers and workers incentives to cheat.  Also important is increasing opportunities to cheat by going underground due to a shift away from the manufacturing sector and toward the service sector.  Other opportunities to cheat easily are self-employment, part-time work, and the market for people to do household chores.  Globalization and the Internet have also increased cheating.

One way to reduce cheating is to restrict the opportunities to engage in it.  The article suggests that another way is to cut taxes,  deregulate the labor market, and reduce red tape.  Another method is to provide incentives not to cheat.

***"The Withering Away of the State," page 189.***

This article reports on research that addresses the question of whether there is an optimal level of government spending.  Research by Vino Tanzi and Ludger Schuknecht suggests that government spending may be subject to diminishing marginal returns, so that above a certain level, additional funding does not deliver appreciable social benefit as measured by a range of economic and social indicators. The researchers found that public spending has increased substantially as a percentage of total spending in the industrialized economies over the past 100 years. Until 1960, increased government spending corresponded with significant improvements in indicators of social welfare such as infant mortality rates, life expectancy, equality, and schooling. After 1960, additional increases in government spending was not accompanied by significant improvements in indicators of social welfare, and countries with the smallest increases in public spending have been more efficient and innovative than other industrialized countries.

The article warns that the findings about the effect of spending on economic and social outcomes should be treated with some caution because the cost of delivering public services of a certain quality has risen faster than inflation. (So if public spending had remained at 1960s levels, social indicators might have declined.) Also, the study did not address the issue of causation versus correlation; it did not look to see if the increases in government spending prior to the 1960s had actually *caused* the improvement in indicators of social welfare, which may have been caused mostly by rising incomes.

Politics would make decreasing public spending because those who would stand to lose money and/or services would resist such changes, even if they might lead to more rapid economic growth in the long run. However, government can create incentives for itself to encourage long-term implications of spending policies.

***"Ukraine: How Not To Run an Economy,"* page 190.**

Ukraine is like many of the countries of the Soviet Union in that it is "struggling" to make the transition from a communist to a market economy. GDP per capita is only $1,000, which is ~3% of that in the US.

Much of Ukraine's problem is rampant corruption. Doctors and government official demand bribes, and businesses hide much of their sales to avoid paying taxes on them, leaving the government. One must work past self-interested and corrupt government officials to start a profit-making venture.

Social expectations that lead Ukrainians to expect the loss of profits to corrupt officials perpetuates the problem of corruption. People's incentives to start businesses is thus lessened. Such expectations also contributes to lax law enforcement efforts to root out corruption.

A factor behind US prosperity is low corruption. By rooting out corruption, as New York City did long ago, Ukraine will be in a better position to prosper.

***"Tax Rules Raise Firm Health Benefits," page 192.***

The government provides a "tax subsidy" for employer-provided health insurance, exempting the money spent on that insurance from both individual income tax and the payroll tax (which funds Social Security and Medicare). The subsidy is costly to the government ($100 billion in lost revenues), people who buy their own insurance do not benefit from the subsidy, the subsidy is regressive in that the tax break is largest for the most highly paid workers, and the subsidy may lead to "over-insurance" and contribute to health care cost inflation. A recent study asks if a reduction or elimination of the subsidy would cause a reduction in the health insurance coverage rate of employees and overall employer spending on health insurance – essentially asking what the elasticity of the "firm's demand for health insurance."

The study suggests such demand is fairly elastic (i.e., responsive to changes in the tax subsidy), so that a reduction or elimination of the subsidy would result in decreased spending on health insurance and decreased rates of insurance offering. For example, a 10 percent increase in the subsidy raise health insurance spending by 7 percent. The study also finds that employers care about the subsidy for both their highest-paid and average-paid employees in making health care spending decision.

The study predicts that subjecting employer health insurance spending to income taxes would eliminate 60 percent of the subsidy, reduce by 10-19 percent of the number of firms offering insurance, and reduce insurance spending by those firms by 20-28 percent. The number of uninsured American would rise 36-66 percent (16-29 million). President Bush's income tax reduction was predicted to reduce offering rates by up to 2 percent and spending up to 4.7 percent – so even modest tax adjustments can have significant impact o n employer health care spending.

***"Why Health Care Costs Are Soaring," page 193, by M. and K. Feldstein.***

The US has the highest quality health care available in the world, but health care costs are rising rapidly – 14% of the GDP (national output) is now spent on health care – and 15 percent of the population lacks health insurance. Many people say that the high cost of health care is due to doctors' making too much money and prescription drugs' costing too much. But doctor's incomes are only one-seventh of total health care spending, and their high incomes attract the high-caliber people to the profession. Prescription drug costs account for only 8 percent of total health care spending. Although hospitals receive 40 percent of all health care spending, most hospitals have annual operating losses. And health insurance companies are either non-profit or make only small profits.

The Feldsteins claim that the tax incentive (called the "tax subsidy" in the previous article) is the main force behind "excessive" spending on health care in the US because it provides an incentive to "overinsure and then choose care without regard to cost." Because most Americans have employer-funded insurance, which is excluded from taxable income, employers have a powerful incentive to provide compensation through health insurance rather than wages. Also, a couple making $40,000 has an incentive to choose a $100 increase in health insurance premiums over $100 in taxable income because the former is tax free and the marginal tax rate of ~50% means the later gives them only $50 in cash. All of this leads to comprehensive health insurance with low deductibles and low co-payments, which in turn makes people "indifferent" about the costs of their treatment, which encourages doctors and hospitals to prescribe the most expensive treatments.

The Feldsteins say that rather than implement Clinton's health care plan, Congress should limit the amount of tax-free health care insurance in order to provide an incentive for consumers to reduce health care costs.

## Economics of road pricing

No city has ever been able to solve its congestion and pollution problems by building more roads. A theoretical answer to this problem is “road pricing”.
Singapore was the first city to try out this solution and it proved to be effective. “Singapore is the only city on the face of the earth without congestion and autoinduced pollution problems.”
Road pricing works in the way that “cars driving into the city must pay a toll based on the roads being used and the time of the day when the driving will occur”.
Different “plates” can be used to allow cars to drive at different timea more expensive one allows more time. Prices depend on supply and demand. “Car bar codes” can be used to record the path a car travels in the city and money is charged from “debit cards for drivers”. The whole system also redistributes income from the rich to poor because rich people choose to drive more and thus pay more.

# Essays on Kyoto Agreement

## Money to burn?

Kyoto treaty allows an international permit-trading system for emission (Carbon Dioxide). US together with many European countries signed this agreement. This is supposed to be a cost-effective way to reduce the global pollution where cuts are cheapest. However, remaining problems are how initial emission credits should be distributed (per capita or per GDP?) and how the logistics should work out.

## It’s immoral to buy the right to pollute

The free international trading for emission is immoral because

1. It creates loopholes that could enable wealthy countries to evade their obligations.
2. Turning pollution into commodity removes the moral stigma that is properly associated with it.
3. It may undermine the sense of shared responsibility that increased global cooperation requires.

The US’s sanction on Kyoto allow developing countries to rightly complain that wealthy nations are buying their way out of global obligations.

## Seeing green

Global warming is a real issue so that polluters should cut their emission like what DuPont voluntarily did. The Kyoto is a bad idea because it facilitates unfair transaction: “the winners are those that can cheaply create what the losers desperately want: reductions in emissions.” Also, consultants are likely to make a big fortune out of the consequent uncertainty that they help clients assess carbon liabilities and assets where arbitrary manipulation may involve.

**What price pollution? Leave that to a global market.**

Kyoto is a bad agreement. It exempts more than 130 developing countries from any restrictions on their industrial pollution. This induces a shift of pollution from developed countries to developing ones which creates an economical inefficiency. In addition, “an international body would be required to take responsibility for the difficult task of monitoring compliance and penalizing violators, but enforcement of compliance is a challenge under any tax or quota system”.
PS. “The price of rights [to pollute] during any month would be determined by market supply and demand for rights at the time.”

