Lecture 1: Introduction to Public Economics I (Erasmus)

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Course logistics

- Once per week 90 mnts lecture.
- Some writing assignments and problem sets.
- Office hours and QnA sessions.
- Wednesday 18:00-19:00 (and/or via Teams)

Our objectives for this course

- Learn methods and develop skills that can be useful:
  1. For understanding daily articles in economic press.
  2. For critically evaluating current economic policy debates.
  3. For understanding published reports from the major international economic and policy institutes.
  4. For working as applied economists in public institutions (e.g., Government Departments , Fiscal Councils) and/or private sector (e.g., Banks, Investment Funds).

Course material

<u>1. Textbooks:</u>

- Gruber, Jonathan., **Public Finance and Public Policy**, 6th Edition, MacMillan (2019).
- Hindriks J. and Myles D., **Intermediate Public Economics**, MIT Press (2006).

<u>2. Lecture slides</u>

<u>3. Additional Reading:</u> Recommended additional reading for each lecture.

- **<u>For general audience:</u>** Economic press (shared via twitter).
- **<u>For economists:</u>** International institutions publications and reports.
- **<u>For experts:</u>** Introductory research papers.

Twitter account

- Find or share interesting articles/lectures/webinars on economics.

@p_varthalitis

Public Economics

(based on
Gruber (2019) and
Saez (2021) slides)

Public economics: focus on the role of the Government in the economy

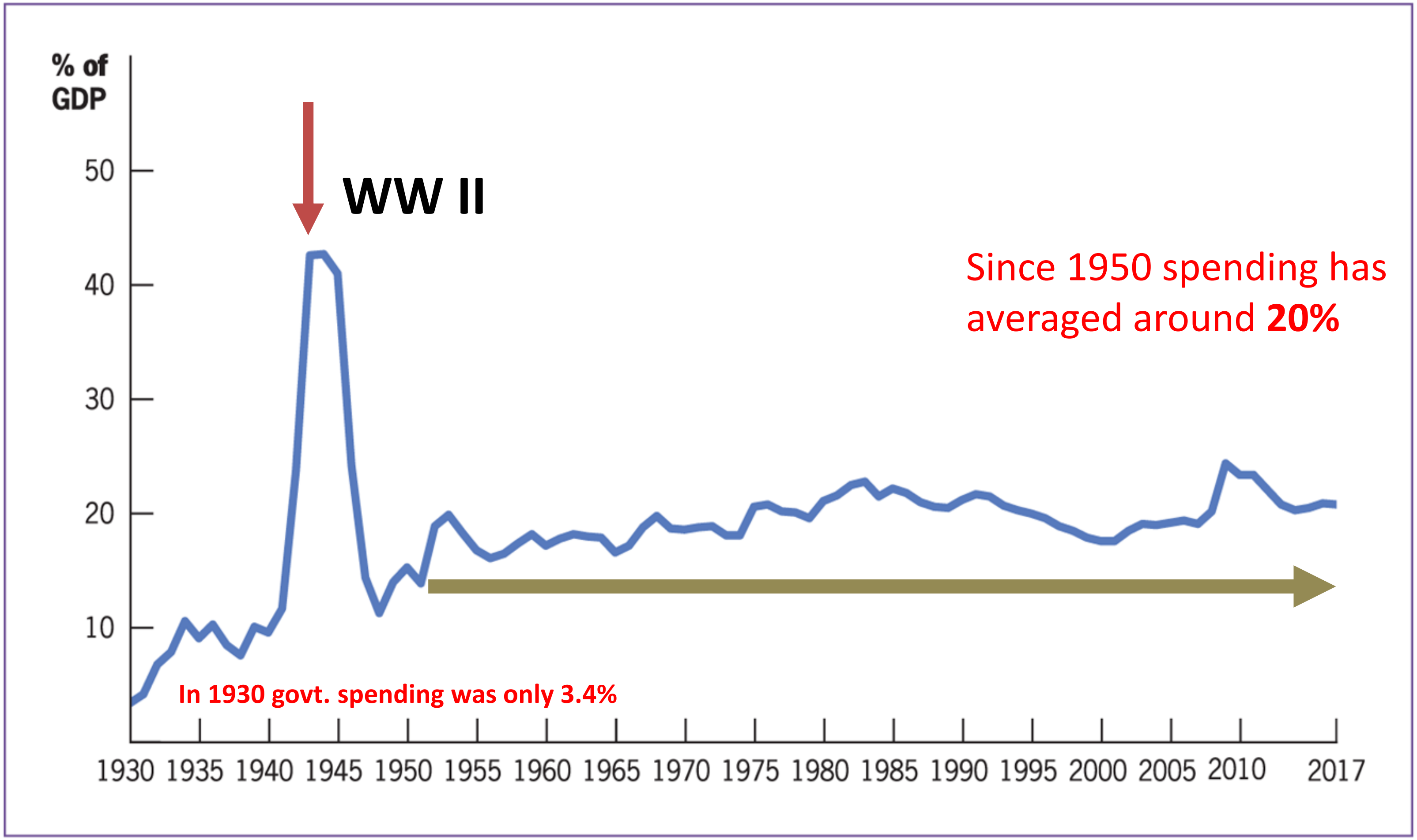
Why we study Public Economics?

