Public Finance Introduction

Instructor: Shunichiro BESSHO

About me

Course description

- ❑ Objectives
  - ■ Public finance at its introductory level
    - ❑ Normative issues: why we need governments to "correct" markets
    - ❑ Positive issues: how governments intervene markets
  - ■ Japan's public finance system
    - ❑ Think about desirable designs
- ❑ Methods
  - ■ Traditional lecture style
    - ❑ Classroom response system
    - ❑ Comments & questions through sli.do
  - ■ Introductory micro and macro are required
  - ■ Course materials are provided via Moodle

Evaluation etc.

- ❑ Evaluation
  - ■ Final 40%, small quiz 60% (via Moodle)
  - ■ Quiz for every week starts next next week (October 21)
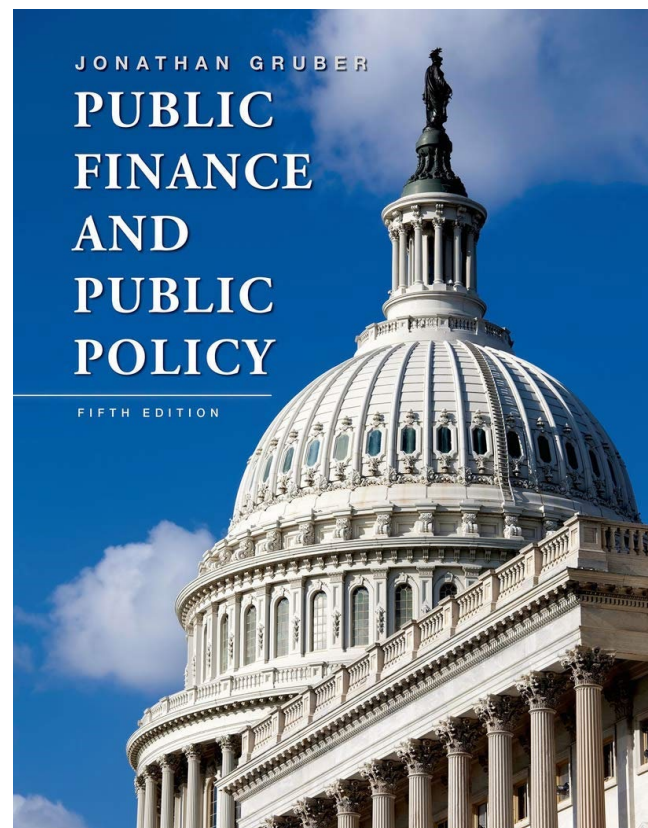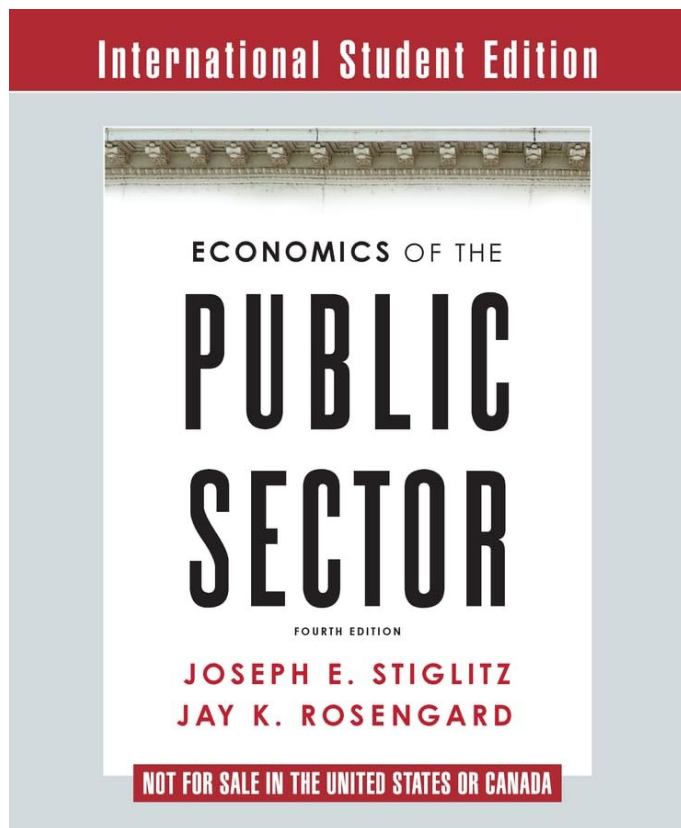 - ■ Open on Mondays, closed on Thursdays
- ❑ Office hours
  - ■ Not available
  - ■ Ask questions to shunbessho@waseda.jp

- ❑ Do NOT ask questions after the class.
  - ■ If you have any questions, ask them in class!
    - ❑ Useful for other students. They may have the same questions.
    - ❑ Asking via Sli.do is also fine (or better?)