## Unit III Summaries

### Schools Brief: State and Market

The point where quantity demanded equals quantity supplied is *efficient* because no changes could be made to make people better off without making someone worse off. When the market does not converge to this point, it is called market failure, resulting from a lack of perfect competition. Market failures occur in several varieties: monopolies, public god that are non-excludable, externalities, and misleading information. However, government intervention is not always the answer; markets can often correct their failures on their own, throught private contracts, warranties, tolls, etc. Thus, markets can be imperfect, but so can governments.

### How To Be Perfect

Economist once thought perfect economic efficiency and competition to be a mere pipe dream, but the Internet seems to make this more possible in two main ways—*aggregation*: bringing together a large number of buyers and sellers, and *matching* what a buyer wants with what a seller can supply. One word of caution regarding the Internet: the best-designed market can only work if people are willing to use it.

### Measuring Flexibility

The study at issue in this article attempts to judge a country’s structural (microeconomic) strengths and weaknesses according to its policies in three distinct categories: 1) long-term potential growth rate that increase the supply of labor and capital (e.g. education), 2) labour-market performance, or the lowest rate of inflation at which inflation is stable (the NAIRU), 3) increasing product-market competition that reduce costs throughout the economy. When these countries are scored on said variables, the English-speaking countries that have undertaken far-reaching economic reforms lately did best, although America fared poorly in education.

**A Productivity Divide**

In the latter part of 1990s, the surge in information technology and business investment made for fast-growing productivity and economic growth. Despite the recent economic downturn, the U.S.—according to Feldstein—will bounce back because of its incentive compensation and lack of regulations preventing companies from taking advantage of new technologies. If Europe does not make similar changes in its policies, the economic disparity between the two continents will only get worse.

**China to Increase Grain Imports**

China is considering importing more grain from countries with a comparative advantage in grain production to meet the needs of a rising and affluent population. China's objects based on fears of declining national security and self-sufficiency, which advisers said can be assured through provision of enough purchasable goods, not wasteful domestic stockpiling.

**Sticky Situation and Sugar Shock**

According to the article, the U.S. insistence on domestic sugar production despite a lack of comparative advantage lead to a huge waste in energy and productivity. The only gainers are cane sugar growers that benefit from import restrictions. Losers include consumers and employees of companies that buy sugar at the inflated price.

**A productivity divide: US economic performance**

**will rebound but Europe risks being left behind, argues Martin Feldstein** (p 144)

As U.S. productivity growth has decelerated economists have debated whether the recent economic growth is sustainable. Feldstein argues that "the U.S. productivity decline is a temporary cyclical setback…[it] will return to a trend level that is significantly above that of previous decades." Biggest reason for increase in productivity growth has been revolution in information technology, it has made possible the reduction of layers of management and support staff. This favourable change will fail to spread to Europe without changes in economics… "its employment practices limit companies' ability to use information techmology. Need to change employment practices, labor markets and management incentives to encourage adoption of new technology.

Feldstein believes that U.S. productivity can exceed past growth because there are still many un-exploited opportunites for companies to use, info. technology revolution has just begun. If Europe does not make changes the gap between U.S. and European incomes will grow.

**China to increase grain imports:**
**Market system favored over 'costly' self-sufficient policy** (p 146)

China has traditionally had a policy of self-sufficiency. Now it is considering a more market-based system. China has historically produced 98.6% of demand but this is an excessive financial and environmental cost, and leads to wasteful stockpiling, corruption, and higher prices than the world price. The cost of irrigation systems alone made for higher production prices in China. Farmers should be able to decide what to grow. Reduction in grain import tariffs is also a requirement for membership in the World Trade Organization.

**Sticky Situation** (p 147)

"Falling world prices and an antiquated U.S. system designed to keep the price of raw cane sugar high" is costing consumers around $1.4 billion a year and has created side effects such as the company Heartland By-Products who buys cheap refined sugar in Canada, turns it into molasses brings it to the U.S. converts it back into sugar to bypass sugar quotas. At the same time Congress is subsidizing the growing of beets for sugar in the Midwest which is a huge waste of energy. These beet farmers upset the balance and the government spends $468 million last year to keep sugar prices at 22.5 cents a pound but prices drop and those who make sugar from raw cane sugar can't compete. Those who benefit from this system are cane sugar growers who are protected under import restrictions. Loser include consumers, and processors that buy sugar at the inflated U.S. price.

***You should be able to illustrate on a supply and demand diagram what happens in the sugar market when the government imposes a tariff on sugar.

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A Welfare-to-Work Success Story

Martin and Kathleen Feldstein

Decline in the number of people on welfare in the past decade

- in 2000, fewer than half as many as were in 1993
- experts agree that a radical policy shift ended the option of lifetime welfare and encouraged recipients to seek work
- increased rewards to work for low skilled people

Low income families are better off now, despite the ending of Aid to Families with Dependent Children

- combination of temporary assistance
- income from work
- expanded tax credits for low income working people

The Welfare Reform Act in 1996

- replaced AFDC
- work based approach; temporary assistance for people who are expected to seek employment
- gives states flexibility to design own programs, setting own eligibility and work requirements, subject to 5 year lifetime limit on federally financed benefits
    - states are allowed to use own funds to support people beyond this lifetime maximum

Expansion of the EITC and greater child support

- reinforces the earnings of low wage workers by giving them more money for every dollar they earn until they reach a threshold income level

- benefits tied to level of earnings and number of children in the family; increases incentive to work along with raising standard of living of low wage people
- ceases to provide incremental transfers at a certain level
- if earnings exceed $13,000, reduction in the EITC at rate of 21 cents for each dollar earned
    - causes total marginal tax rate to exceed 50% with incomes of about $30,000

New system increases reward for work among the very poor
Increase payoff from working explains the increased in the labor force participation of low skilled women
The success of similar welfare reforms in individual states
- WI: "waivers" by federal government allowed experiment with work incentives and welfare limits

Guess What?  Welfare Reform Works
Gary S. Becker

The welfare reform act of 1996 limits families to two years of welfare income during any one spell and caps the total time on welfare over a mother's lifetime at five years.
Late 1980s - WI, MA, NJ introduced reforms that discouraged women from having children while on welfare, and put pressure on them to find employment.
- cut welfare populations
- reduced welfare caseload
- encouraged more young women to finish high school and sharpen economic skills

Economists Hill and Main attribute more than 1/3 of the decline in MA's welfare rolls since 1995 to the reforms and not only to its economy.
The federal law recognizes…
- number of families in need
    - welfare spell allowed to last up to two years
    - mothers with dependant children can have multiple spells, up to a total of five years over lifetimes
    - aims to discourage attraction of welfare to able-bodied women during good times
- poor working mother will not earn enough to provide decent standard of living
    - children of unmarried working mothers eligible for Medicaid and food stamps
    - benefit from the earned-income tax credit

Very important gain - greater self-respect
- treated as responsible adults and offered effective incentives

Shorter Hours Raise Living Standard of the Poor
Chris Farrell

Decline in hours worked
- average employee logs in less time at work than a strict 9-to-5 schedule

- under-appreciated improvement in American living standards

Gains in hours worked not distributed equally

- high wage workers put in the most hours
- researcher Costa: "I find that although hours of work have fallen for all workers, the decline was disproportionately large among the lowest paid workers."
- implications for trends in income inequality
  - common wage and wealth data may underestimate long-run improvements in living standards among low paid workers
  - accounts for more than half of the earnings inequality among women and 17% of the increase in total household earnings inequality among husband and wife households

What's behind changes in hours worked

- Costa doubts that state legislative actions limiting the workday had much impact
- changes in the willingness of workers to supply their labor dominated
- increases in the hourly wage no longer encourage people to take more time away from work
  - workers are not as time poor as they once were
  - impact of wage hike is smaller due to higher incomes than before

Why the Wage Gap Just Keeps Getting Bigger
Laura D'Andrea Tyson

Performance of the American economy has been strong, but the gains in income enjoyed by the majority of American workers have been meager.

