

# Economics and Public Finance

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## Lecture 2

### Public Finances and Theories about the Role of Government – PART 1

## **Chapter 1: Public finances and the role of the state**

### 1.2. Public finances and several theories about the role of the government

#### 1.2.1. Introduction: an overview

#### 1.2.2. The minimal state and the primacy of the market

##### 1.2.2.1. The English classical school: the *laissez-faire* doctrine

##### 1.2.2.2. Robert Nozick: The market as a fair process

#### 1.2.3. The welfare state

##### 1.2.3.1. Definition

##### 1.2.3.3. The (re)distribution of income

##### 1.2.3.3. The provision of primary goods

# Economics and Public Finance – Readings

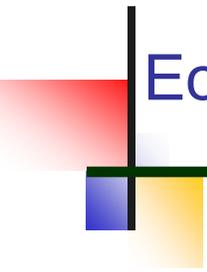
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- Readings English:

- PEREIRA, P. and Nunes, F. (2016) Summary of Chapter 2 Teorias sobre o papel do Estado.
- MUSGRAVE, Richard (1996), "**The role of the state in fiscal theory**", International tax and public finance, Vol. 3, pp. 247–258. **sections 1-2.**

- Readings Portuguese:

- Chapter 2 of Pereira et al. **Economia e Finanças Publicas (5ª edição/6ª edição, p. 21-31.)** and Chapter 2 of Pereira and Nunes **Economia e Finanças Publicas: da teoria à pratica.**



## Economics and Public Finance – Core topics

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- The *laissez-faire* doctrine
- The minimal state: concept and justification
- The welfare state: concept and justification
- The *Rawlsianism*
- Utilitarianism

- **There are different views about the role of the state**, in particular related to key aspects of public financing and the function of the public administrations.
  - This stems from different notions as to what should be:
    - ***The role of the government***
    - ***The role of the market***

- **Three crucial questions about the role of the state arise:**
  - A. What is the purpose of the existence of the state?
  - B. What is the appropriate size of the public sector?
  - C. What is the most advantageous composition of public expenditure?

## Economics and Public Finance – Role *versus* type (an overview)

<b>The role of the state</b>	<b>Type of “<i>public finance</i>”</b>
The minimal state ( <b>MS</b> )	<i>Classical public finance</i> ( <b>allocation</b> , small public sector, balanced budgets and no debt except to fund wars)
The welfare state ( <b>WS</b> )	<i>Financial interventionism</i> (allocation, <b>redistribution</b> and stabilization Higher expenditure, taxes and debt)
The imperfect state ( <b>IS</b> )	<i>Financial constitutionalism</i> (allocation and general rules for redistribution, Constitutional constraints on governments)
<b>A mix of Welfare and Imperfect States</b> (normative and positive approach)	<i>“Modern” public finance</i> (dominant in European Countries)

### A. The “minimal” or liberal state – primacy of the market

- **Reduced weight of public sector** - The size of government expenditures in mixed economies relative to GDP should range from **10%** to **15%**.
- **Provision of public goods** - The role of the state should be restricted to providing public goods required to the good functioning of the market, such as:
  - Regulation and protection of property rights
  - Law and order
  - Infrastructure

## Economics and Public Finance – The liberal state (2/6)

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- The school of **classical liberalism**: ***laissez-faire*** (XVIII/ XIX centuries).
  - **Adam Smith**: “*the simple system of natural liberty*”.
  - **David Ricardo** (quoting Jean-Baptiste Say): “*the very best of all taxes is that which is least in amount*”.
  - **John Stuart Mill**: “*laissez-faire should be the general practice: every department from it, unless required by some great good, is a certain evil*”.

- **Utilitarian Ethics (Jeremy Bentham)**

- The well-being of society is ascertained by the **aggregate well-being** of all the individuals that comprise that society.
- Utilitarianism:  $W_u = U_1 + U_2 + \dots + U_n$
- The “**wealth of the nations**” is the ultimate goal and **not** the redistribution of income or wealth.
  - Note: It is implicitly assumed that the marginal utility of income is constant.