Let's start with some facts on Government around the world:

- Government spending represents a large sector of the world economies.
- This spending is financed with taxes and/or with debt.
- Many sectors are also directly affected by regulation.

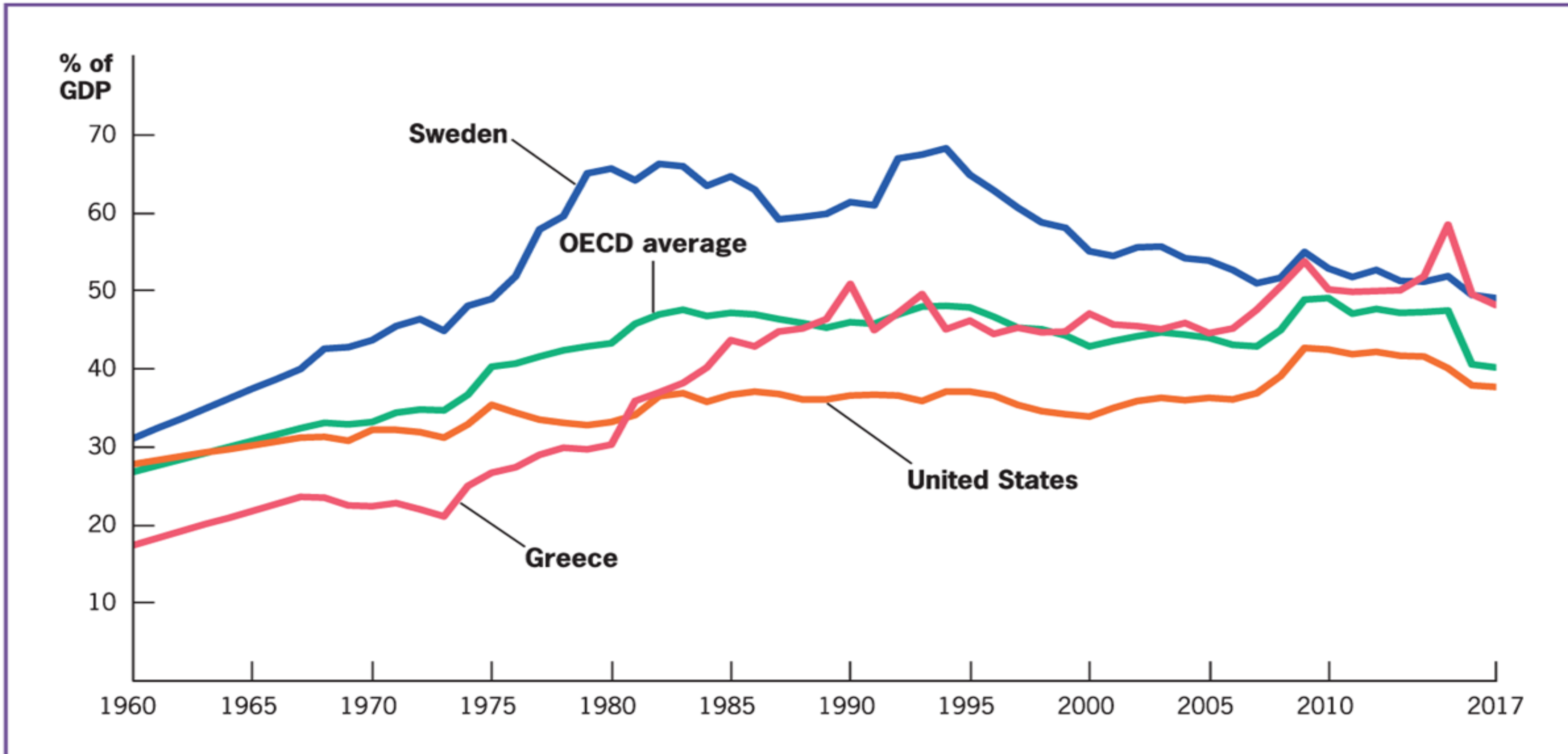
Public Finances facts

The Size and Growth of Government U.S. Federal Spending over 1930–2017 (% GDP)



Gruber, *Public Finance and Public Policy*, 6e, © 2019 Worth Publishers

The Size and Growth of Government: Total Spending across developed economies over 1960–2015 (% GDP)



Gruber, *Public Finance and Public Policy*, 6e, © 2019 Worth Publishers

In 1960, the United States was squarely in line with the average of the OECD in terms of the government spending share of GDP. Government growth was much faster in other OECD nations in the 1960s and1970s. All have now surpassed the United States.

Spending, Taxes and Deficits

Government have a budget just like households do.

- Revenues > spending → A budget surplus.

- Revenues < spending → A budget deficit.