Real compensation of the median worker was 3% lower in 1997 than it was in 1989.

Real income of the median family regained its 1989 level by 1997.

- due to the median family in 1997 working more hours

The share of the nation's income going to the bottom 60% of American families has continued to fall, while the share going to the top 5% has reached a high. Why?

- strong profits suggest a shift in favor of capital income at the expense of labor income (evidence disagrees)
  - share of corporate profits in national income has increased but stays lower than in 1960s

The higher one goes up the wage distribution, the larger the rise in pay.

- largest pay increases for CEOs and professional basketball players
- only workers above the 75th percentile of the wage-and-salary scale have enjoyed significant real increases in their take-home pay
- growing inequality in wage and salary distribution between and within occupations, skill levels, age cohorts, and educational categories

Most important determinant of growing inequality in labor incomes

- increasing demand for workers with a high level of skills, particularly those with a college or graduate degree
  - experienced the largest increases in compensation
  - workers with less education have continued to see the real value of their earnings erode

Growth in earnings inequality among workers in the same educational category

- changes in the workplace due to the Information Revolution
- high levels of initiative, analytical capability, and communications skills to use technologies well

Value of a college degree

- percentage of high school graduates enrolling in college has increased
- nearly 1/3 of all beginning college students require remedial courses in one or more subjects
- many K-12 school systems are not providing students with adequate skills
- college enrollment and completion rates are lower for poor children

Share of the workforce with a college education must continue to grow

- requires future workers to have the training and financing options they need to obtain a college degree

**"Money to burn?" p. 156**

**"Controlling global warming will be expensive. Emissions trading is an intelligent way to lower the cost."**

The author suggests that the way to reduce emissions of greenhouse gases is through tradable emissions permits. Each country would be given a certain allocation of allowable emissions that could be traded either domestically between factories and plants or internationally between other nations. So, some plants or countries would continue to emit the same amount of pollution, but others would reduce their emissions enough to compensate for those who do not. The key is that overall global emissions would be reduced.

The problems the idea is that, one, rich countries could "avoid taking domestic action to curb greenhouse gases." Also, tradable emissions permits do nothing about pollution from cars and homes.

**"It's Immoral to Buy the Right to Pollute" p.157**
**by Michael J. Sandel**
**"What's next? Tradable credits for littering and other asocial acts?"**

Sandel addresses the idea of trading emissions permits as immoral and wrong. He claims that the United States is looking for a cheaper and "less painful" way to reduce emissions. His main example of trading pollution rights: "The United States might find it cheaper to pay to update an old coal-burning factory in a developing country than to tax gas-guzzling sports utility vehicles at home." The 3 problems he has with the policy are as follows.

1) Wealthy countries are able to evade their obligations in the treaty.
2) It reduces the moral stigma associated with pollution; it turns a fine for pollution into a fee. Pollution then becomes a luxury, a status symbol.
3) "…it may undermine the sense of shared responsibility that increased global cooperation requires."

**"Emissions: Seeing Green" p.158**

The author observes that before the Kyoto Protocol, companies had denied that global warming was occuring and had created disadvantages to protecting the environment such as high costs and job cuts. Now, however, companies are changing their outlook on pollution and the environment. Pollution, itself, has become a profitable market with 3 parts:
The losers – the big industries and companies for which reducing emission is very expensive.
The winners – agribusinesses which can easily prevent greenhouse gases from entering the atmosphere.
The middlemen – banks, insurance companies, and foreign companies who could provide the emissions-trading permits.
Basically, everyone is out to make a profit from pollution.

**"What Price Pollution? Leave That to a Global Market" p.159**

**by Gary S. Becker**
**"Fair Play: The Kyoto pact limits the U.S. greenhouse gases but lets poor nations off the hook. A market in emission rights would help everyone."**
Becker discusses the 1997 Kyoto Protocol, who approved it and what exactly it stated. Poorer, developing nations were exempt from the emissions reductions. Becker argues that this current treaty would actually worsen pollution, and he proposes 2 modifications:
1) Instead of quotas on emissions, "all countries should receive allownaces on greenhouse-gas emissions," and developing nations could be given more generous allocations.
2) "The Kyoto Protocol should allow all greenhouse-gas allowances to be freely bought and sold…." That way, poorer countries would receive an income for selling their allowances, and developed countries could buy more rights.

**"Economics of road pricing" p.160**

**by Lester C. Thurow**
**"More roads encourage more people to use their cars, to live farther away from work and use more road space."**
Thurow argues that "no city has ever been able to solve its congestion and pollution problems by building more roads," and that the solution is road pricing. Drivers would be charged according to where and when they drive. The revenue collected would reduce taxes elsewhere. Two expected problems:
1) Too much government interference
2) Driving would become a luxury, something that only the rich could afford.
Thurow suggests solutions for each:

1) Bar code readers, like toll booths, could read bar codes on issued debit cards, or even bar codes on the cars, and send the driver a monthly bill.
2) To be more egalitarian, each debit card could have a specified balance paid for buy the government. In this case, there would be no extra revenue for the city, but drivers willing to carpool or use public transportation would receive an income supplement.

**p. 164-170**

*"Higher Prices Would Reduce Campus Violence"*
*David R. Francis, NBER Digest*
*September 1999*

A study by NBER Research Associates Michael Grossman and Sara Markowitz suggest that an increase in beer prices would reduce violence on college campus. More precisely, they estimate that a 10 percent increase in beer costs will lead to a 4 percent decrease in campus violence. In order to complete this study, they first divided campus violence into four parts: trouble with police, residence hall, or other college authorities; damaging property or pulling a fire alarm; getting into an argument or a fight; and taking advantage of another person sexually or having been taken advantage of. They used data from 1989-91 from 191 colleges in 29 states and measured beer prices using average prices of Budweiser and Miller Light in the respective states (price differences attributed mostly to taxes). They then proceeded to compare beer prices and violence rates to obtain the above-mentioned results. They note, however, while a 10 percent increase in beer prices will yield gains, a larger increase in price would decrease campus violence by a proportionally larger amount.

*Higher Alcohol Prices May Lower Spousal Abuse*
*David R. Francis, NBER Digest*
*August 1998*

*Please excuse the quality and content of this summary: the article was very poorly written, lacking substantial evidence and profuse with personal bias (you may want to consider reading it for a good laugh).*

Sara Markowitz asserts in "The Price of Alcohol, Wife Abuse, and Husband Abuse that an increase in the price of alcohol will reduce the amount of sever violence that men impose on their female partners. If the weighted average price of pure alcohol in alcoholic beverages were higher, for instance, the number of men beating their wives would be less. Markowitz uses information for the years 1985-1987 from the National Family Violence Survey and compares her sample of 1,541 married couples to alcohol prices in respective states. While evidence suggests this change, estimates of it exact degree vary. Markowitz finds only mixed evidence that a higher price of alcohol will cut down the violent abuse of men by their female partners. The article also cites that a number of social factors, such as lower economic status, a stressful lifestyle, and being a minority tend to be associated with a higher rates of domestic violence.

*"Lojack Benefits All Car Owners in its Area"*
*NBER Digest*
*July 1997*

The Lojack car retrieval system uses a small radio transmitter hidden a car. When the car is reported stolen the police remotely activate the transmitter and it allows police to precisely follow the location of the car. This system has allowed for the recovery of about 95 percent of stolen autos as opposed to a national average of 60 percent. In states that have introduced the Lojack, there has been a noticed decrease in overall auto theft. In Boston, for instance, a 50 percent decline in auto theft rate occurred. This is partially due to the fact that this system has led to the apprehension of many thefts and the crackdown of several "chop-shops". This study raises the issues of positive consumption externalities. Because the Lojack decreases overall auto-theft, one needs not actually purchase the system to reap the benefits. This externality, furthermore, will likely cause the Lojack to be dramatically undersupplied (market not efficient).

