PUBLIC ECONOMICS

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Aim of the course

- **Public economics** studies the role of government in market economies. The aim of the course is:

  - To examine the role of the government in modern economies
  - To provide an understanding of the economic rationale for government intervention,
  - To discuss the effects of government's actions in terms of efficiency and equity criteria

Course outline/1

The course is organised into the following units:

1 - **An introduction to public economics**:

- the economic role of government,
- the rationale and limits of public intervention according to economic theory,
- the effects of government intervention in relation to efficiency and equity;

2 - **Public expenditures**:

- basic theory,
- application to some expenditure programmes: welfare policies, education policies, employment policies;

3 - **Taxation**:

- microeconomic and redistributive effects of fiscal policy and of the structure of taxation.

4 - **Welfare states and inequalities (Prof. Wickham)**

Course outline/2

References:

- Lecture Slides

- Public Economics Textbooks:

- J. Gruber, **Public Finance and Public Policy,** 2007. Chapters 2, **5**, 6**, 7**, **11, 12,13, 14**,17, **18,19, 20**
- E. Stiglitz, **Economics of the public sector**, W.W. Norton & Company, 3rd edition, 2000, chapters **3,4,5**, *6,7,8,9,* **10,14, 15,16,17,19,20**,26; or
- in alternative other textbooks in the library , such as H.S. Rosen, **Public Finance**. Irwin, 1992.

- Optional readings will be mentioned in the course

Examination

- 2 hours **written examination** at the end of the course

- **optional:**

  short review paper (4-5 pages) and **oral presentation** on one/two articles (+ 0/2 points on the grade of the written exam). The list of articles will be available by end of March, short papers have to be handed in by **May 25**.

1. Introduction to public economics

- Public intervention is widespread and largely influence our daily life:
- The government **provides goods and services** (health, social assistance, education, defence, environment, infrastructures, etc.),
- it **defines the rules for socio economic behaviour** (legal structure and property rights, environmental regulation and protection of natural resources, safety regulations, employment regulations, etc.)
- it **ensures a stable socio-economic environment** (macroeconomic policies,..)
- it **finances its activities with taxation** and this affects income distribution, and production, consumption and saving decisions.

Public Deficit and Public Debt

- The extent of public intervention in the economy is very different across countries, as shown for example by the ratio of public deficit and debt over GDP. The crisis has increased deficits and debt in all OECD countries.
- The **public deficit** is the difference between government spending and the revenues it receives (from taxation) during a particular year.
- The **public debt** is the total amount of money owed by the government to creditors due to the accumulation of past deficits.

The ratio public Deficit/GDP in the EU = (TOTAL REVENUES – TOTAL EXPENDITURES)/GDP

Source: EC and Eurostat

	2000	*2007*	*2010*
Austria	-1.7	-0.9	-4.4
Belgium	0.0	-0.3	-4.1
Finland	6.9	5.3	-2.5
France	-1.5	-2.7	-7.1
Germany	1,1	0.2	-4.3
Greece	-3.7	-6.5	-10.6
Ireland	4.7	0.1	-31.3
Italy	-0.8	-1.6	-4.6
Netherlands	2.0	0.2	-5.1
Portugal	-2.9	-3.1	-9.8
Spain	-0.9	1.9	-9.3
United Kingdom	3.6	- 2.7	- 10.3
EU27	0.6	-0.9	-6.6
United States	*1.6*	*-1.1*	*-8.9*

2) Ratio Public Debt/GDP

	2000	2007	2010
Austria	67.0	63.4	78.2
Belgium	107.8	84.1	96.2
Denmark	52.4	27.5	43.7
Finland	43.8	35.2	48.3
France	57.3	64.2	82.3
Germany	60.2	65.2	83.2
Greece	103.4	107,4	144.9
Ireland	37.5	24.8	92.5
Italy	108.5	103.1	118.4
Netherlands	53.8	45.3	62.9
Portugal	48.5	68.3	93.3
Spain	59.4	36.2	61
United Kingdom	41	44.4	79.9
EU27	61.9	59	80.1
United States	58.2	62.1	97.9

Fundamentals of public economics

- ***Public economics*** studies: the role of the government in *market* economies, the rationale of its intervention and the economic and social effects in terms of **efficiency and equity**.

