

# PUBLIC FINANCE

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## 1- Introduction

### What is Public Finance?

It is also known as “**public sector economics**” or “**public economics**.”

#### It is about:

- The **taxing activities** of the government.
- The **spending activities** of the government.

#### Note:

Scope of public finance is unclear

Although government has role in many economic activities, the focus will be on taxes and spending.

- However, the resources for all government expenditures ultimately come from the **private sector**.

- So, public sector decisions affect **private sector decisions** in many ways.

#### Note:

- The overall impact of public sector decisions must be examined in the context of their impact on private sector behavior.

### In studying the public finance, we want to know:

- ❖ how does the government secure its revenues – both **process** and **amounts**?
- ❖ how are the **revenues** spent?
- ❖ how does the government make **decisions** or **choices** among alternatives?

### in studying the public finance, the following economic *consequences* of public policy are considered:

- Resource allocation:** Allocation
- Income distribution:** Distribution
- Level of economic activity:** Stabilization

The goal of public finance is to understand the proper role of the government in the economy.

#### Four questions of public finance are considered:

- ✓ **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?

### A. When Should the Government Intervene in the Economy?

#### Market Failures

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**market failure** Problem that causes the market economy to deliver an outcome that does not maximize efficiency.

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#### Redistribution

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**redistribution** The shifting of resources from some groups in society to others.

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## B. How might the Government Intervene?

### ✓ Raise or Lower prices of Private Sale or Purchase

- One way that the government can try to address failures in the private market is to use the price mechanism.
- That is, government policy is used to change the price of a good in one of two ways:
  1. Through taxes, which raise the price for private sales or purchases of goods that are **overproduced**, or
  2. Through subsidies, which lower the price for private sales or purchases of goods that are **underproduced**.

### ✓ Restrict or Expand the production of Private Sale or Purchase

- The government can **directly restrict** the private sale or purchase of goods that are **overproduced**, or **expand** the private purchase of goods that are underproduced and force individuals to buy that good.

### Expanding the Private Production

#### Public Provision

The government can provide the good directly, in order to potentially attain the level of consumption that maximizes social welfare.

#### Public Financing of Private Provision

Governments may want to influence the level of consumption but may not want to directly involve themselves in the provision of a good.

## C. What are the Effects of Alternative Interventions?

### Direct Effects

**Direct effects** The effects of government interventions that would be predicted if individuals did not change their behavior in response to the interventions.

### Indirect Effects

**Indirect effects** The effects of government interventions that arise only because individuals change their behavior in response to the interventions.

## D. Why do governments choose to intervene in the way that they do?

**Political Economy** The theory of how the political process produces decisions that affect individuals and the economy.

## What are the various government levels?

### Federal Government

- The power to tax is exclusive to the federal government
- Equal tax rates across states
- Can run budget deficits

### Local Government

- Derive power to tax and spend from the States
- Can impose spending / taxing restrictions on itself, so different tax rates across states
- Many governorates cannot run budget deficits.

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## Growth of Government

- ✓ To what extent are society's economic resources controlled by the public sector?
- ✓ Has this control over resources been growing over time?

## Size of government – how to measure?

- Number of government employees
- Annual expenditures: Purchases of goods and services, transfers, and interest payments

### For example,

United States versus other developed countries.

- U.S. public sector is quite small compared to Sweden or France.
- Although large, the U.S. government is small in relative terms (compared to the private sector).

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## Explanations for the Size and Growth of Government

Mueller in “The Growth of Government” listed five explanations for public sector growth:

1. .The government as provider of public goods and eliminator of **externalities**
2. .The government as **redistributor** of income and wealth
3. **Interest groups** as a cause of government growth
4. **Bureaucracy** as a cause of government growth
5. **Fiscal illusion** as a cause of government growth

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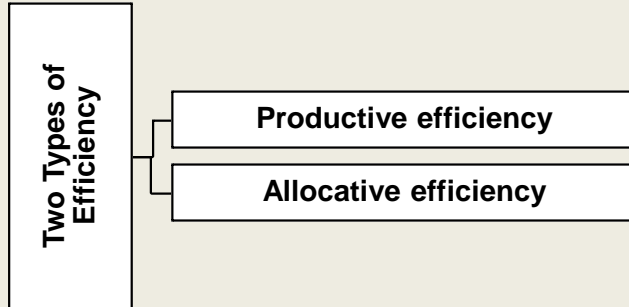
## The Role of Government in Making a Free Market Possible

A **free market** consists of the **voluntary interaction** of producers and consumers of goods and services.

### Two Related Questions

- Is it necessary to have a government?
- Why does free market usually work well for consumers?

Free markets are **efficient**

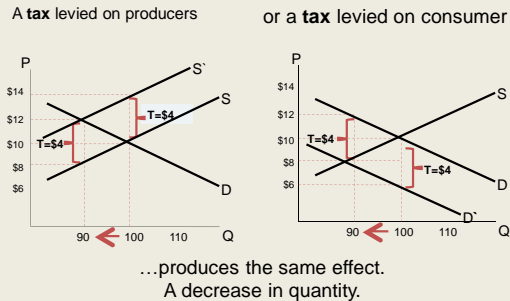


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In the Wealth of Nations, **Adam Smith** emphasized four "justifiable" functions of government:

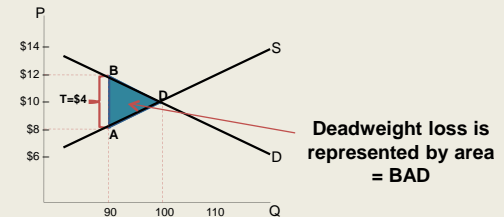
- The duty of **protecting the society** from violence and invasion by other independent societies;
- The duty of **protecting every member** of society from injustice and oppression of every other member of society;
- The duty of **establishing and maintaining** those highly beneficial public institutions;
- The duty of **meeting expenses** necessary for support of the sovereign

**Taxes, Subsidies, Regulations, and Inefficiency**

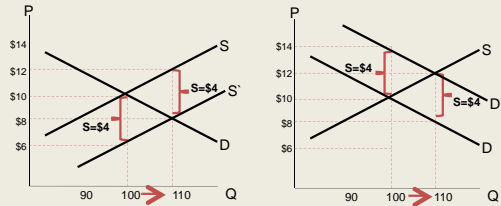


**Deadweight loss**

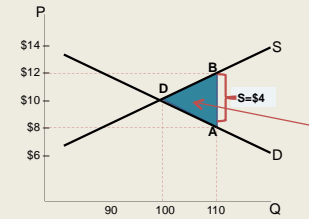
- An inefficiency which causes a reduction in society's welfare



A **subsidy** given to producers or a **subsidy** given to consumers



...produces the same effect:  
an increase in quantity



Deadweight loss is represented by area = BAD

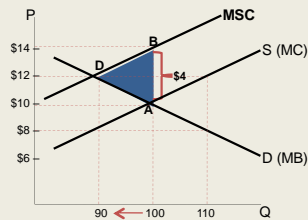
## Problems for the Free Market

### Externalities

**Negative externality**

**MSC** = (MC + marginal environmental damage)

**Solution?**  
A corrective tax.



### Externalities

Figure 1.9

**Positive externality**

**MSB** = (MC + marginal benefit to other people)

**Solution?**  
A corrective subsidy.

