

Economics and Public Finance

Lecture 1

The Public Sector in a Mixed Economy

Chapter 1, section 1.1.

Chapter 1: Public finances and the role of the state

1.1. The public sector in a mixed economy

1.1.1. The positive and normative approaches

1.1.2. The normative principles: efficiency, equity and liberty

1.1.3. The functions of the state: allocation, distribution and stabilisation

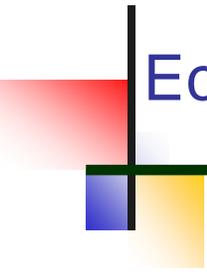
Economics and Public Finance – Readings English

- Readings English

- Stiglitz, J. Rosengard (2015). ***Economics of the Public Sector***, 4th ed. W. W. Norton Company, Inc., Chapter 1 p. 36-58 (Fenix)
- Complementary:
- Musgrave, R., Musgrave, P., ***Public Finance in Theory and Practice***, 5th Ed., 1989, McGraw-Hill, p. 3-14.

Readings Portuguese:

- Chapter 1 of Pereira et al. *Economia e Finanças Publicas* (6^a edição), Escolar Editora
- Chapter 1 of Pereira and Nunes *Economia e Finanças Publicas: da teoria à pratica*. (6^a ed.) Almedina



Economics and Public Finance – Core topics

- Normative economics and analysis
- Positive economics and analysis
- Efficiency, equity and negative freedom
- The allocation function
- The distribution function
- The stabilisation function

Economics and Public Finance – What is our object of study?

- The main purpose of this course in “*Economics and Public Finance*” is twofold:
 - to develop **positive** and **normative** approaches to the economic analysis of the entities of the public sector (revenues and expenditures).

Economics and Public Finance – Distinctions (1)

- **Positive analysis:** Explain **what exists** and forecast the consequences of specific policies in certain identifiable “objective” variables, either instrumental or structural.
- *“When they describe the economy and construct models that predict either how the economy will change or the effects of different policies, they are engaged in what is called **positive economics**.” Stiglitz and Rosengard.*
- **Normative analysis:** Ascertaining “social states”, *i.e.*, making “normative” value judgments in terms of how things should be, in particular issues surrounding:
 - **current state of affairs,**
 - **the implementation of public policy, and its evaluation according to normative criteria (mainly on efficiency and equity).**

Economics and Public Finance – Distinctions (2)

- **Examples:**
- **1) Parliament** (the only institution that is intitled to approve taxes) **considers the possibility of increasing a specific tax on beer of 1 euro.**
- **2) Parliament approves that in attending urgencies in public hospitals, citizens may pay a small “moderation fee” (*taxa moderadora*)**
- **What sort of questions arise when we think of...**
- **Positive analysis?:**
- **... and ..**
- **Normative analysis?:**

Economics and Public Finance – Positive analysis

- The **positive approach**:
 - 1. What are the effects of **manipulating certain fiscal policy variables pursuing economic, social or environmental objectives?**
 - 2. What are the effects of **changing structural variables** (such as rules and institutions of the political system) in order to **implement public policies?**
- *Note: 1. is the day by day usual policy of governments. 2. is a more fundamental institutional change (also more seldom) but sometimes needed for substantial reforms.*

Economics and Public Finance – Normative analysis

- The **normative approach**:
 - To what extent should the government get involved in the economy in terms of public expenditure and revenues? Which policies should government give priority (education, health, etc.)?
 - Which generic public sector instruments (**rules and institutions**) should be put in place in order to formulate, adopt and implement public policies?

Economics and Public Finance – The normative principles (1/3)

- **Efficiency:** Optimal allocation of resources is the allocation, according to citizens' preferences, so that it is only possible to improve one person's well-being by worsening the well-being of others – **the Pareto optimality criterium.**
- Given a resource endowment, how much private goods and public goods should a society produce to satisfy citizens' preferences (on public and private goods)?
- *Note that there is a tradeoff: more private goods means less public goods and vice-versa.*
 - The Pareto criterium, only needs knowledge of individual preferences and excludes *interpersonal comparisons of well-being* (or utility) between individuals (we will come back to this topic later).
 - Do not make a confusion with the concept of **technical efficiency or X-efficiency:** to produce a given output with a minimum of inputs, or to produce the maximum output with a given set of inputs.

Economics and Public Finance – The normative principles (2/3)

- **Equity (or fairness):**
 - Assess or measure social well-being of society as a function of the well being of individuals.
 - For instance, some equity social transfers to improve the situation of the destitute and reduce social inequalities.
 - Example: how to determine the effects of tax burdens and benefits of public expenditure, in social well-being?
 - Equity requires an interpersonal comparison of individual levels of well being.

Economics and Public Finance – The normative principles (3/3)

- **Negative freedoms:**
- The individuals should enjoy some spheres of autonomy immune to coercive public intervention.
 - Examples: In order to protect (negative) freedom, there should be put in place stringent limitations to state intervention in the personal (private/intimate) life of citizens
 - or taxes/expenditures should be low, in order to minimize political decision on goods and services and maximize private market choices.
 - Isaiah Berlin: *liberty in the negative sense involves an answer to the question: “What is the area within which the subject—a person or group of persons—is or should be left to do or be what he is able to do or be, without interference by other persons”. In Two concepts of liberty*

Economics and Public Finance – Diverging views

- **Positive analysis**

- Diverging views on
 - **more realistic models,**
 - **empirical analysis and verification.**

- **Normative analysis**

- Diverging views on
 - **hierarchical** normative criteria,
 - **level of conflict and juxtaposition** between criteria.

Economics and Public Finance – The functions of the state (1/4)

- What should the public sector do?
- According to Richard Musgrave, there are three basic functions of the state:



Economics and Public Finance – The functions of the state (2/4)

- **The Allocation function** is a **microeconomic perspective on the role of the public sector**. Here the aim is to promote an **efficient allocation of resources**
 - Guaranteeing the institutions needed for a well developed **market** (property rights, courts, ...)
 - Overcoming **market failures** (the supply of public goods, the reduction of asymmetrical information, the correction of externalities, ...)

Economics and Public Finance – The functions of the state (3/4)

- **The Distribution function** is also a **microeconomic perspective**: improving justice (or fairness) in society as a whole:
 - **Guaranteeing equal opportunities** to all citizens, namely providing equal access to primary health care and education, as well as, other social security or social assistance programs.
 - Overcoming income inequalities by achieving an **equitable distribution of income.**

Economics and Public Finance – The functions of the state (4/4)

- **The Stabilisation function** is a **macroeconomic perspective** on the role of public sector. Fiscal policy should promote:
 - Employment
 - Price stability
 - Economic growthand should reduce
 - Balance of payments' imbalances