Public Finance II. / Public Economics

LECTURE 1 – ECONOMIC PRINCIPLES

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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.

Rules

- Be here on time
- If you must arrive later or leave sooner, please do it quietly
- There are no stupid questions
- The more you discuss, the more you learn
- Lectures include in-class experiments and incentivized quizzes - bring smartphones/tablets/laptops in order to participate

Grading

Exam

- Multiple-choice exam, 25 questions
- Correct answer 4 points, incorrect answer -1 point, no answer 0 points
  - A: 91-100 points
  - B: 81-90 points
  - C: 71-80 points
  - D: 61-70 points
  - E: 51-60 points
  - F: less than 51 points

Extra points

- Every lecture finishes with quick quiz of 10 questions, delivered through Kahoot/Mentimeter.
- Top 5 students in each quiz receive extra 5-4-3-2-1 points towards overall grade.

Principles of Economics (Gregory Mankiw)

- 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)
- Country's standard of living depends on its ability to produce goods and services
- Prices rise when the government prints too much money
- Society faces a short-run tradeoff between inflation and unemployment.

Decision-making and rationality?

- Most human activity can be understood as a matter of people making decisions
- People have preferences and pursue their goals

- Why do we need theories of decision making?

- The key word is prediction
- Theories do not tell you what you should want
- They focus only on how you should decide given your preferences
- Rational decision is thus a decision that is in line with the underlying preferences

- What follows from that is that in order to make “rational” decision, you have to have rational preferences.

- Consumers and firms use as much of the available information as they can to achieve their goals = Weight the benefits and costs of each action

People face trade-offs

- People constantly face trade-offs in the use of their resources.
- We are forced to make trade-offs because of scarcity (of money & resources such as time)
- To get one thing that we like, we usually have to give up another thing that we like. Making decisions requires trading one goal for another.
- Efficiency vs. equality trade-off
  - efficiency: the property of society getting the maximum benefits from its scarce resources.
  - equality: the property of distributing economic prosperity fairly among the members of society.

The cost of something is what you give up to get it

- Because people face trade-offs, making decisions requires comparing the costs and benefits of alternative courses of action.
- The true cost of any choice includes what you gave up, or the opportunity cost.
- The opportunity cost is defined as:
    - the next best alternative foregone when making a decision
    - whatever must be given up in order to obtain some item
    - the loss of potential gain from other alternatives when one alternative is chosen

What is the cost of?

- going to a Uni?
- seeing a movie?

Rational people think on the margin

- Optimal decisions are made at the margin = Rational people make decisions by comparing marginal benefits and marginal costs.

- Some decisions are all or nothing, e.g. open a new restaurant, go to a Uni, take a job
- Many decisions involve doing a little more or little less, e.g. decrease spending and increase savings
- When individuals let how much money they have previously spent on a particular project/venture (sunk costs) influence future spending patterns, they are not "thinking at the margin."
- Thinking at the margin is important as it enables individuals to make rational choices about the allocation of scarce resources.
- Thinking at the margin, or marginal analysis, involves deciding what to do with the next dollar, hour, or resource.

People respond to incentives

- Because rational people make decisions by comparing costs and benefits, they respond to incentives.

- Incentive is something that induces a person to act.

- Understanding incentives is crucial in explaining the behaviour of individuals and groups.

- This knowledge may then be used to influence behaviour.

- Types of incentives:
    - psychological (e.g. envy, compassion, guilt, preference for fairness..)
    - beliefs (social norms, religious beliefs..)
    - economic incentives

•Taxes, Seatbelts, Crimes

Voluntary trade can make everybody better off

- Often when making choices, some of the options are available due to trade.
- Trade is not like a sports competition, where one side gains and the other side loses.
- Free trade gets a lot of bad press, however, if the trade is voluntary, then any person/company/country that is made worse off by trade simply wouldn’t do it.
- Trade allows people/countries to specialize in what they do best.
- Competition results in gains from trading.
- Therefore, we assume voluntary trade makes everybody better off.

Markets are usually a good way to organise economic activity

- Many countries that once had centrally planned economies have abandoned this system and are trying to develop market economies = economies that allocates resources through the decentralized decisions of many firms and households as they interact in markets for goods and services.

- Markets are where the buyers and sellers can meet to get goods and exchange items.

- Market prices reflect both the value of a product to consumers and the cost of the resources used to produce it = The free interaction of buyers and sellers (via markets) is most often the best way to achieve an efficient allocation of scarce resources.

- However, markets sometimes fail to clear, or they fail completely.

Governments can sometimes improve market outcomes

- There are two broad reasons for the government to interfere with the economy and address market failures: the promotion of efficiency and equality.

- A market failure: a situation in which a market left on its own fails to allocate resources efficiently.
  - externality: the impact of one person's actions on the well-being of a bystander
  - market power: the ability of a single economic actor (or small group of actors) to have a substantial influence on market prices.

- Note that the principle states that the government can improve market outcomes. This is not saying that the government always does improve market outcomes.

A country's standard of living depends on its ability to produce goods and services

- Differences in the standard of living from one country to another are quite large.
- Changes in living standards over time are also quite large.

- The explanation for differences in living standards lies in differences in productivity = **the quantity of goods and services produced from each hour of a worker's time.**
- High productivity implies a high standard of living.

- Thus, policymakers must understand the impact of any policy on our ability to produce goods and services.
- To boost living standards the policy makers need to raise productivity by ensuring that workers are well educated, have the tools needed to produce goods and services, and have access to the best available technology.

Prices rise when the government prints too much money

- inflation: sustained increase in the overall level of prices in the economy.
- When the government creates a large amount of money, the value of money falls.

Society faces a short-run trade off between inflation and unemployment

The short-run effect of a monetary injection (injecting/adding money into the economy) is lower unemployment and higher prices.

- An increase in the amount of money in the economy stimulates spending and increases the demand of goods and services in the economy.
- Higher demand may over time cause firms to raise their prices but in the meantime, it also encourages them to increase the quantity of goods and services they produce and to hire more workers to produce those goods and services. More hiring means lower unemployment.

Questions?

THANK YOU!

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