Textbooks

- No textbooks, all materials are provided through Moodle

Plan

	日付	
1	10/7	Introduction
2	10/14	Roles of governments
3	10/21	Scope of governments and budget systems (1)
4	10/28	Scope of governments and budget systems (2)
5	11/11	Public investment and public capital
6	11/18	Local public finance and intergovernmental relationship (1)
7	11/25	Local public finance and intergovernmental relationship (2)
8	12/2	Tax systems and their effects (1)
9	12/9	Tax systems and their effects (2)
10	12/16	Public pension
11	12/23	Public health insurances
12	1/6	Budget balance
13	1/20	Ricardian equivalence
14	1/27	Review

What is public finance?
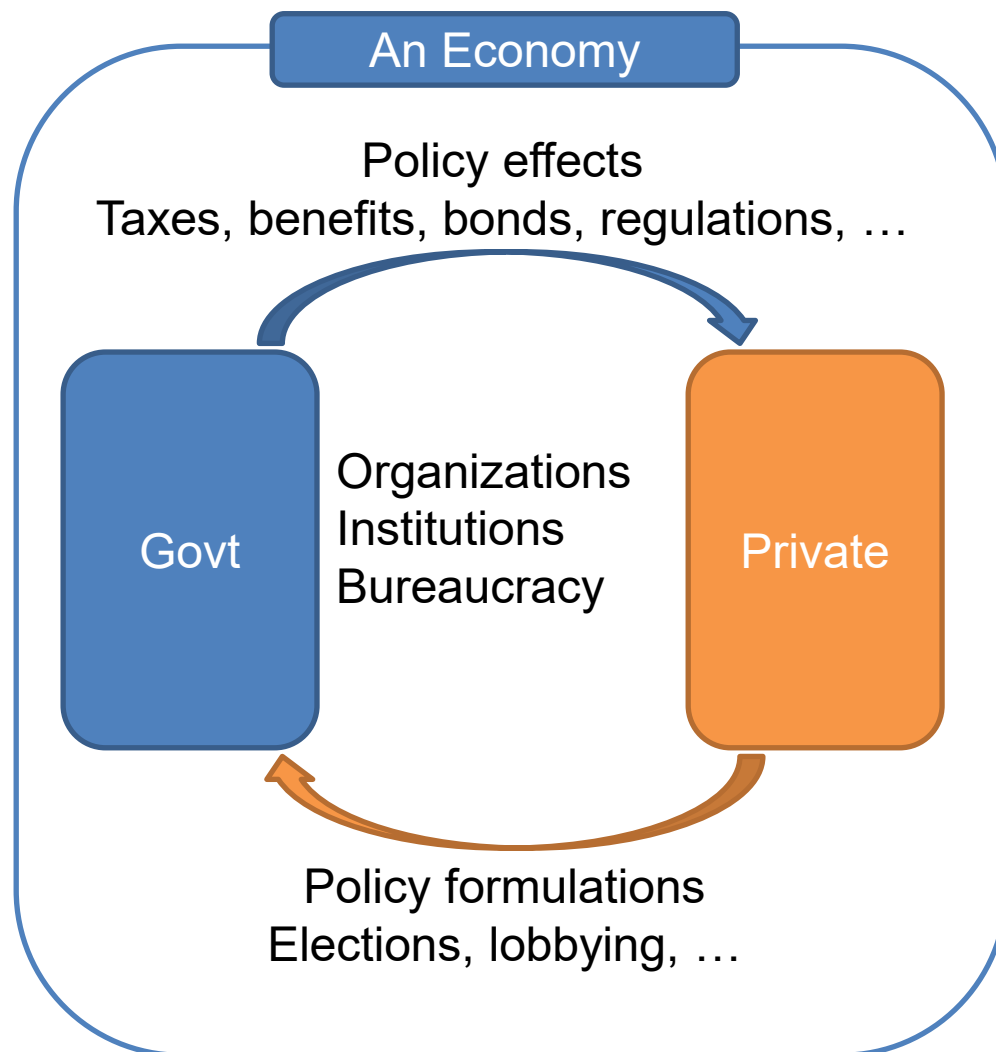
- ❑ Public Finance
  - ▪ Governments'
  - ▪ Economic activity
- ❑ Policies
  - ▪ Effects
  - ▪ Formulation
  - ▪ Optimal ones
- ❑ Examples
  - ▪ Tax on whom and how?
  - ▪ How much borrow?
  - ▪ Expend funds on what and how (much)?
  - ▪ What happens if taxed?

