1. Economy and public finances in democracy[1]

Summary

The *book Economia e Finanças Públicas (Escolar Editora*) examines the role of the public sector in a mixed economy, with a particular focus on the Portuguese economy.

This chapter clarifies, first of all, the political-economy approach that goes beyond mere economic analysis of regulatory intervention by the public sector. It takes into account the institutional constraints and political constraints involved in collective decision-making.

It is clarified the essential distinction between positive and normative analysis. The first assumes the existence of a model based on a set of assumptions and aims to anticipate the effects on certain end-state variables of the manipulation of instrumental variables. The normative analysis (which often does needs a prior positive analysis) is intended to make value judgments about certain features of contemporary society (e.g. income distribution, characteristics of the labour market, etc.) and the results of the implementation of certain public policies.
Within the normative criteria used by economists, stand out three criteria: fairness, efficiency and equity. In the case of value judgments, there is not a consensus among economists either in relation to the priority of each criterion with respect to others, or the nature of the trade-off between them. It contributes to the transparency of economic and political debate that every economist clarifies what its priorities are, and what is his or her understanding of the conflict between, for example, efficiency and equity. However, "Too often we witness recommendations of economists with moral and political implications, as if they were scientific statements."

For example, the liberalization of the rental market contributes to an improvement in efficiency in the allocation of resources (housing) but what is the effect on equity? Some will say that the effect is negative assuming that on average the homeowners group is better off than the group of tenants, although the mean hide very different situations. The primacy given to the criterion of efficiency clearly suggests total market liberalization while the stronger weighting of equity does not suggest a full liberalization and especially recommends the use of appropriate instruments (taxation and social benefits) to pursue equity objectives.

Differences of economists' views are more pronounced in the normative analysis, but they also extend to positive analysis. Also there are differences in

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the models that best fit the reality and the desirability (or not) of models to be based on realistic assumptions.

As far as the how to approach society, there is some agreement among economists on a humanistic (or individualistic) approach in which society is seen as a community of individuals and the welfare of society is necessarily related to the well being of these individuals. Thus, the impact of public policies in society will necessarily be analyzed in terms of the impact on individuals who compose it. This view is opposed to an organic view, not shared by most economists, in which society would be seen as an autonomous entity and it would be possible to identify its "will", its "welfare" as something strange and alien to the individuals who compose it (e.g. a political or religious leader that "reveal" the common good of society).

The role of government in a democratic society has been analyzed differently by economists who have been addressing the public finances. In a tradition dating back to Erik Lindhal and whose pinnacle was, until recently, Richard Musgrave, government has been perceived as a benevolent dictator, an agent wanting to maximize the welfare of society operating without institutional constraints. In a sense this approach is more relevant in democratic societies, where through voting and opinion polls, citizens express preferences for public policies. Another tradition, dating back to Knut Wicksell, whose main architect was James Buchanan, gives greater importance to institutional constraints, and has adopted, especially in public choice theory (see Chapter 4) a more sceptical view of government, namely its subordination to the rent-seeking behaviour of interest groups, the budget maximizing behaviour of bureaucrats, and the vote maximizing behaviour of politicians. The emphasis on each way to approach government, also suggests different perspectives on the relative importance of public sector in a mixed economy.

Musgrave classified the three public sector roles in a modern mixed economy: improving the efficiency of resource allocation overcoming certain market failures, increasing the equity and social justice through policies to redistribute income and promote equal opportunities, and stabilizing the economy through the promotion of growth, employment, price stability and smoothing economic cycles.