- Essential functions of the **prince** (according to Adam Smith)
  - Protection of society against **foreign invasion**.
  - Protection of each individual against injustices performed by others.
  - Provision of certain institutions and public works of public interest that are not provided by the market.
  - "erecting and maintaining those public institutions and those public works which, though they may be in the highest degree advantageous to a great society are, however, of such a nature that the profits could never repay the expense to any individual or small number of individuals, and which it therefore cannot be expected that any individual or small number of individuals should erect" (Smith, 1776, p. 211)
    - citado no texto de Musgrave (Áquila)

- Summary

- To create the required conditions for proper **market functioning** (defence, security, judicial system, rule of law)
- To provide certain goods that would not be produced even in conditions of *free functioning markets*.
- **The reason for state intervention is largely linked to the allocation function.**

## Economics and Public Finance – The minimal state (6/6)

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- Modern advocacy of the “minimal state”
  - The notion of basic **fundamental rights of the individuals** (private spheres) **the liberty criteria**.
  - A theory on **inequality creation** (based on the different behaviour of agents – spending/saving; work/leisure).
  - The notion of the **state as an voluntary association of individuals** (*quid pro quo* relationship between citizens and the government)
- “The market is a fair process whenever private property is **fairly acquired**, *i.e.*, not by theft, extortion or other illegal form.” (**Robert Nozick**)

## Economics and Public Finance – The welfare state (1/5)

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**B. The welfare state** entails a different perspective about markets.

- **If markets are competitive** they act as powerful and irreplaceable mechanisms of information dissemination between economic agents (**efficient resource allocation**).
- However, markets **do not operate as a completely fair process, and can (re)produce significant inequalities**, especially if the starting point is a very unequal distribution of property rights.

## Economics and Public Finance – The welfare state (2/5)

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- **Definition of the welfare state:** A state where organised political power deliberately attempts to **modify the functioning of the market forces** in at least **three** directions:
  1. Guaranteeing to all individuals and families a **minimum income** regardless of the market value of their property.
  2. Decreasing the extent of **insecurity**, allowing individuals and families to face social contingencies.
  3. Assuring that certain **social services** are **universally available** to all individuals regardless of status or social class.

*Asa Briggs (1961, pp. 228)*

## Economics and Public Finance – The welfare state (3/5)

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- The fundamental reason for the welfare state is the **distribution function**, can be justified using **two types of arguments**:
  - Redistribution of income (**Utilitarianism**)
  - Provision of basic or primary goods (**Rawlsianism**)

- **The redistributive state:** One can ascertain a modified version of the classical utilitarianism, *i.e.*, **the diminishing marginal utility of income.**
  - The marginal utility of an additional euro to a poor individual is greater than the decrease of utility that results from one less euro to a rich individual.
  - As such, the redistribution of income in favour of poorer individuals of society increases the overall social well-being (the sum of the utilities of all individuals).

- **John Rawls** emphasized the role of the state in the construction of a *fair society* based on **two** principles:
  - **1<sup>st</sup> The principle of equal liberty:**
    - “Each person is to have an equal right to the most extensive scheme of equal basic liberties compatible with a similar scheme of liberties for others.”
  - **2<sup>nd</sup> The difference principle (maximin principle):**
    - “Social and economic inequalities are to be arranged so that they are both reasonably expected to be **to everyone’s advantage** and attached to positions and offices **open to all...**”

# Economics and Public Finance – *Rawlsianism* (1/2)

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- **Topics to take into account**

1. **The 1<sup>st</sup> principle has priority over the 2<sup>nd</sup> principle:**

- Basic liberties (like freedom of thought and freedom of speech) cannot be sacrificed in order to gain access to economic and social advantages.

2. **Inequalities are defined in terms of primary goods** not in terms of income:

- There should be **equal opportunities** and **positive discrimination** is justified towards marginalised groups (like ethnic minorities and disabled people).
- Inequalities are only justified when they lead to improving the economical and social situation of the least-advantaged members of society – **the maximin principle**.

- **Topics to take in account**

3. **Social institutions tend to reproduce natural inequalities** as well as those resulting from lifestyle options (personal choices and decisions).
4. **The role of the state is to ensure the access to social primary goods** in particular to the least-advantaged members of society (social primary goods such as rights, freedoms and guaranties, equal opportunities to income and wealth).

There should be **equal opportunities** and **positive discrimination** is justified towards marginalised groups