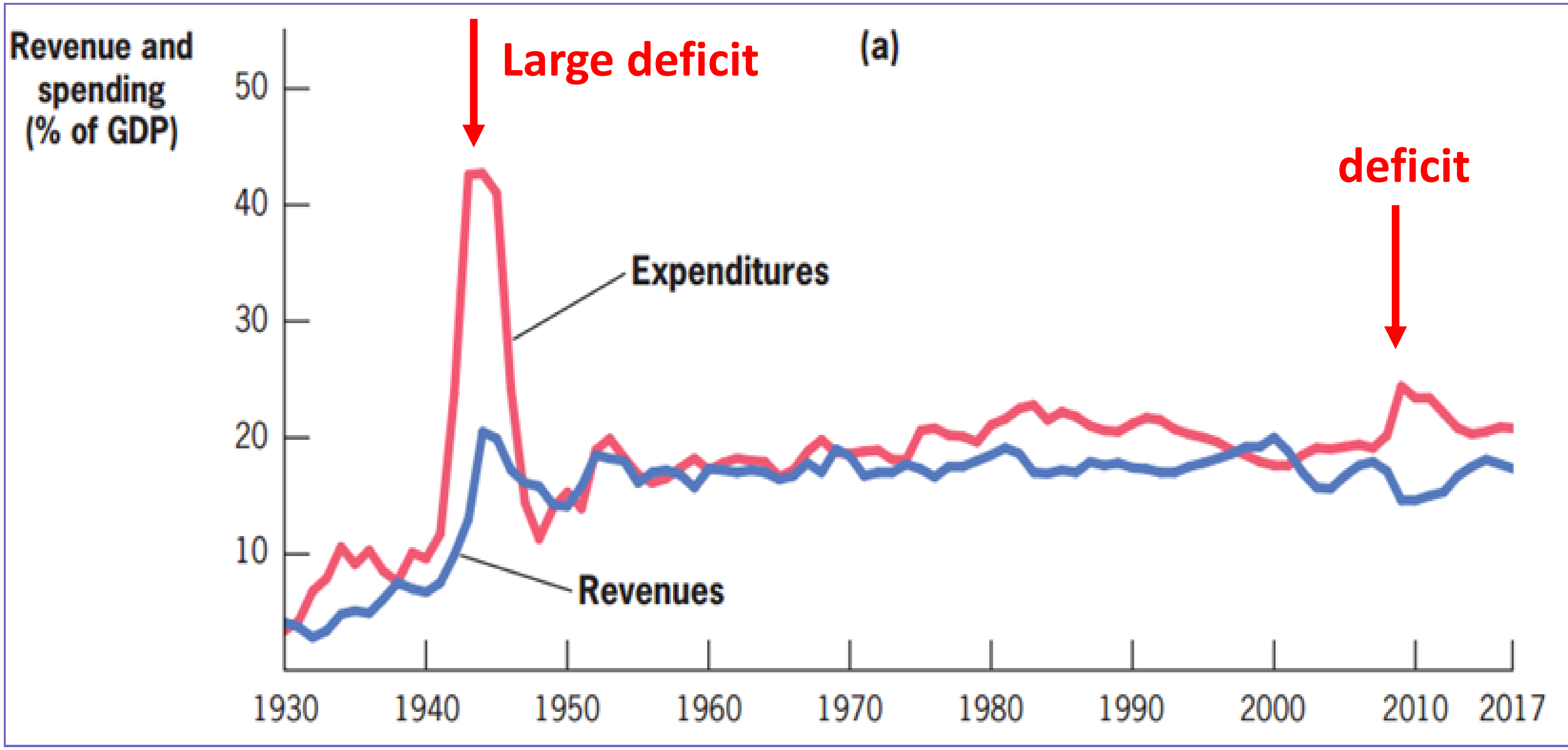
How are deficits financed?

- Each dollar of government deficit adds to the stock of government debt. That is, the deficit measures the year-to-year shortfall of revenues relative to spending.

- The debt measures the accumulation of past deficits over time.