An Economy

Policy effects
Taxes, benefits, bonds, regulations, …

Govt

Organizations
Institutions
Bureaucracy

Private

Policy formulations
Elections, lobbying, …

"Schools" of public finance

- ❑ Public finance as a field of applied economics
  - ■ Mainstream: as a field of applied micro- and macroeconomics
    - ❑ Public economics
    - ❑ Economics of public sectors
  - ■ Traditions in each economy

- ❑ Big or small?
  - ■ Small governments: e.g., night-watchman state, freshwater economics
    - ❑ Market-oriented
    - ❑ Deregulation, tax cuts,…
  - ■ Big governments: e.g., welfare state, saltwater economics
    - ❑ Active fiscal policy
    - ❑ Generous social welfare, …

Subfields of public economics

- Theory: normative (should be), positive (as is)
  - Microeconomics
    - Price theory: effects of taxes / regulations on households / firms
    - Game theory: policy formulations, local public finance
  - Macroeconomics: business cycle, public pension, public bonds,…
- Empirical:
  - Statistical, econometric analysis. Case studies
    - How (much) do households/firms respond to policy (changes)?
    - How are policies formulated?
- Institutions
  - Legal system, practices, traditions,…
  - "restrictions"

- Intersections with other fields
  - With labor, urban, industrial organizations, political science, …

Recent topics of public finance

- Skyrocketing public debt in Japan
  - Long-term borrowing more than 250% of GDP
  - Tax hike? (VAT, consumption tax)
- Inflation
  - Lump-sum tax cuts
- Population ageing
  - Shrinking population
- Poverty, Income gap
  - Inequality
  - Gap between urban and rural areas
- Political process

Musgrave's three functions

❑ A classical theory

  ■ Easy to understand, but not consistent with micro & macro theory
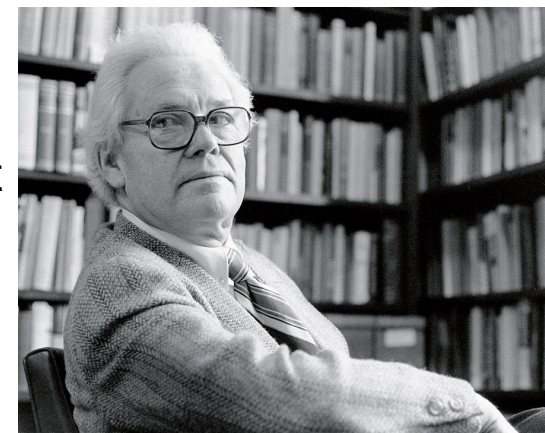
1. Resource allocation

  ■ As market fails, government intervenes to correct

  ■ Future generations: environmental issues
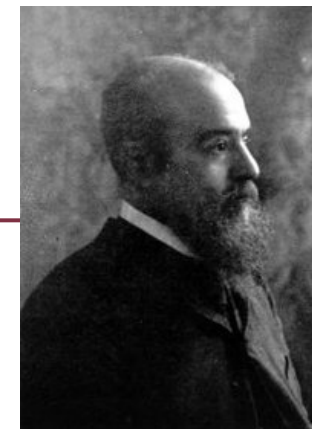
2. Income redistribution

  ■ Government corrects inequality

  ■ If no market failures, distribution may be unequal

3. Macroeconomic stabilization

  ■ Stabilizing the economy against business cycle

Market and Government

The 1ˢᵗ fundamental theorem of welfare economics

Market failure

If market is perfect,
Competitive eqn is Pareto efficient

If market does not work

Even if market works

Outcome is not desirable
w.r.t. Pareto criteria

Outcome is not desirable
w.r.t. other (not Pareto) criteria
(equality, fairness, stability…)

How to achieve Pareto
efficient outcome

Government
steps in

How to achieve equal, fair or
stable outcome

What, when, how should government do?
(How should policy be?)

Government failure

But government is not perfect

Government failure

- ❑ Governments may not intervene markets properly because…
  - ■ Even worse outcome
- ❑ Inside lags
  - ■ Recognition lags
  - ■ Decision lags: Preparing laws / budgets
  - ■ Implementation lags
- ❑ Outside lags
  - ■ Transmission lags: e.g., monetary policy
- ❑ Distortion of political process
  - ■ Election system, voting behavior
  - ■ Lobbying of interest groups
  - ■ (public choice, political science)
- ❑ Inefficiency
  - ■ No market pressure, principal-agent problems, X-inefficiency ….
  - ■ Karpoff (01, JPE): Most major Arctic discoveries were made by private expeditions. Most tragedies were publicly funded.