Public Finance II. / Public Economics

Lecture II - **Government**

Matej Lorko
matej.lorko@euba.sk
www.lorko.sk

Office Hours (Room 5C.30)
Mon 15:15 – 16:00
Tue 14:15 – 15:00

Readings:

- Gruber, J. (2005). Public finance and public policy. Macmillan.

Public economics

- Originally - narrow focus on collection and spending of government revenues
- Now - concerns with every aspect of government interaction with economy = study of economic efficiency, distribution and government economic policy = study of the role of government in economy
- How the government makes decision and what decisions it should make
- To understand *how,* it is necessary to investigate motives of the decision makers within government, how decision makers are chosen and how they are influenced by outside forces
- To determine *what*, one needs to study the effects of alternative policies

Assume that it takes 4 days to produce a food and 1 day to steal it.

What is the production equilibrium?

Why public sector at all?

- Property rights - rules defining the ownership of property - solve lack of trust, prohibition against theft

- Contract laws - rules governing the conduct of trade - ensure that participants in a trade receive what they expect from that trade or can seek compensation, e.g. formalisation of weights and measures, obligation to offer product warranties..

- Both need also to be enforced (+more general criminal laws, national defense..)

- But for all this, there needs to be a source of income —> taxes

- Minimal state - assists with the attainment of economic efficiency by providing an environment in which trade can flourish = provides contract law, polices it and defence the economy against outsiders. Organized economic activity can't exist without at least a minimal state => that is why there is public sector.

Four questions of public finance / economics

- When should the government intervene in the economy?
- How might the government intervene?
- What is the effect of those interventions on economic outcomes?
- Why do governments choose to intervene in the way that they do?

When to intervene?

- Think of an economy as a series of trades between producers and customers
- A trade is efficient if it makes at least one party better off without making any other party worse off
- The total efficiency of economy is maximised when as many efficient trades as possible are made
- -> competitive market equilibrium is the most efficient outcome for society = the outcome that maximises gains from efficient trades, S=D

Market vs. government

- Beyond minimal state, there are other situations where intervention in the economy can potentially increase welfare - two categories - involving market failures or not
- Involving market failures
  - externalities (effects that one economic agent imposes on another without their consent)
  - imperfect competition
  - existence of public goods (e.g. defense, education, social insurance, health, infrastructure…)
- Governments interventions can, however, create more harm than good
  - For example, if the problem is imperfect information and the government is even less informed
  - Public officials can abuse power in their own interest

Equity

- In addition to market failure, government intervention can be motivated by widespread inequality of income, opportunity or wealth
- This can occur even if the economy is efficient in a narrow economic sense
- Provision of state education, social security programs, compulsory pension schemes…

Do you think it is better to divide a cake

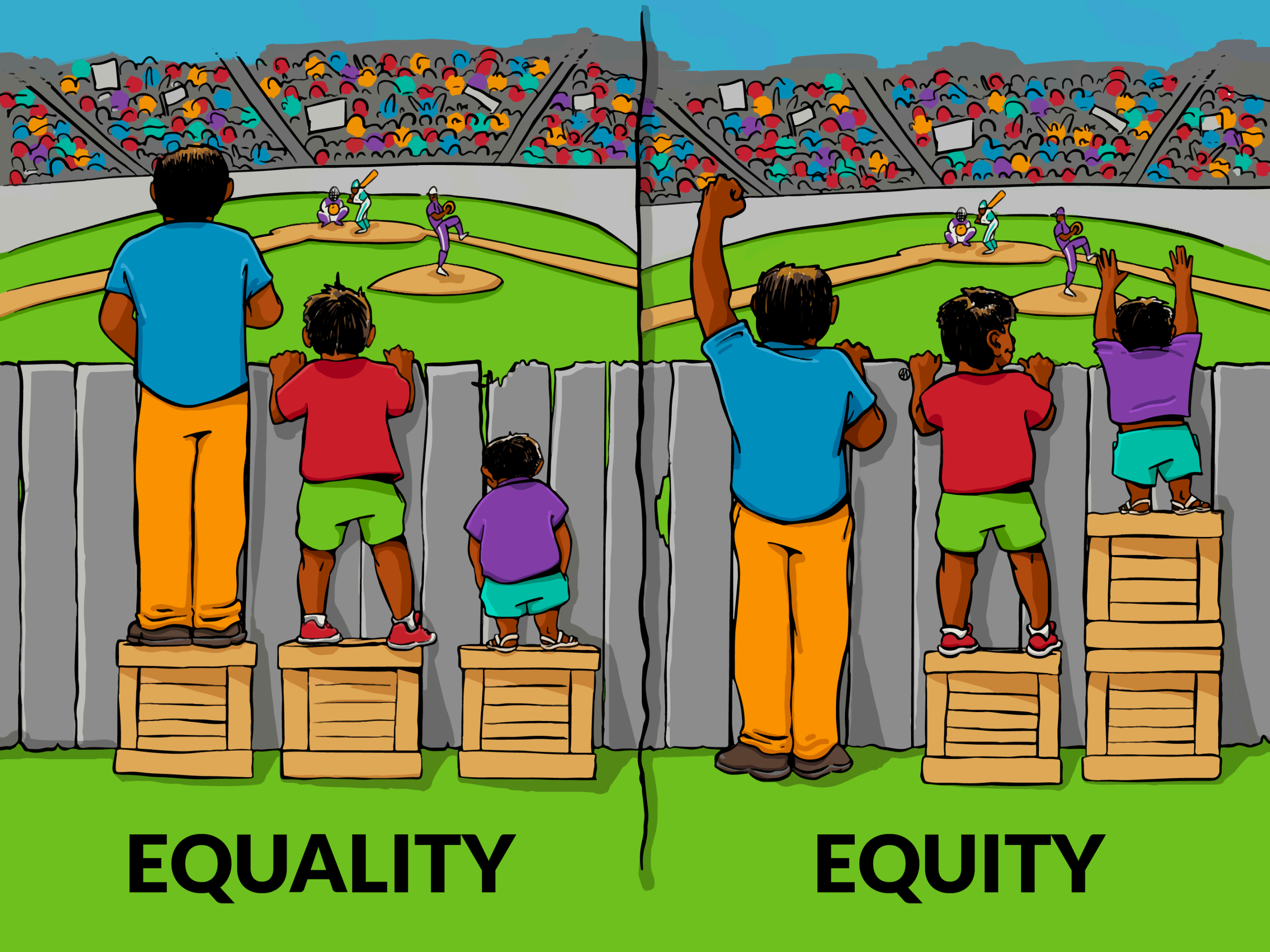
- by 75% to one party and 25% to the other party,