*A Marginal Error*
*The Economist*
*April 2, 1994*

In 1994 the US saw a raise in the income tax, raising the rate for the bracket above $140,000 for married couples ($115,000 for singles) from 31% to 36%. This initiative represented a change in the fashion that was seen in the 1980's. During the '80's, the top bracket was cut from 70% in 1980 to 28% by 1988 (later raised to 31%). The debate in the income tax has two sides, one arguing that a higher marginal rate provides less incentive for more work, the other arguing that people must, and will, work more to bring home the same income: most empirical studies of male employment show that these two effects cancel each other out. A raise in tax, therefore, would just increase government revenue. Marty Feldstein, however, argues otherwise. This argument, he believes, ignores three things. One, marginal tax rates usually rise with income. Two, studies have put too much emphasis on men, and women would work more and enter the work force with lower taxes. Three, high taxes encourage a preference for non-monetary income methods, such as stock options, and shift their savings into tax-free assets. His studies also show that the rich find ways to avoid tax increases, and lower classes end up baring more of the burden. Cuts in the tax-rate from 1985-88 increased the net-of tax rate (NTR), which is the portion of last dollar of gross income which taxpayers get to keep across the board. The rich, however, reaped most of the gain. Tax cuts also lead to an increase in taxable incomes, most notably among the wealthy (lower taxes convinced high-earners to switch their pay to actual monetary income). The 1994 tax increase, Feldstein argues, will have the opposite effect, which will, in turn, decrease government revenue as the wealth try to avoid taxes.

*"Tax rates that benefit no one"*
*Martin and Kathleen Feldstein, Boston Globe*

*January 4, 2000*

In this article Martin and Kathleen Feldstein examined the issue of taxes, relevant to proposals were being made as Bush took office. They cite the policy by which the government currently takes one-third of national income through taxes, and question its validity. Using a hypothetical situation, they explain how a marginal tax rate will discourage people from working extra hours because the marginal tax-rate makes the respective not worthwhile. By distorting these peoples decision as whether to work, furthermore, the government is creating dead-weight loss. Without the high marginal tax rate in the example, the woman would have chosen to work additional hours, and thus the entire nation would benefit. These rates, they believe, have other negative effects as well, for instance the taxes adversely affect an individual's decision to take on more responsibility and to obtain more training. Also, it will shift the preferred payment towards more tax-free fringe benefits. Bush's tax proposal, the Feldstein's suggest, will bring cuts across the board, but give the most gains to lower income families.

"Why Getting Married Still Costs You"

The basic problem rests in that 42% of married couples pay higher taxes because of the marriage penalty, averaging 2% of their income and giving the Treasury $29 billion every year. But then, another 51% actually pay lower taxes due to a marriage bonus of 2.3% of their income, costing the Treasury $33 billion.

Whether a couple pays more or less (and is therefore better off married or simply living together) depends on the split of earnings between the two. If one makes more than the other, a marriage bonus is likely. If both have similar incomes, then they can expect a hike in their tax bill. "Think of it as a tax on power couples, and a subsidy to those living the *Leave It to Beaver* life."

Points of an Ideal Marriage Tax:

1. **Marriage Neutrality**: A couple's tax liability should not change when they marry
2. **Equal Treatment**: A couple's tax liability should depend on total income, not on the earnings of each partner
3. **Progressivity**: Taxpayers with higher incomes should face higher tax rates
4. **Problem**: As a matter of mathematical logic, reaching all three goals at once is impossible.

An excellent example, too long to transcribe here, explains how all three are not possible. Basically, as two are achieved the third one must be inevitably set aside. US lawmakers have abandoned neutrality, resulting in the marriage tax system present today.

"The 28% Solution"
(Wall Street Journal)

In 1986, President Reagan and a Democratic Congress cut the top tax rate down to 28%, while expanding the income subject to tax in the hopes that lower taxes would prevent people from avoiding taxes. Bush Sr. and Clinton raised rates beyond 50%. Martin Feldstein strongly supports the George W. Bush tax cut aimed at returning the top federal rate to 28%--a tax cut that over time would cost $1 trillion dollars and fit easily within the $5.6 billion surplus over ten years. Feldstein argues that cutting the marginal tax rate is advantageous in various ways…

1. Allows people keep more of the money they earn
2. Reduces distorting and disincentive effects
3. Induces people to accept income benefits instead of untaxed, fringe benefits ✍ The latter often causes a dead weight loss (Feldstein argues that $600 billion in DWL would be eliminated through this tax plan).
4. Induces changes in personal behavior ✍ Greater investment and work-hour will largely offset the cost of the tax cut.

“Reform the Estate Tax, Don’t Repeal It”

"House Republicans, with the help of some accommodating Democrats, want to give $50 billion to Steve Forbes, Bill Gates, and other wealthy campaign contributors."

This will be the result of a repeal of the estate tax laws. "The elimination of these taxes would mean a massive break for the richest Americans, as well as the removal of the most progressive element of the tax system." A repeal would cost the Treasury $50 billion within a decade and mean diminished financial support for tax-exempt institutions. There is only a little benefit for the economy.

Proponents claim that this repeal is supposed to help small businesses and farmers, but the reality is that the repeal would forward on average $3.4 million to each of the 2,400 estates paying taxes in 1997. It would also discourage charitable giving because right now that is an excellent way to avoid estate tax (those with estates over $20 million give 41% to charity). The tax has always been aimed at the sons and daughters of the elite.

The reform should include a "lowering of the top rate to below 50% on the largest estates. Plans to boost the tax credit to $2 million should be completed immediately." The tax for someone who dies young with children in school should be lower than for someone who dies at 80 with married children. Reform should also include attacks on "vulture trusts" that allow wealthy people to avoid the estate tax altogether.

“Kill the Death Tax Now…”

Martin Feldstein presents evidence suggesting that the estate and gift tax is bad tax policy. Feldstein presents a powerful argument culminating in an important suggestion (Suggestion or Demand? That is the real question!): the estate and gift tax should be eliminated immediately. It's important to note that this suggestion really serves as a powerful blow to Clinton's ignorant (in Feldstein's view) belief that maintaining the estate and gift tax is important.

Martin Feldstein's main argument is that the estate and gift tax serves as a form of double taxation that discourages work and saving, imposes high compliance costs, and, by distorting incentives, reduces personal income tax revenue by more than the quantity it collects itself.

Tax rates that result from the estate and gift tax are unfair and are said to reduce the incentive to work and save. Many are encouraged by the high estate tax to retire early or simply work less, save less and take less investment risk. The result is as waste of talent. These tax rates also encourage tax-planning actions aimed at reducing the government's bite.

Martin Feldstein disagrees with Mr. Clinton's contention that the nation could not afford the revenue loss associated with an elimination of the estate and gift tax. The revenue from this tax accounts for only 1% of the total federal tax revenue, and, because of incentives, the impact of the estate tax is probably to reduce overall tax revenue.

"High Income Taxpayers are More Responsive
to Marginal Tax Rates"

Jonathan Gruber, NBER Research Associate, and Emmanuel Saez contend that **the overall elasticity of taxable income with respect to changes in net-of-tax marginal rates is 0.4**. This suggests that a 10 percent change in the marginal net-of-tax rate leads to a 4 percent change in taxable income.

Gruber and Saez suggest that this elasticity is primarily the result of a greater response by taxpayer with high incomes. Through analysis of the Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1986, Gruber and Saez have discovered that taxpayers with higher incomes tend to have higher elasticities…

| **Income** | **Elasticity** |
|---|---|
| \$100,000 – Above | 0.57 |
| \$50,000 -- \$100,000 | 0.11 |
| \$10,000 -- \$50,000 | 0.18 |

The primary argument is that for lower income groups, the primary source of income is labor. The only way for such people to manipulate their incomes is to work more or less. For higher income groups, on the other hand, capital income gains greater importance. The result is an increased ability to manipulate tax payments thorough allocation of assets…

The authors suggest that the high elasticity for high income brackets warrants a tax system that features declining marginal tax rates. The authors also show that standard behavioral responses, such as working fewer hours or saving less, are only one component of what drives taxable income, and that other responses include the form of compensation and compliance.

