

# PUBLIC FINANCE

## Government—What is it good for?

- **Set** common rules of behavior
- **Protect** citizens from external threats
- **Pool** resources for the common good
- **Address** and **correct** market failures
- **Procuring public goods** (production and provision)
- **Arranging and funding** various **transfers** (particularly in the social area)
- **Directing entities** existing in the economy towards **socially desirable behaviors**; for instance through taxes, penalties, subsidies and other stimuli and charges.

- In order to arrange the funding of the above-mentioned areas,

there is a **fiscal system (public budgeting system)** whose aim is to:

**collect the required amount of public revenue.**

Public revenue serves, at various levels of public budgets (governmental, regional and local), to fund **public expenditures**.

**Public expenditures, public revenue** and particularly **taxes** may be considered to be the fundamental elements of public finance. Important terms derived from these elements include **deficit, public debt, budgetary policy and fiscal policy**.

Since the 1930s, the state's role in the economy has been noticeably gaining in importance;

- Therefore, the traditional functions of the state (legislative, social, security, etc.) have been supplemented with the **economic function** (sometimes called the **fiscal function** or the **public finance function**).
- The state uses **legislative** and **executive** powers, as well as its own **public administration** bodies and institutions (centralized and decentralized) to perform them.
- The state's **economic function** has become predominant particularly in the school, health care, social services and social security sectors.

With regards to the role of the state in the economy, **two approaches** have emerged:

1. State interventions are **undesirable** for the economy; therefore they are rejected (**individualistic views**).
2. State interventions are **advocated** (**collectivist views**).

**Note that:**

The public sector coexists with the private sector. These two sectors permanently influence each other with respect to both size and activity. The state strongly influences the private sector through various restrictive measures. One of its control tools is **public finance**.

**Three cases require a government intervention:**

**Market  
Failure**

**Macroeconomic  
Failure**

**Social Injustice**

One of the purposes of the government intervention is to deal with the market failure, in order to achieve three main elements: ***efficiency***, ***stability*** and ***fairness***:

**The government intervenes in the case of the followings:**

- The allocation of resources is not efficient,
- The economy in the area of macroeconomics indicators oscillates around the desired values
- The distribution of wealth and income may diverge from the consensus on fairness.

## Market Failure

If the conditions for perfect competition are not met, a malfunction in **the price mechanism** will arise, which disturbs the **allocation mechanism**. Therefore, a government intervention is required.

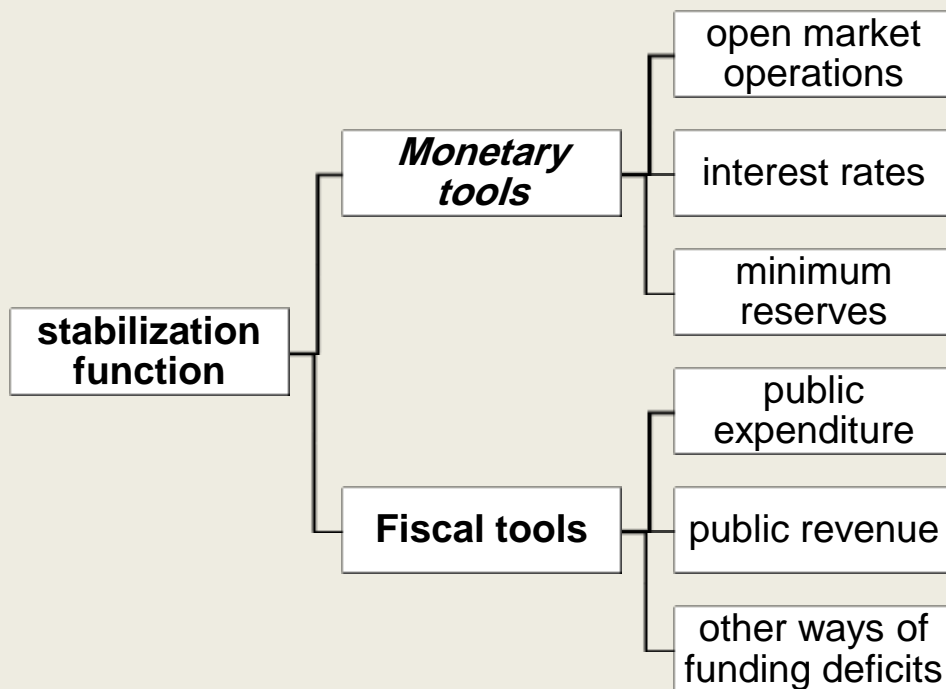
## Macroeconomic Failure

It is indicated by instability in the ***economic system*** that usually suffers from cyclical inflation, a high rate of unemployment, low or even negative growth of production or problems in the foreign trade balance, etc.

**This is why the government undertakes the stabilization functions (*stabilization fiscal functions*)**

The state uses several economic tools to perform the stabilization function.