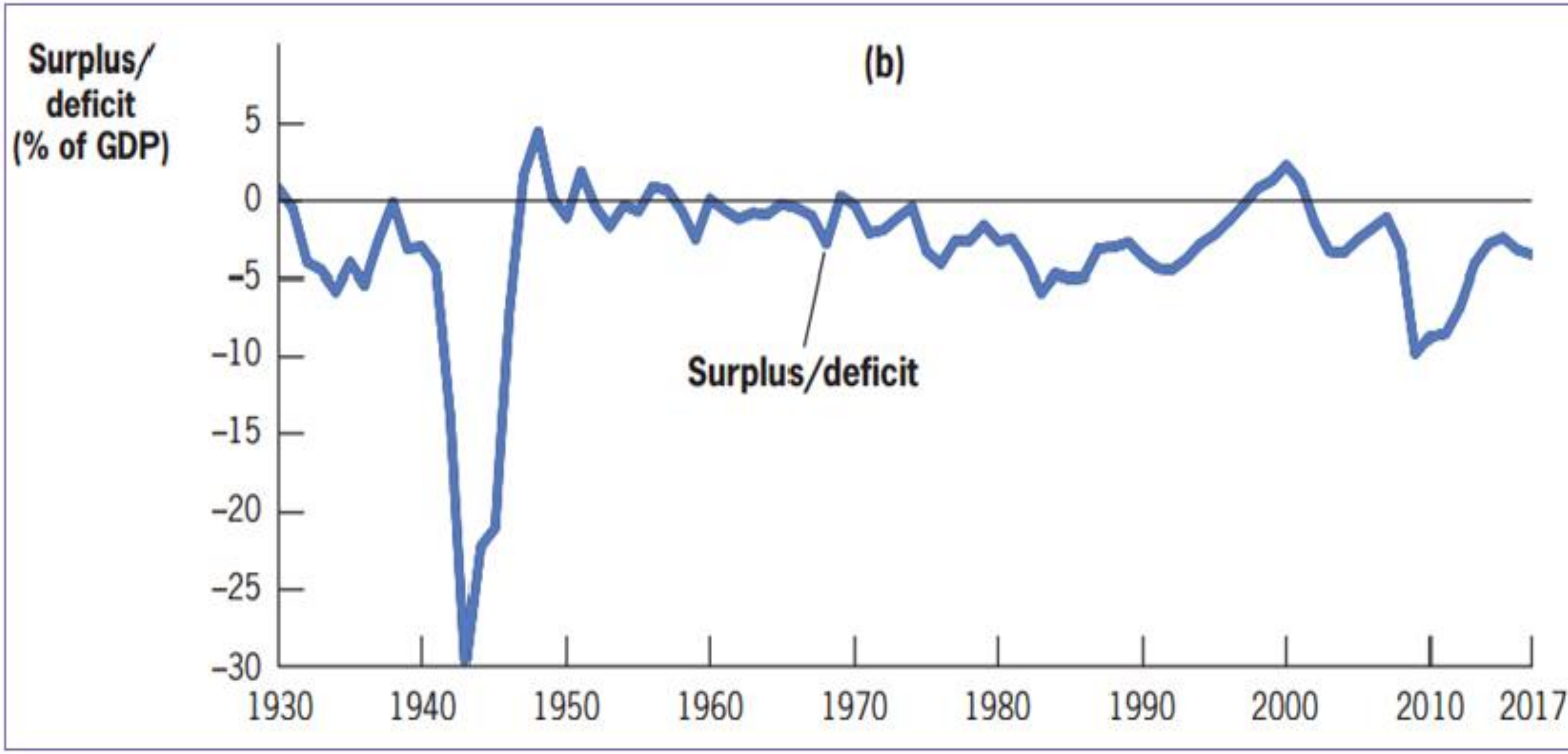
- Government debt must be financed by borrowing from either citizens of one's country or other nations.

Spending, Taxes, Deficits, and Debts: U.S. Federal Revenues and Expenditures over 1930–2017