“High Income Taxes Inhibit the Growth of Small Firms”

"It is a common belief among entrepreneurs and policymakers that the tax system is an obstacle to the establishment and growth of small businesses. To date, however, there has been little evidence to support this notion."

Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey Rosen used tax data surrounding the Tax Reform Act of 1986 to determine how reductions in marginal tax rates affect the growth of small firms. It turns out that income taxes exert a significant influence on growth rates because apparently **a cut form 50% to 33% would increase the size of the business, measured by receipts, by about 28%.**

The years of the Tax Reform are used because that kind of cut actually happened. It is also important to note that not all the businesses in 1985 survived until 1988. Even so, the impact of these tax changes on survivorship has been marginal.

Taxation Without Representation

This article deals with the effects of college costs on the income of families and calls them “a unique supplementary income tax.” College costs operate on the basis of the school putting costs up as much as possible and then putting the extra money into financial aid. The article calls this policy **monopolistic price discrimination**- the practice of varying prices to extract the maximum out of each helpless customer. Through “financial aid,” colleges figure out how much this maximum that each family can pay is. They typically use the “Institutional Methodology” developed by the college board to determine this figure. This system, similar to that which determines taxes, is more stringent in that it also assesses assets and includes a portion of these assets, including interest earned on savings, in its figure of the annual extractable maximum. According to the article, this “college tax” constitutes an additional marginal tax rate of between 22% and 47%. Few economic studies have been done on the effects of this “college tax,” but according to Martin Feldstein, it could reduce people’s willingness to put money into savings, since with fewer assets they become eligible for more aid. Furthermore, according to Stephen Entin, of Washington DC’s Institute for research on the Economics of Taxation, the total effect could be knocking ½% to 1% off the GNP, resulting in a loss of output and income of $30 billion to $60 billion per year.

Hope Program Increases College Attendance, but also Widens Racial Gap

The main point of the article is that new student aid policies implemented by the government are being targeted on middle and higher income families, rather than the poorest families who might need the help the most. This is because programs such as the Hope Scholarship offer tax benefits most appealing to higher income families, and thus do not help those families too poor to pay taxes or those with low marginal tax rates. <u>The results on college attendance of the Georgia HOPE scholarship were analyzed to see what effects the federal Hope scholarship would have on the national level. It was found that while the scholarship did increase college attendance by 7 to 8%, it had widened the gap between black and white students and also between students of low-and high-income families. While the white enrollment rate rose, the scholarship did not affect the black enrollment rate, and also provided almost no benefits for the lowest-income students.</u>

<u>School's Brief</u>
Efficiency – point where quantity demanded equals quantity supplied is efficient because at this point benefit from consuming one more unit exactly matches the cost of producing it. Markets will produce an outcome such that it is impossible to make anyone better off without making someone worse off. (evidence of Adam Smith's invisible hand)

Demand curve – benefit to consumers of one more unit
Supply curve – cost to sellers of one more unit

Conditions for perfect market:
-many indistinguishable buyers and sellers
-fully informed

Market failure: when there is deadweight loss (there is DWL when not producing at equilibrium, social surplus greatest at equilibrium)

Four varieties of market failure
-Monopoly

-but if other firms can easily enter the market, the monopoly is not damaging eg. Microsoft, and even for a 'natural monopoly', competitors would try to enter the market through innovations or other means.

-Public goods/non-excludable goods: not supplied by market

-but some supplied privately because they can charge fee eg. fee for lighthouse collected at port, toll for road, subscription for cable television.

-Externalities

-it is argued that as long as property rights are clearly established, externalities will not be a problem, but high costs will prevent the necessary transactions. Markets also can deal with externalities eg.externality of bee-keeping is that surrounding plant-growers benefit from pollination, so – in Washington, bee-keepers and apple-growers had a contract.

-Lack of information

-but can buy from seller with good reputation or who offers guarantees.

Poor history of govt intervention

Why?
-tendency of regulated firm to 'capture' their regulators
-regulations tend to protect rather than control eg. requiring licenses for certain occupations, Interstate Commerce Commission, European telecommunications.

How to be Perfect

Perfect market = many buyers and sellers, fully-informed, no barriers to entering/leaving market, each buyer matched to seller who best meets needs, prices at equilibrium, no 'transaction costs' eg. wasted time in seeking right product.

Flaws = often not fully-informed, prices not at equilibrium and slow to change, one-to-one interaction and may not be negotiating with best person.

Auctions – but need to assemble potential bidders
'Request for quote' – but transaction costs in having to prepare quotes

Internet – assemble in same virtual place
- hardly any cost of getting participants together
- lots of information
- huge number of buyers and sellers

eHubs – bring firms and suppliers together to auction or compare prices
benefits – 'aggregation': huge number of buyers and sellers in one place, cutting transaction costs.
- 'matching': buyers and sellers interact until they find best match.

Commodities can be matched well because only negotiating prices, most markets negotiate on more dimensions.

Perfect.com – 'request for quote' process without transaction costs, but depends on many people using it.

Internet will only create perfectly competitive market if competing for only price of homogenous goods, but in practice, many slightly different products competing on many things other than price.

Measuring Flexibility

Measuring importance of structural reforms for economic performance: used qualitative and quantitative variables eg. education standards, tax rates. Each variable is scored and averaged.

Categories of strengths and weaknesses:
-Long term potential growth rate

- increasing supply of labor or capital, or increasing efficiency of use of labor and capital eg. education.

-Labor market performance

- reduce non-accelerating-inflation rate of unemployment (NAIRU) ie. Lowest rate of unemployment at which inflation is stable.

-Product market competition

-reducing costs eg. allowing imports or attacking monopolies.

Each category has 4 sub-categories eg. labor market performance: wages and costs, flexible working practices, employment protection, taxes and benefits.

Weaknesses

-doesn't include recent policy changes eg. tax cuts in Europe

-all variables given equal weight

A Productivity Divide

Increase in US productivity growth due to Information Revolution and rise in business investment. But recent deceleration due to companies not reducing their employment by as much as they cut production.

Expectations that there will be further productivity growth – growth in gross domestic product (GDP) and large budget surpluses.

US – companies able to take advantage of Information Revolution (no regulations), incentive compensation to make changes to increase productivity eg. changing tasks of existing employees or dismissing workers made redundant by productivity gains. Further growth possible because still many unexploited opportunities in technology and information – advancing at rapid rate.

Europe – employment practices limit companies- ability to use information technology. Need changes in employment practices, labor markets, and management incentives to encourage adoption of new technology which can raise productivity while increasing employment.

China to Increase Grain Imports

Traditional policy of self-sufficiency caused financial and environmental costs – wasteful stock-piling, corruption, price structure which made price of grain higher than world price without corresponding boom to farmers' incomes, environmental damage from intensive farming eg. water shortage, also needed expensive irrigation systems.

Wanted self-sufficiency because feared that imports jeopardized national security, but now will increase imports – will decrease grain import tariffs. Result: allow farmers to decide what to grow or whether to develop other businesses on the basis of 'comparative advantage'. Grain import tariff reduction was also a requirement for membership to WTO.

Sticky Situation

US system trying to keep the price of raw cane sugar high, protecting sugar producers from falling world price. Results: inefficiency eg. cheap Brazilian sugar bought in

Canada and melted in molasses before being brought to US and made back into sugar – to bypass US sugar quotas, taxpayers subsidizing stock-piling of sugar.
Slim profit margin due to falling world price and competition from beet sugar.
Who benefits from system? Cane sugar growers
Who loses? consumers, sugar processors, employees of companies that buy sugar at inflated US price.

**Reducing Poverty, Not Inequality pg 239**

Martin Feldstein

Recently, there has been a general trend towards an increase in the inequality of income distribution – the result of this has been the addition of new redistributive policies

However, Prof. Feldstein disagrees with this policy, he believes the real problem is poverty, not inequality.

**Pareto Principle** – Change is good if it makes someone better off without making anyone else worse off\

But can't base economic policy only on this principle, must also look at the balance between how much the gainers gain vs. how much the losers lose.