The basic classification of these tools is a division into **monetary** and **fiscal** tools.



## Social Injustice (income inequality)

It is possible for growth rates to be positive and those at the bottom the distribution to be worse off

- Is more inequality bad?

Not clear what the optimal distribution is

- Gini coefficient is lower in Egypt than the United States but most people would not want to exchange places

### Inequality and Growth

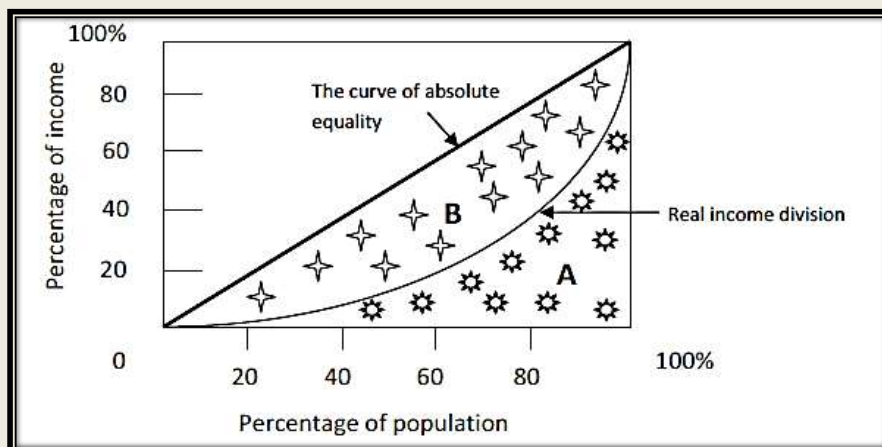
Generally there is negative relationship between *Gini* coefficient and growth, but there are countries with high *Gini* and high growth rates

The state performs the redistribution function through two basic categories of tools:

- The first includes **revenue (tax)**
- and the other **expenditures** (transfers, grants and subsidies).

- First, a tax transfer mechanism may be implemented through a combination of progressive taxation of high incomes and transfers (subsidies) in favor of low-income households.
- Secondly, this can occur through the taxation of luxury goods combined with subsidies on goods for the low-income population.

- The question of fairness is connected with **income inequality**. Its monitoring serves to seek necessary redistribution that will be perceived as fair by society.
- The most well-known tools are the **Lorenz curve**



## Measure of Inequality

Assume we have an economy with 10 people with the following incomes

1	20
2	40
3	100
4	200
5	50
6	600
7	1000
8	750
9	400
10	250

## Order by income

<b>1</b>	<b>20</b>	<b>20</b>
<b>2</b>	<b>40</b>	<b>40</b>
<b>3</b>	<b>100</b>	<b>50</b>
<b>4</b>	<b>200</b>	<b>100</b>
<b>5</b>	<b>50</b>	<b>200</b>
<b>6</b>	<b>600</b>	<b>250</b>
<b>7</b>	<b>1000</b>	<b>400</b>
<b>8</b>	<b>750</b>	<b>600</b>
<b>9</b>	<b>400</b>	<b>750</b>
<b>10</b>	<b>250</b>	<b>1000</b>

## Compute % of income for each quintile

**% of individuals    % of income**

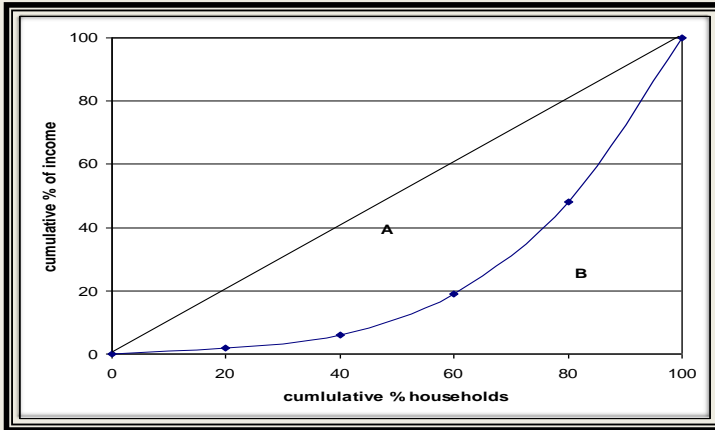
<b>20</b>	<b>2</b>
<b>20</b>	<b>4</b>
<b>20</b>	<b>13</b>
<b>20</b>	<b>29</b>
<b>20</b>	<b>51</b>

Compute cumulative %

**cumulative %    cumulative  
of individuals    % of income**

<b>20</b>	<b>2</b>
<b>40</b>	<b>6</b>
<b>60</b>	<b>19</b>
<b>80</b>	<b>48</b>
<b>100</b>	<b>100</b>

## The Lorenz curve



If income is equally distributed Gini is 0.

Larger Gini means more inequality

Thank you