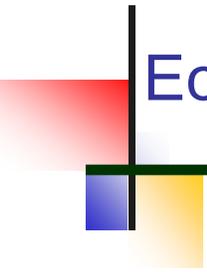


# Economics and Public Finance

---

## Lecture 3

### Public Finances and Theories about the Role of Government – PART 2



# Economics and Public Finance – This session outline

---

## **Chapter 1: Public finance and the role of the state** (conclusion)

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

#### 1.2.4. The imperfect state

#### 1.2.5. The classical approach to public finance, interventionism and constitutionalism

##### 1.2.5.1. *Classical* public finance and the minimal state

##### 1.2.5.2. Financial interventionism and the welfare state

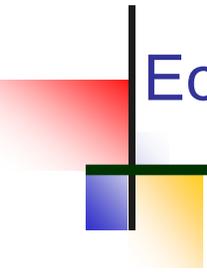
##### 1.2.5.3. Constitutionalism and the imperfect state

##### 1.2.5.4. Characteristics of *modern* public finance

# Economics and Public Finance – Readings

---

- **English:**
- MUSGRAVE, Richard (1996), "**The role of the state in fiscal theory**", International tax and public finance, Vol. 3, pp. 247–258. **sections 4.**
- Summary Chapter 2 (translation)., P.T. Pereira and Nunes, F. Economia e Finanças Públicas. Da teoria à Prática, Almedina
- Appendix of Chapter 2 of textbook . P.T.Pereira et al. Economia e Finanças Públicas, Escolar editora
- **Portuguese:**
- Chapter 2 of P.T.Pereira et al. (2022) Economia e Finanças Públicas, Escolar editora



## Economics and Public Finance – Core topics

---

- The imperfect state
- *Classical* public finance
- Public finance and welfare state (interventionism)
- Constitutionalism
- *Modern* public finance

## Economics and Public Finance – The imperfect state (1/3)

---

- Approach allegedly positive (predictive) of the conduct of public sector agents:
  - Is the state always serving the public interest?
    - Some authors argue that all individuals whether in **private choices** (of markets) or in the **public sector** only promote personal interests (**this is a crucial assumption to the development of the analysis**).
    - This position leads to a rather critical and somewhat negative view of the state.

## Economics and Public Finance – The imperfect state (2/3)

---

- **Historical grounds for the existence of the state**
  - **Hobbes (XVII): “*man is the wolf of the man*”.**
  - The state should hold the monopoly on the use of force to impose cooperative solutions to all individuals.
    - **Example:** A non-cooperative game (war/peace) between feudal lords 
  - With absolute power granted by its subjects, the state (“**the prince**”) is allowed to grow beyond optimal size by means of unlimited collection of tax revenues.
  - With the monopoly on the use of force (for instance, the armed forces) and the ability to tax, the state can become a “monster” nourishing itself beyond what would be desired by citizens.

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

---

- There are failures of government:
  - **Rent seeking:** favouring special individuals/firms (for example, by means of certain types of monopoly power and fiscal benefits).
  - **Bureaucracy:** governments sometimes have *less* information than administration officials who purportedly they control and oversee (e.g. see NISKANEN, William “*Bureaucracy and Representative Government*”).
  - **Political-economic cycles:** political decisions are made according to electoral cycles (reduce taxes/increase expenditure before elections and the opposite afterwards).
  - **Inconsistency in intertemporal choice:** endemic predisposition to generate public deficits in democratic regimes (*detrimental to future generations* that “do not yet vote”).
  - **Hence,** a need of Constitutional devices to constrain politicians.

## Economics and Public Finance – Role *versus* type (1/6)

<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>
The welfare state ( <b>WS</b> )	<i>Financial interventionism</i>
The imperfect state ( <b>IS</b> )	<i>Financial constitutionalism</i>
<b>WS and IS</b> (normative and positive approach)	<i>“Modern” public finance</i>

## Economics and Public Finance – Role *versus* type (2/6)

---

- **Classical public finance (and the minimal state)**
  - **Expenditure (the allocation function):** public goods (for instance, diplomacy and foreign affairs, defence, internal security, justice and infrastructures).
  - **Revenues:** mainly taxes (*do not accept public debt financing*).
  - **Budgetary balance:** balanced.
  - **The function of public finance:** to make public expenditures with minimal interference in the private agents' behaviour.
  - **Size of the public sector:** public expenditure between 8% to 12% of GDP.
- **Historical background: English classical school (XVIII-XIX Centuries).**

## Economics and Public Finance – Role *versus* type (3/6)

---

- **Financial Interventionism (and the welfare state)**
  - **Expenditure (allocation, distribution, and stabilisation functions):** public goods, distribution of income and budgetary policy.
  - **Revenues:** taxes and public debt.
  - **Budgetary balance:** public deficit is accepted (specially during recessions).
  - **The function of public finance:** to finance public expenditure in public goods, distribution of income and subsidies to economic activity.
  - **Size of the public sector:** public expenditure between 40% and 60% of GDP.
- **Historical background: Roosevelt's New Deal, Keynesianism.**

## Economics and Public Finance – Role *versus* type (4/6)

### • Financial constitutionalism (and the imperfect state)

- Given foreseeable *failures of government*, **fiscal rules** should be in place, preferably of **constitutional nature** to **limit the deficit and public debt**.
- **Federalism**, or a multi-tier government is a way to constrain the powers of the executive.
- **The function of public finance**: finance public expenditure in public goods, and distribution of income according to generic rules (to avoid rent seeking).
- **Size of the public sector**: public expenditure, 20%-30% of GDP.

**Historical background**: in the 80's and 90's of the XX Century: liberal principles with criticism to the *Keynesianism*; the EU **Stability and Growth Pact**.

## Economics and Public Finance – Role *versus* type (5/6)

---

- Some consensus on how far should “**healthy**” public finances comply with the *essential principles* are well established in what is now called “**modern public finance**”
- Such principles are strongly supported by the existing views put in place by EU countries as to how properly conduct public finance (an indepth analysis will be developed in Chapter 6 of this course).

## Economics and Public Finance – Role *versus* type (6/6)

- **Modern public finance** has some elements of **financial interventionism** (the size of the public sector, acceptance of public debt, ...) but also some elements of **constitutionalism**, such as:
  - **Sustainability:** well managed public deficit and public debt, *i.e.*, *intertemporal stability* – *Fiscal rules for deficit (<3% GDP) and debt (<60% GDP).*
  - **Priorities**
    - Resource allocation to sustain economic growth.
    - Promotion of social justice and reducing social inequalities.
  - **Financing of expenditure:**
    - Current expenditure financed by taxes.
    - Capital expenditure partially financed with debt (“golden rule”).
  - The existence of **state-owned enterprises.**

# Economics and Public Finance

## A non-cooperative game (war/peace)

		<i>Lord B</i>	
		Seek peace	Invade
<i>Lord A</i>	Seek peace	3, 3 (I)	1, 4 (III)
	Invade	4, 1 (II)	<b>2, 2</b> (IV)

*Prisoner's dilemma and the origin of the State.*

***Equilibrium of Dominant strategies: invade,***  
*permanent instability*



# Economics and Public Finance

## A non-cooperative game (war/peace)

		<i>Lord B</i>	
		Seek peace	Invade
<i>Lord A</i>	Seek peace	<b>3, 3</b> (I)	<b>1, 4</b> (III)
	Invade	<b>4, 1</b> (II)	<b>2, 2</b> (IV)



*The role of the state: to enforce peace  
(monopoly of violence) and **cooperation***