Prof. Feldstein believes that a change that makes the well off even better off (without hurting anyone) should be enacted; even though it increases inefficiency.

An argument against this is that the poor are hurt by the rich getting richer because they "feel" worse off by seeing the rich get richer (**spiteful egalitarian**) but Prof. Feldstein rejects this.

**Gini Coefficient –** a measure of income inequality. Measures the concentration of incomes in the nation. The higher the Gini coefficient, the higher the concentration of incomes. (an increase in the incomes of the wealthy with no effect on the poor increases the Gini Coefficient ) Since some regard a higher Gini coefficient as negative (Prof. Feldstein doesn't), this implies that the social marginal utility of high incomes is negative (it is bad when the rich get richer).

Prof. Feldstein contributes the higher incomes of the rich to (all of which he says are good):

> **Increases in productivity** (more educated individuals, markets reward this now more than ever, giving more incentive to people to acquire these skills)
>
> **Entrepreneurial successes** (creation and growth of new businesses)

**Increased work by high wage individuals** (general trend towards people with high incomes working longer hours than in the past)

**Lower cost of capital** (translate into higher stock and bond prices)

Poverty problem (people with incomes in the bottom decile or quintile of the income distribution)

**Three possible sources of poverty –** unemployment, a lack of earnings ability (because of inadequate schooling or training), and individual choice

**Possible Solutions to:** unemployment – reforms like in the 1980's that subject unemployment benefits to the personal income tax, reduces the possibility people will choose not to work in order to have a higher net income; lack of earnings ability – improve education through decentralization and competition (through an increased number of school districts, and more available public education), a solution for training is to provide on the job training, but this is difficult for min. wage employers, problem is gains are less than the costs, other possible solutions include decreasing drug abuse, alcoholism, etc.; indiv. choice – since some value not working more to working for a low wage, we must reexamine the structure of out welfare programs, another solution is to force people to work for a period of time to see if they like it – "tough love" (welfare reform option)

**Problems with measuring poverty –** cash income is a poor indicator because of in-kind benefits not accounted for; temporarily low income; mis-reported incomes; also there is a difficulty in measuring the changes in the cost of living (overstate the growth in CPI, and therefore understate the growth in real income)

**College Financial Aid and Antitrust Action pg 214**

1989-1991 US Dept. of Justice launched an anti-trust case against 23 colleges for price-

fixing

Caroline Hoxby did a study of this case

The DOJ was against annual meetings amongst the colleges, on the grounds that they colluded on higher tuition

Colleges defended these meetings by saying they needed to have meetings to agree on the calculations used to look at the number of needy students they accepted

The colleges won the case, but after the case they became more focused on the student's scholastic abilities and less on their parents incomes – this actually reversed the trend of having relatively more black and Hispanic students and fewer well-off kids; although this reversal was moderate.

The question she leaves us with is do students want a more diverse body of talented students even if this diversity based ob incomes is more expensive than just having a diversity based on merit

**SUGAR SOLUTION (p.149)**

America's sugar growers have secured a cosy domestic market by pouring millions of dollars into political campaigns and winning special subsidies. The resulting price supports and import tariffs have lifted the price that Americans pay for their sugar to about three times the world price.

Heartland By-Products, a tiny firm in Michigan, imports a sugar-molasses mixture from Canada. The company began after the Customs Dept. decided that its product wasn't covered by the sugar restrictions (and thus the high tariffs).

In September 1999 Customs suddenly changed its mind, and faced with tariff increases of up to 7,000%, the company challenged the decision in the Court of International Trade. The court sided with the firm, but in April 2000 government litigators began their appeal.

Heartland has been accused of being a sugar smuggler, but the CIT ruled as it did by pointing to the precedent that products should be classified according to the way they are imported, not their ultimate use. The court also maintained that an importer had the right to design products specifically to get a lower duty rate. Other importers fear a reversal of the decision suggests that politics may be entering supposedly impartial rulings. Experts say a reversal may violate WTO rules against raising tariffs. The sugar lobby is trying to slip in an amendment to a trade bill for Africa and the Caribbean Basin that would change the definition of the sugar syrup to one of ultimate use rather than what is imported, making the ruling irrelevant but putting Heartland out of business.

from "The Economist

A DEAL EVEN TRADE HAWKS CAN LOVE (p. 150)

by Clyde Prestowitz
"Wall Street Journal" 2000

Congress was forced to decide whether to grant Permanent Normal Trade

Relations (PNTR) to China in conjunction with China's bid to join the WTO. The author was in favor, understanding two things: Congress wouldn't be voting on China's accession to the WTO since entry is up to the WTO's member nations, and neither will Congress be deciding whether to grant normal trade relations to China--the US has granted that status for twenty years. The question was whether or not to make it permanent.

China's imminent (at the time) WTO membership made the vote all the more important: WTO rules require members to extend PNTR to each other. The rules governing US/China trade had been very unequal over the past twenty years; China enjoyed the same benefits as Britain and Japan, for example, but US enterprises suffered high tariffs, heavy-handed regulation, and extensive restrictions in China. "Last fall" in its efforts to join the WTO, China agreed to new trade rules with the US (Prestowitz supports these). The US would give up nothing while China would reduce tariffs, remove regulations, open distribution channels, and accpt binding dispute-settlement procedures.

Opponents of PNTR argued that annual reviews of trade relations were needed to pressure China on human rights, environment, and labor conditions. This was wrong for three reasons:
--No evidence that annual reviews have any impact on China's policies.
--Disregards rationale for PNTR; ie promoting economic development/interdependence leading to greater Chinese freedom.
--Unlikely would ever suspend trade relations anyway.

Finally, the US has worked for many years to bring China into the community of nations more fully. The US must give China a chance to improve as have Korea and Taiwan over the past 50 years. The US cannot refuse now.

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CHINA GAMBLES ON WTO ENTRY (p. 151-152)
"The Boston Globe" Feb. 1, 2000
By Martin and Kathleen Feldstein

"Last fall," the US and China agreed on conditions for US support of China's entry into the WTO, requiring China to open its markets to a wide range of US products and services and to permit increased investment in China by US firms. The agreement needed ratification by Congress, though.

For China, WTO membership means "most favored nation" status--meaning that the tariffs on Chinese goods cannot be higher than the tariffs on the same goods imported from other countries. China has in all reality been enjoying this status one year at a time. As a member, China can no longer be held hostage to annual Congressional debates in which advocates of political and human rights reforms threaten to block Chinese exports to the US. This will encourage US and Chinese companies to develop long-term relationships that will lead to further trade and to increased direct investment in China by American countries, leading to beneficial broader market access.

(Opponents ignore the fact that if imports were interrupted, US consumers woud find similar products from other countries in Asia with slightly higher price tags.)

China is taking a risk, though: increased imports from the US and others and production in China by foreign firms will provide devastating competition to many state-owned industries, leading to Chinese unemployment. Chinese reformers have sought membership to force the domestic economic changes inside China that otherwise would be blocked by Chinese industrial bureaucrats and politicians who like business as usual. They understand the long-term consequences of breaking down the old system of state enterprises and replacing them with the growing number of private firms.

In the US, organized labor and environmental groups oppose membership, seeing this as an opportunity to strike a political bargain to introduce environmental conditions and labor rights into the WTO rules. However, any attempt to add labor rights to the general WTO process as a condition for admitting China would end the whole process of Chinese WTO admission. Newly emerging market economies oppose attempts to introduce labor rights into the international trade rules, viewing any such linkage as simply disguised protectionism, an excuse for blocking imports from low-wage countries that cannot afford the kinds of labor benefits and conditions that have evolved in the West.

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SETTING GOALS FOR THE WTO (p. 153)
"The Boston Globe" Nov. 1999
By Martin and Kathleen Feldstein

There were difficult trade issues to be resolved with our European trade partners at the WTO meeting in Seattle in November. Breaking down trade barriers between countries provides an opportunity to make Americans better off both as employers and as consumers. The primary US goal in Seattle was to increase the gains from trade by improving access for American products in foreign markets. (Trade group rules and low tariffs don't apply to agricultural products, for example.)

