

Economics 5300.03 : Public Economics I
Midterm Exam : October 16 1996

time = 1 hour

Do all 3 questions. All count equally.

1. Suppose a decision maker had a “Rawlsian” social welfare function (i.e. the decision maker wishes to maximize the well-being of the worst-off person in society).

Suppose also that there is no government expenditure on goods and services, so that the proceeds from taxation are used solely for redistribution.

Suppose further that the only policy instrument available is a proportional sales tax, with the proceeds to be paid equally to all people.

Discuss as precisely as possible the policy choice of the decision maker.

2. Discuss the effect of a proportional tax on interest income on the savings decision of a person whose utility function can be written

$$U(C_Y, C_O) = C_O - e^{-aC_Y}$$

where C_Y is the person's consumption when young, C_O is her consumption when old, and a is a positive parameter. The person is assumed to have an exogenous income, which is received entirely when the person is young.

3. Outline the framework of the Harberger (two-sector, general equilibrium) model of tax incidence, stating the key assumptions underlying the model, and the significance of these assumptions.