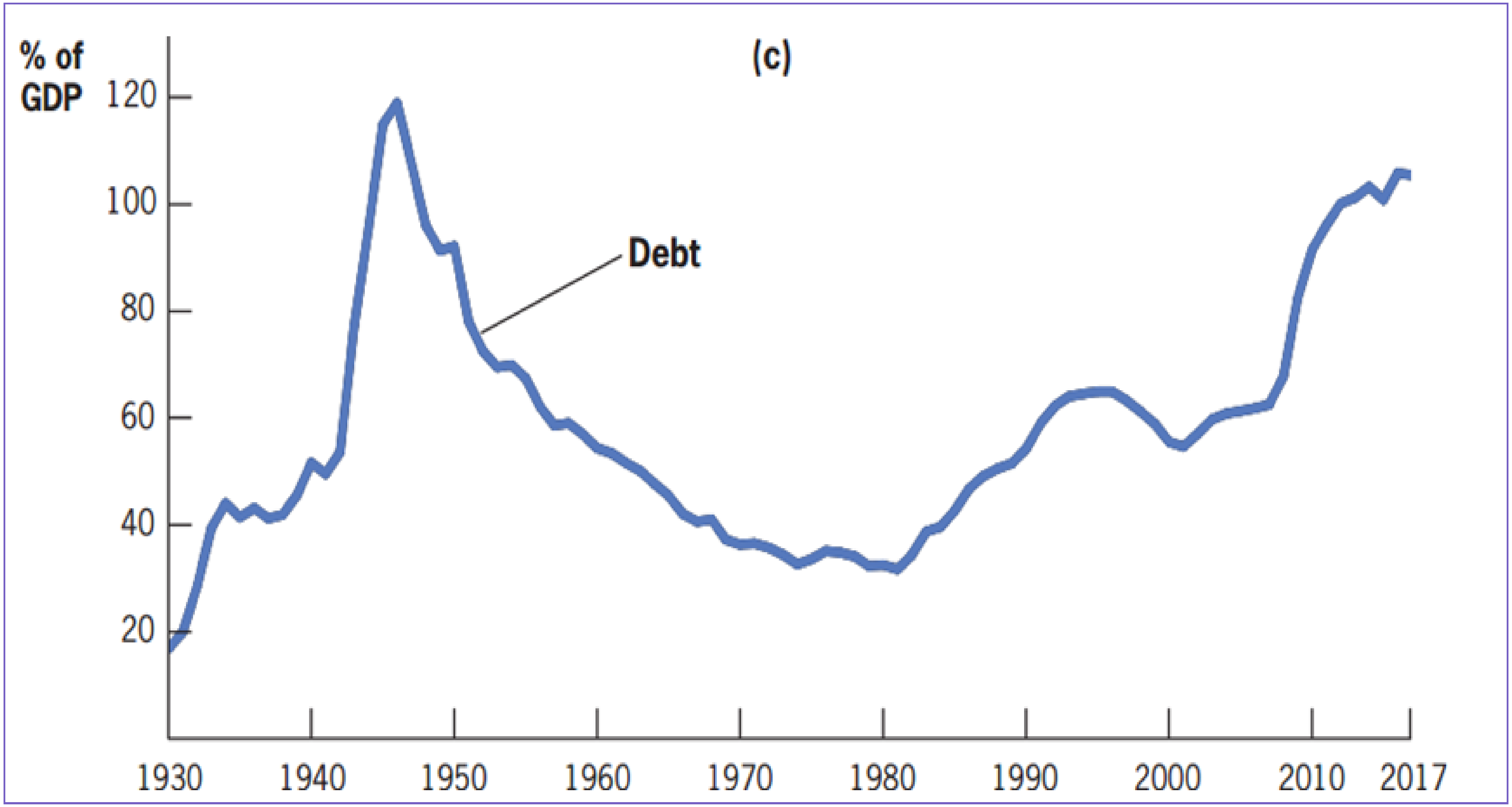
With the exception of an enormous increase in spending unmatched by increased taxation during World War II (1941–1945), the federal government's budget was close to balanced until the late 1960s.

Spending, Taxes, Deficits, and Debts: Federal Surplus/Deficit, 1930–2017



From the mid-1970s through the mid-1990s, there was a relatively large deficit, which shrank dramatically in the 1990s. The United States was back in deficit by the early twenty-first century, with the deficit becoming very large in the late 2000s.