It was equally important for the US to prevent a backsliding on the trade opportunities that now raise our standard of living and contribute to world economic growth, the source of which comes primarily from Europe. The European Union proposed a variety of loopholes that would allow them to restrict imports currently covered by WTO rules, but that would also hurt both European consumers and American producers. This would include imports from the US of manufactured food products with genetically modified material.

A final European proposal would have made the violation of labor rights an allowable reason to block imported products; this is understandably opposed by developing countries. Introducing labor standards into the conditions for trade not only would hurt American consumers directly but could begin the gradual unwinding of the entire structure of free trade. If the developing countries feel that they have been unfairly discriminated against, they will find ways to retaliate by blocking US exports.

China's Premier came to the US in April of that year, offering a massive program of Chinese reforms but was sent home without a deal. Then many Chinese began to oppose WTO membership. It was important to reverse this error for US exports and Chinese economic and political development.

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FARMERS SHOULD GO TO MARKET (p. 154)
By Martin Wolf

Some claim the UK and Europe are suffering because they participate in globalization instead of localization and intensive farming instead of organic husbandry. A member of Parliament said the solution was to pursue a localist rural and food policy. Its goal would have been to keep production closer to the point to consumption and help protect and rebuild local economics around the world. But the author and Adam Smith say this is nonsense.

First, there has been little liberalization of global agricultural trade. Because of its restrictions, the UK satisfies far less of its food consumption from countries outside the Eu than a generation ago, although it does trade more with its European partners.

Second, protection (like raised prices and import restrictions) increases the intensiveness of farming, raising the price of land and creating an incentive to economize on its use by higher yields.

Third, trade and long-distance transport. Protection can never be an efficient way to reduce the wider costs associated with energy use. The right policy is to tax energy use, letting the best patterns of production and consumption emerge.

Finally, the view that we must now move to organic, small-scale farming and local trade is romantic folly. Organic farming will bring lower yields, leading to higher imports for such countries as the UK. Farms would also need to be bigger. There are many consequences for local food self-sufficiency (lack of variety, spoilage, and loss of income from food). In addition, "local" cannot be defined in any rigorous way.

Neither liberal trade nor technical progress is the problem and neither greater market fragmentation nor organic farming is the solution. Policies should include:
--abolish producer-dominated farm ministries and replace with ministries of rural affairs
--create strong, independent food safety agencies for regulation
--continue liberalization of trade barriers
--use subsidies targeted at specific objectives
--make taxes to cover environmental costs
--eliminate input-intensive farming
--label organic foods to allow for more consumer choice
Local self-sufficiency is not the future of farming.

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A BETTER WAY TO FIGHT POLLUTION (p. 155)
"The Boston Globe" July, 1997
By Martin and Kathleen Feldstein

In a G-7 summit of national leaders and UN meetin on the evnironment, Western European leaders sharply criticized the US for not joining them in adopting explicit national targets to reduce carbon dioxide emissions. The US was right, though.

Each European Union country has agreed that by 2010 they will have reduced their emission of CO2 to no more than 85% of the level that prevailed in 1990. The Feldsteins agree that this is a suitable subject for international agreement.

But... Since CO2 pollution spreads through the atmosphere, it makes sense to identify the countries that can reduce CO2 at lowest cost and induce them to do so. The European 85% plan doesn't make sense: big polluters will still be big polluters and the plan doesn't consider the developing world, which has the fastest-growing rate of emissions.

Tradable pollution permits are the answer. Each country could discharge an amount of CO2 equal to its permits, discharge a smaller amount and sell the excess permits, or buy permits to discharge larger amounts. Thus a world price for each permit to discharge one ton of CO2 would result, reducing the world level of discharge to the agreed amount in the least costly way.

There is, however, no economically or scientifically correct way to dtermine the appropriate global number of permits or the fair distributions of those permits among countries. An equal per capita plan would benefit China and India. A GSP or past pollution levels distribution plan would help the US and wealthy nations.

The focus should not be arbitrary reductions amond a few industrial countries but determining the appropriate global emission of CO2 and negotiating a fair distribution of CO2 permits among all countries.

Beginning of new summary
"Estate Taqx is one Death Penalty too many" Mankiw
Estate tax is unfair. Person A and Person B are millionaires. A spends his money extravagently and dies without leaving much of an estate. B spends conservatively and leaves a big estate. The current estate tax penalizes B. We should either make them pay the same tax, or penalize A for extravagant consumption. But instead we penalize B, which makes no sense. If we want to make the rich pay their fair share, then tax more of their income, or tax consumption. But don't tax people's savings. Taxing savings penalizs people who save, and we don't want to discourage saving.

"A Bad Heir Day" Krugman
Bush tax plan is a joke on everyone who is not very, very rich. The Estate tax will be phased out, but in order to balance the budget, a sunset caluse was added to this phase-out. That means that the Estat tax will be fully reinstate in 2011. Someone who dies Dec 31, 2010 will leave behind an unstaxed estate. Csomeone who dies a day later will have a 50% tax levied against the estate. This doesn't make sense, but iwas necessary in ordert for Bush to help the very, very rich, while at the same time not destroying the balanced budget. The alternative minimum tax is also phased-out before suddenly being reinstated in 2004, according to Bush's tax plan. This tax affects the upper-middle class. This tax plan is absurd.

"Incentives Increase Work by Single Mothers" NBER Digest
When incentives to work are given to poor, single mothers, these mothers work. The Earned Income Tax Credit (EITC) encourages people to work. Medical insurance incentives also encourage people to work. Some of the

disincentives to work were taken away, (over period of 1984-1996), such as the steep loss of welfare benefits in the phase-out period (as your income increases). EITC accounts for 63% of the increase in weekly employment of single mothers.

"Married Women work Less because of the EITC" NBER Digest
EITC is the largest cash-transfer system for lower-income families with children. But one side effect is that the EITC effectively subsidizes women to stay home. (It is found that EITC reduces married women's employment EITC is based on family income.) When husband's salary places family at beginning of phase-out ($11,650) the family's credit is reduced 21 cents per dollar earned. Married women in the phase-out are 5% less likely to work, and will likely work fewer total hours.

"Taxes, not rules, reduce drunk-driving deaths." NBER Digest
The best way to reduce traffic fatalities is to inreae the tax on beer. Of all the people killed in the traffic accidents, 40% of passengers and 50% of drivers have been drinking. Stiffer penalties for drunk-driving will not be effective unless they are draconian. Though traffic fatalities have decreased, that may not be because of stricter alcohol regulations. It could be because of more grassroots involvement (MADD) or because riding in a car has become safer (seat-belt laws). So the moral of the story is that laws won't help, but incentives will. Make bad behavior (drinking) more expensive and people will stop.

"Higher Tax on Beer Can Reduce Physical Child Abuse" NBER Digest
Look at average price of a six-pack to see how a price increase discourages consumption and affects child abuse. A 10% increase in the beer tax would trim the number of abused children by 152,000. The authors compared child abuse in different states with different states' beer taxes, and found that when beer was more expensive (because of the tax, presumably) there were fewer incidents of child abuse. Laws that made beer harder to buy (limiting its sale to liquor stores) also reduced child abuse. Prohibiting advertisement of beer has no effect on child abuse. The lesson, again, is that people respond to incentives. Make beer more expensive, fewer will consume, and child abuse will go down.

## Summaries pp. 140-143 Unit 3

**"Schools Brief: State and Market"**

--This article provides a useful summary of several of the topics covered in Unit 3, and argues strongly in favor of markets. This article would probably be useful to read through yourselves, as there is a lot to summarize.