- **MAIN QUESTIONS:**

- **<u>When</u> should the government intervene in the economy (should the government intervene more or less than it does?)**
- **<u>How</u> might the government intervene (should it intervene differently?)**
- **<u>What</u> are the effects of public intervention?**
- **<u>How</u> social choices are made?**

When should the government intervene in the economy? Roles and tools of Government intervention

- The public sector has different roles in market economies which interact with each other:
  - **Allocation** of resources (efficiency goal)
  - **Income (re)distribution** (equity goal)
  - **Stabilisation** of the economic cycle

When and how to intervene?
Allocation role (efficiency)

- The **ALLOCATION ROLE** is to provide **in an efficient way** goods and services that the market is not able to produce efficiently (**market failures)** through:
- The ***production of public goods or the public financing of private provision***: i.e. all those goods and services which are not produced (or would be produced inefficiently) by the market, due to market failures;
- The ***regulation*** of market activities to support market competition **(**property rights, legal system, restrictions)
- ***Taxes and subsidies*** which change the market price of goods/services and affect the production and consumption decisions of economic agents.

When and how to intervene? Redistributive role

- The aim is to foster **equity** correcting the distribution of resources resulting from market mechanisms, by shifting resources from some groups in society to others and/or by changing initial endowments through:

- ***Monetary transfers*** (such as welfare benefits to support the income of the poor or the unemployed)
- ***Transfers in kind*** (provisions of public services such as education, health services, social services)
- ***Income Taxes/subsidies*** (for example with progressive taxation or exemptions or subisidies)

When and how to intervene? Cycle Stabilisation role

- **Smoothing over the business cycle and external shocks**, supporting full employment and controlling inflation through:
- ***Fiscal policy*** (transfers and taxation, automatic stabilizers, public expenditures)
- ***Support to productive activities***

What are the effects of government intervention?: The analysis of government failures

- Behind public intervention in modern market economies is the need to correct actual or perceived **market failures (efficiency goal) and to ensure an equitable distribution of resources (equity goal)**

- However government intervention may also produce negative direct and/or indirect effects (**government failures)** due to:
  - *Limited information*
  - *Limited control on private markets responses to public intervention*
  - *Limited control over the public bureaucracy*
  - *Limitations imposed by the political process*

What are the effects of public intervention? Evaluation of effects

- Have to consider **direct and indirect effects** of public intervention on individuals and markets:

  - ***Direct effects*** are those expected *assuming that the behaviour of economic agents do not change* as a consequence of government intervention
  - ***Indirect effects*** are those that arise because *economic agents change their behaviour* in response of the intervention (for example increasing taxation may reduce labour supply)

- It is very difficult to measure effects (especially indirect ones) and to establish **causation: i.e. whether the effects we observe are due to the government intervention under analysis or not** (see Gruber ch.3 if interested)

How decisions are taken?The analysis of social choices

- **Political economy** studies how the *political decision making process* produces decisions that affect individuals and the economy.
- This part of public economics analyses how socially desirable goals are chosen
- Socially desirable goals relate to:

  - the capacity to support socio-economic growth,

  - the capacity to guarantee adequate living conditions to citizens,

  - the capacity to guarantee equality in opportunities for all.

Key economic issues in public economics

- ***Efficiency:*** Maximise the size of the pie, given the available resources
  - What is produced,
  - How it is produced and how much it is produced (public vs private goods/services): given available resources make the pie as large as possible

- ***Equity:*** how the pie is distributed
  - For whom it should be produced and who should pay for it: distribute the pie in the most equitable way
  - How are decisions taken?
- ***Trade offs***:
- an efficient outcome might be not equitable
- an equitable outcome might be inefficient

Theoretical tools at the basis of Public Economics

(Stiglitz ch.3 and 5; Gruber ch.1, 2; Rosen ch. 1,2, 3 and 4)

- Consumer theory (constrained utility maximization)
- Production theory
- Equilibrium and social welfare theory