Public Finance II.

Lecture I - **Economic Principles + Government**

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Office Hours (Room 5C.30)
Tue 10:00 – 10:45
Thu 12:30 – 13:15

Readings:

- Gruber, J. (2005). Public finance and public policy. Macmillan.
- Congdon, W. J., Kling, J. R., & Mullainathan, S. (2011). Policy and choice: Public finance through the lens of behavioral economics. Brookings Institution Press.

Course description

- theoretical concepts as well as empirical evidence on the role of the government in the economy
- issues of market failures, public goods, externalities, information asymmetry and others
- impact of public policies on the allocation of resources, market efficiency and equity
- microeconomic tools and empirical findings for analysis when and how the government should intervene
- public policies from the viewpoint of behavioral economics

Learning Objectives

- Understand the concepts related to economic efficiency, equality and government economic policy.
- Learn how the government makes decisions regarding market interventions.
- Understand how the insights from both theoretical and empirical research are applied to policy design.
- Employ economic analysis and behavioral economics findings to evaluate public policies.
- Develop competency to assess what decisions the government should make.

Principles of economics

- People face trade offs
- The cost of something is what you give up to get it
- Rational people think on the margin
- People respond to incentives
- Voluntary exchange (trade) can make everyone better off
- Markets are usually a good way to organize economic activity
- Governments can sometimes improve market outcomes (public goods, externalities)

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

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.

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

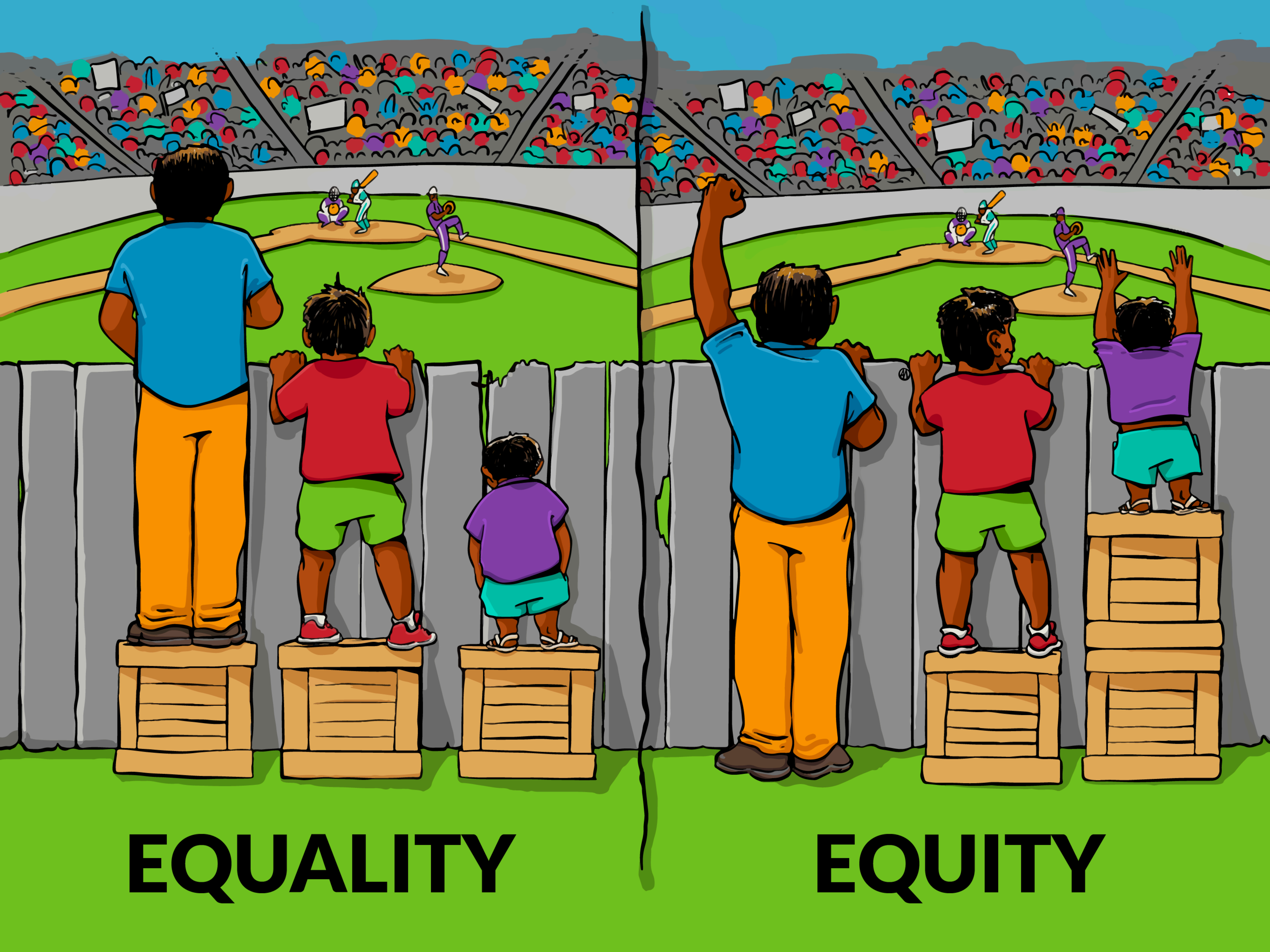
- by 75% to one party and 25% to the other party,

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

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

Questions?

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