Course Description and Syllabus

Outline

This mini course provides an introduction to macroeconomic policy design. Our focus is upon the design of good fiscal policy. What should we tax? When should we tax? Who should we tax? These are classic questions in public finance upon which recent macroeconomic theory builds. However, in contrast to public finance, macroeconomics places much more emphasis on the dynamics of policy.

We begin by describing the classic Ramsey approach to policy design. This assumes that the government is restricted to using linear or proportional taxes. The dynamic extension of this approach has stark implications for macroeconomic policy. First, asset taxes should be avoided. Second, in uncertain environments, the government should take a position in bond markets that allows it to smooth taxes and insure tax payers. We outline these results and then use them to provide some perspective on post war US public finance.

The restriction to linear "tax contracts" implicit in the Ramsey literature is undertaken for analytical convenience, but it lacks an economic foundation. In practice, tax schedules are often highly non-linear. An important practical restriction on a government is its limited knowledge about the circumstances of individual tax payers. In a static setting, Mirrlees (1971) provided a classic analysis of (constrained) optimal tax policy when tax payers are privately informed about their ability to generate income. In this setting a trade off between equality and the provision of incentives for effort emerges. Mirrlees’ contribution had a large impact on public finance, especially in the 1970’s, and on contract theory more generally, but little on macroeconomics until recently. Over the last 10 years, however, the so called New dynamic public finance, has extended the Mirrlees’ insights to dynamic environments. This literature has provided new qualitative insights into the design of capital taxes and the smoothing of taxes over time and states of nature. Recently, attempts have been made to calibrate new dynamic public finance models and derive quantitative implications. We review these insights and implications.

It has been recognized for a long time that the policy prescriptions which emerge from macro-public finance models are rarely "time consistent". That is to say, these prescriptions involve plans for the future that are optimal today, but will not remain optimal
when the future arrives. Thus, unless the government can commit to optimal future policy, there is no guarantee that this policy will be implemented. Macroeconomists have used game theoretic ideas to analyze policy design in environments without social commitment. We briefly describe these. In addition, we discuss recent contributions that explicitly incorporate politics into models of policy design.

Topics

Tentative topics for this mini course include.

- The static Ramsey model.
- The dynamic Ramsey model.
- First implications of the dynamic Ramsey model: Zero asset taxation.
- Second implication of the dynamic Ramsey model: Fiscal insurance.
- Assessing real world policy: Dividend tax cuts.
- Assessing real world policy: Fiscal insurance in practice.
- The static Mirrlees model.
- The dynamic Mirrlees model.
- Calibrating the dynamic Mirrlees model.
- Politics, taxes and inequality.
- Where next?

Some Further Reading

We will discuss several recent papers in the literature. Listed below are several surveys and monographs that provide additional discussion.