OR

- throw some part of the cake away and then equally split what is left?

Efficiency vs. equity

- Efficiency - organising economic activity so that the best use is made of economic resources
- Equity - government’s role related to distribution of economic benefits
- Tradeoffs - often efficient policy is highly inequitable, while equitable policy can introduce significant distortions and disincentives


EQUALITY
EQUITY

How much equity?

- The marginal benefit of a public good is a decreasing function of public good provision level -> the preferred PG level is decreasing as income rises -> with a proportional income tax the rich pay a higher share of the cost of PG than poor -> public good provision disproportionally benefits the poor

- How much PG then? Usually resolved by majority voting - but since everybody prefers the level of PG to be as close as possible to their preferred level, PG is always provided on the level that is preferred by the consumer with median income = median voter

- The political equilibrium level of PG increases with income inequality as measured by the ratio of the median to mean income - the more inequality, the more median voter requires PG

How might the govmt intervene?

- Tax or Subsidize private sale or purchase
  - Intervention uses price mechanism
  - Taxes raise the price of goods that are overproduced
  - Subsidies lower the price of goods that are underproduced
- Restrict or mandate private sale or purchase
- Public provision
- Public financing of private provision

Why these interventions?

- Government - not only mitigating market failures or assuring proper distribution of social resources
- In practice, gvmt faces difficult problems of aggregating the preferences of millions of citizens into a coherent set of policies decisions

What are the implications of imposing quality standards for drinking water?

Policies

- Policy analysis - in what ways does it change the equilibrium of the economy relative to status quo? What is the equilibrium of alternative policies?
- Positive/descriptive (what are the chosen policies and why those?) vs. normative (what are the best policies?)
- Government objectives
  - Selflessly cares about the aggregate welfare?
  - Or is it composed of individuals pursuing their own selfish agenda?

Effects of interventions

- Direct effects = effect that would be predicted if individuals did not change their behaviour in response to the intervention

- Indirect effects = the effects of government interventions that arise only because individuals change their behaviour in response to the interventions

Why is government often excessive?

- Bureaucracy - while the private sector rewards employees for efficiency, bureaucrat salary is typically unrelated to the efficiency - seeking of patronage, power, reputation

- Budget-setting - politicians obtain satisfaction from the size of their budget - should we rather think about privatisation to eradicate such inefficiencies?

- Monopoly power (of government), however unlike profit-maximizing monopolist, government often does not restrict its level of output below competitive level but rather oversupplies its output

- Corruption - often in form of predatory regulation - intentionally creating regulations that enterprises have to pay bribes to get around

- Cost diffusion - common resource problem - speeding is dispersed (every agency has own spending priorities) while collection is only at the treasury

Spending, taxes, deficits, debts

- Households - live on the budget = outflows of cash for groceries, rent, clothing, entertainment etc. must be financed by inflows of cash from work or other sources

- Any excess of income over spending is a *cash flow surplus* and can saved for future spending by you or your offspring

- Any shortfall of income below spending is a *cash flow deficit* and must be financed by past savings or borrowings from others

- Any borrowings results in the buildup of household *debt* which must be ultimately repaid from future inflows of cash

Spending, taxes, deficits, debts

- Government finances follow similar rules to those of households
- outflows = government spending, inflows = tax revenues
- If revenues exceeds spending - budget surplus, otherwise budget deficit
- Each dollar of deficit (year-to-year shortfall) adds to the government debt (accumulation of past deficits)
- Government debt must be financed by borrowing from either own or foreign citizens

Government debt

- Debt can be viewed as the substitution of current government expenditures for future expenditures
- It imposes a cost on future taxpayers to provide expenditures for current taxpayers
- Government debts are usually sustainable - promised payments on the debt can be made - however not always - in such cases, the government defaults - then needs to borrow for higher rates to compensate the risk
- If country issues debt in own currency - then instead of default has an option to print more money and deal with inflation. However if the country does not have own currency, it does not have such option

Big questions of expenditures

- Food and drug administration (0.1% of government budget vs. $2 trillion worth of goods annually, over 30% of total consumer expenditures)

- Social security - today's young workers pay for retirement benefit of today's older retirees (8:1 in 1950, now 3:1) - raise payroll taxes or scrap transfers so that individual save only for their own retirement?

- Health care - 5% of GDP in 1950, 18% today, single payer or private market with tax subsidies to private insurance?

- Education - do we need more resources or less monopoly of public schools and more competition?

Questions?

Matej Lorko
matej.lorko@euba.sk
www.lorko.sk

Office Hours (Room 5C.30)
Mon 15:15 – 16:00
Tue 14:15 – 15:00