Spending, Taxes, Deficits, and Debts: Federal Debt, 1930–2017



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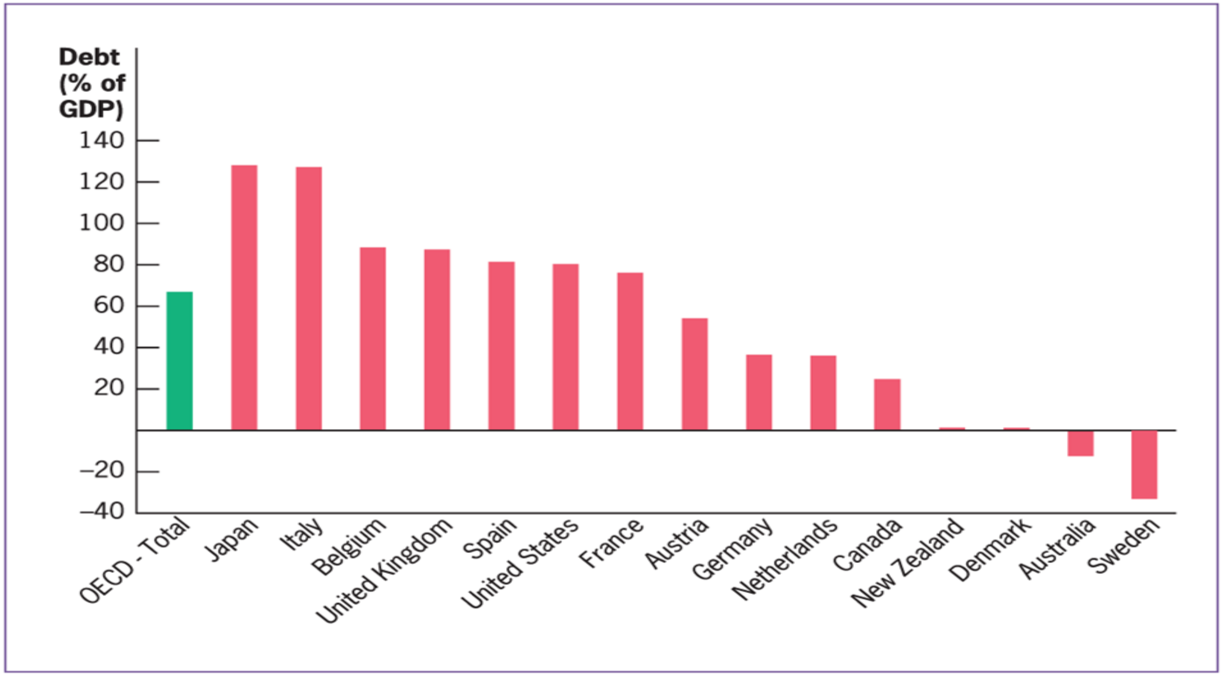
Spending, Taxes, Deficits, and Debts: Debt Level of OECD Nations in 2017



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The United States has higher debt levels than most other comparable nations, but its load remains well below that of others.

Key questions in public economics

1) When should the government intervene in the economy?

2) What is the effect of those interventions on economic outcomes?

3) Why do governments choose to intervene in the way they do?

When should the government intervene in the economy?

1) **<u>Market Failures:</u>** Market economy sometimes fails to deliver an efficient outcome

Governments intervene to improve this

2) **<u>Redistribution:</u>** Market economy generates inequality in economic recourses across individuals.

Main Market Failures

1) Externalities.

Example: Climate change

2)Imperfect competition.

Example: Natural monopoly

3)Imperfect or Asymmetric Information.

Example: Insurance contracts

Redistribution

- Even if the market outcome is efficient, society might not be happy with the market outcome.
- The market outcome might generate very high economic disparity across individuals.
- Governments use taxes and transfers to redistribute from Rich to Poor so as to reduce inequality.
- However, taxes and transfers might distort incentives to invest and/or work (efficiency costs).
- This creates the so-called <u>**equity-efficiency trade-off**</u>

What is the effect of those interventions on economic outcomes?

Interventions have direct and indirect effects.

- **Direct effects:**
  - The effects of government interventions that would be predicted if individuals did not change their behavior in response to their interventions.
    - With 49 million uninsured, providing universal health insurance covers 49 million people.

- **Indirect effects:**
  - The effects of government intervention that arise only because individuals change their behavior in response to the interventions.
  - If people drop private coverage, many more people may end up covered by the public plan.

Why do governments choose to intervene in the way they do?

- Governments do not always choose efficient or socially desirable outcomes.

- Governments face enormous challenges in figuring out what the public wants and how to choose policies that match those wants.

- **Political economy:** The theory of how the political process produces decisions that affect individuals and the economy.

- **Example:** Understanding how the level of taxes and spending is set through voting and voters' preferences.

Normative vs Positive analysis

- Positive analysis: Analysis of how things are.

The labour tax rate is equal to 40% at the same time GDP growth averages 2% over the last decade

- Normative analysis: Analysis how things should be.

- What is the optimal level of the labour tax rate that maximizes an objective function (e.g. social welfare)?