--Efficiency – In this context it says: the market will produce an outcome that will make it impossible to make anybody better-off without making somebody else worse-off, given the allocation of the economy's scarce resources.
--the point where quantity demanded = quantity supplied is efficient b/c at this point the benefit from consuming one more unit exactly matches the cost of producing it. If output were higher, then the cost of producing extra units would exceed the extra benefits. If output were lower, then the benefit from consuming more would exceed the cost of the good's production.
--Conditions for market efficiency are extremely demanding for its application in real-life. It requires "perfect competition" and so market failure is probable. There are 4 ways in which a market failure can be expressed:

a) Monopoly – causes DWL as consumption and production < efficient
b) Public goods – low rivalry consumption and excludability
c) Externalities – cost or benefit for which no compensation is paid
d) Lack of information – info. important to buyers and sellers

--consider how much market failure matters in practice before intervening. Can govt. help in putting failure right?
--markets often correct their own failures. e.g. monopolies. A monopoly is harmful if barriers to enter into that market are too high. If barriers to entry are low – then monopoly not necessarily harmful.
--"natural monopoly" – a firm not subject to the law of diminishing returns, whose costs continue to fall as output increases. Telecommunications once considered this but now, due to new tech. and deregulation = competitive business.
--ex. of public goods are national defense and law and order. e.g. lighthouse, which is not a public good by definition as paid for by the state but has some relevant characteristics. i.e. services are both non-excludable and extra ships can consume without existing ships consuming less.
--television broadcasting was non-excludable as had low rivalry of consumption but now perfectly excludable due to satellite tv.
--when markets fail: if the failure damaging and govt. can do something, then intervention welcomed. However, record of govt. intervention poor as difficult. e.g. monopolies, near-monopolies, licensed professions.

**"How to be Perfect"**

This article discusses the possibility of creating a perfectly efficient market on the internet.
--a perfect market would allow buyers and sellers to meet, with useful info about supply and demand, with no barriers to entry or exit of the market.
--real world: liquid markets closest to perfect market except access often restricted and participants uninformed.
--traditional markets: some sellers publish a menu of prices that do not result in equilib. btwn. supply and demand.
--competitive auctions usually efficient but their usefulness limited by their need to assemble all potential bidders at once.

--Internet promises greater efficiency as can gather many bidders at low cost and provide lots of info and processing power.
--Online exchanges and "eHubs" part of "business to business" (B2B) markets. 2 ways in which they can enhance economic efficiency:

a) aggregation: bringing together large number of buyers and sellers with a fixed menu of prices.
b) Matching: dynamic process in which buyers and sellers interact until they find best match.

--eHubs which allow matching are better but only really work well when considering goods that are relatively standardized and with commodities.
--commodity markets usually only concerned with price, but internet exchanges allow competition of other factors, e.g. shipping deadlines, warranty period, supplier's reputation, to attract suppliers.
--internet market – "perfect market" implied but in reality all markets for goods and services have imperfect competition.

**"Measuring Flexibility"**

Structural economic reform can be an important factor in improving overall economic performance. Article mentions a study that tried to measure this reform.
--country's strengths and weaknesses grouped into different categories in order to guage the importance of structural reforms for economic performance.
--Lehman Brothers conducted study, building a database to investigate > 400 variables in 21 countries.
--strengths and weaknesses in micro-policy sorted into 3 main categories:

1) Policies that increase an economy's **long-term potential growth rate**, by increasing labor or capital supply, or increasing the efficiency in which these are used.
2) Policies that affect **labor-market performance** (that reduce non-accelerating-inflation rate of unemployment – (NAIRU)), i.e. the lowest rate of unemployment at which inflation is stable).
3) Policies that produce **product-market competition**, so reduce costs through the economy.

--3 categories split into 4 sub-categories:

i. Wages and costs
ii. Flexible working practices
iii. Employment protection
iv. Taxes and benefits.

--Results:

1) US, Canada, UK, New Zealand and Australia have undergone greatest micr-economic reform. Japan and Europe behind.
2) US has best labor and product-mkt. policies but behind Sweden in terms of long-term growth b/c of poorer education standards (ranked 11 out of 21).
3) Japan = $8^{th}$ in labor-mkt. policies but only $17^{th}$ in product-mkt. competition.
4) Spain = $9^{th}$ in labor mkt., but $20^{th}$ on policies that affect growth rate.

5) In Europe, of the 3 main economies, i.e. France, Germany, Italy, France has best overall policies. Sweden, the Netherlands, Ireland rank even higher.
6) Weaknesses in research: excludes some recent policy changes, e.g tax cuts in France and Germany; all the variables under consideration are given equal weight but some more important than others, e.g. labor-market and product-market policies should not have same values.

--The precise rankings are not entirely accurate but do give a broad overview of the countries' policy weaknesses.

**"True Price of Depression Treatment is Declining" pg194**

1) History has shown it difficult to construct price indexes for the health sector

a) CPI like some other past indices only deal with consumer' direct out of pocket payment and does not incorporate amounts paid by the employers towards employee insurance

b) BLS like others were based on repricing of particular procedures or services over every couple years, which mean the whole cost of treating the illness is not calculated

2) Ernst Berndt, Susan Busch and Richard Frank came up with "Price Indexes for Acute Phase Treatment of Depression"

a) their indexes take into account treatment episodes, quality, and expected outcomes

b) distinguished between was supply-side index like BLS, and demand-sided like CPI

i) supply-sided indexes tended to be flat or decreasing over span from 1991-1995

ii) demand sided indexes showed annual increases, the reason for this may be the increasement of co-payments and deductibles

c) overall found that where the spending increased a larger number of effective treatments were being provided

**"To Ease Crisis In Health Care, Canadians Eye Private Sector" pg 195**

1) Canada institutes a system of universal heath care

a) all residents are entitled to the same health care

b) hospitals charge local province for cost of serving patients, about 67%

c) health care Canada's most expansive social service

2) Large price tag has made actual care received very poor

a) in some cases women are waiting weeks for mammograms or their trips to the US are being subsidized by Canadian government (very costly for Canada)

b) one son would have had to wait months for his father's eye operation because of back up

c) patients placed in corridors of hospitals during flu epidemic

d) Joshua Fleuelling died of asthma attack because his ambulance was rerouted because congestion of the original target hospital

3) Canada has taken more steps toward privatization (like system in US)

a) Alberta government passed legislation to license private hospital

b) Following examples of HMO's 200 doctors in seven Ontario cities are binding their practices in clusters
c) Toronto University' Health Network selling their ability to read x-rays and magnetic-resonance imaging (MRI)

**"Lawmakers Propose Tax Credit to Help Millions Pay for Health-Care Coverage" pg 197**

1) Lawmakers proposed a tax credit to help 27 million people pay for healthcare coverage
a) $1000 credit for individual, $2000 credit for family coverage
b) meant for workers without employment-based health insurance earning too much to qualify for programs like Medicaid
c) can be used to buy individual or group coverage or to extend coverage offered by previous employer for people between jobs
d) can also be for small-business employees

2) Critiques about plan
a) credit would be hard for government to promote and administer
b) could encourage small firms to stop offering insurance and thus raise the number of uninsured
c) for credit to work some claim that it would have to ensure almost the entire cost of coverage

**"More Patients and Less Money Threaten Health Clinics for the Poor" pg 198**

1) NYC's recently instituted health clinics are now falling under after a group during the earlier 1990's
a) there has been a rise in the number of people uninsured 27% percent of city residents under age 65 lack insurance
b) heavy funding cuts from Medicaid program and reimbursements from other managed-care companies

2) Why these clinics needed
a) coming to a clinic is more cost-efficient care than having the poor and uninsured run to the emergency room with every injury
b) clinics can regularize the care that poor individuals receive
c) for a time doctors in residency had a greater amount of places to do their residency

**"Expanded Medicaid Crowded Out Private Insurance" pg 200**

1) Expanding eligibility for public health insurance causes providers of private care to be crowed out
a) expansion of Medicaid in 1987-1992 increased eligibility of children by 50% but comparitavely created a reduction in private insurance coverage
b) women of child-bearing age had a .8 million increase in eligibility for Medicaid but also had the same number in reduction of private coverage