**What is public finance?**

During the global financial crisis that started in 2007, the economy of Kenya and of other countries across the globe slowed a lot. To boost growth, most countries resorted to stimulus packages- huge spending on public works and other projects in a bid to inject cash and hence boost consumer demand that drives the economy. In Kenya, for example, a stimulus package was passed that led to construction of fish ponds for farmers and model schools in every constituency.

The controversies over the proper role of the government in dealing with this economic crisis raise the fundamental questions addressed by the branch of economics known as *public finance*. The goal of public finance is to *understand* *the proper role of the government in the economy*. On the expenditures side of public finance, we ask: What kind of services should the government provide, if any? Why should the government be spending billions of shillings on local schools, health care, and new electrical grids? More generally, why is the government the primary provider of goods and services such as roads, education, and health care, while the provision of goods and services such as clothing, entertainment, and property insurance is generally left to the private sector? On the revenue side of public finance, we ask: How much should the government tax its citizens, and how should that amount be related to the economic circumstances of those individuals? What kinds of activities should be taxed or be given tax relief in difficult times? What effect do taxes have on the functioning of the economy?

In the simplest terms, public finance is the study of the role of the government in the economy. In public finance, we seek to answer the following questions:

* When should the government intervene in the economy?
* How might the government intervene?
* What is the effect of those interventions on economic outcomes?
* Why do governments choose to intervene in the way that they do?

We examine each of these questions below.

1. **When Should the Government Intervene in the Economy?**

To understand the reason for government intervention, think of the economy as a series of trades between producers (firms) and consumers. A trade is efficient if it makes at least one party better off without making the other party worse off (if this condition is met, we say a trade is Pareto efficient). The total efficiency of the economy is maximized when as many efficient trades as possible are made. The fundamental lesson of basic microeconomics is that in most cases the competitive market equilibrium is the most efficient outcome for society—that is, it is the outcome that maximizes the gains from efficient trades. The free adjustment of prices guarantees that, in competitive market equilibrium, supply equals demand. When supply equals demand, all trades that are valued by both producers and consumers are being made. Any good that consumers value above its cost of production will be produced and consumed; goods that consumers value at less than their cost of production will not be produced or consumed. If the competitive market equilibrium is the most efficient outcome for society, why do governments intervene in the operation of some of these markets? There are two reasons why governments may want to intervene in market economies: market failures and redistribution.

**Market Failures**

The first motivation for government involvement in the economy is the existence of market failures, problems that cause a market economy to deliver an outcome that does not maximize efficiency.

Market failures impede the operation of the market forces leading to inefficiency. Take the case of the millions of Kenyans who have no medical insurance. They choose not to have the medical insurance either because the cost is too high (poverty) or because they don’t really value it. When such a person gets ill, they may not access proper medical attention, and are more likely to pass on the disease to others- raising the total cost of medical care for the country as a whole. This gives rise to the idea of **social costs** and **social benefits;** having medical insurance is not just beneficial to myself but to others too, and the decision or lack of capability to buy medical insurance is not only costly to the individual but to the society as a whole. Thus the fact that the market for health insurance leaves out so many people uninsured is an illustration of a market failure.

The above market failure is also an example of a ***negative externality****,* whereby my decision imposes on others costs that I don’t bear. As a result of this negative externality, I am underinsuring myself from society’s perspective because I don’t take into account the full costs that my medical decisions impose on others.

If the competitive equilibrium does not lead to the efficiency maximizing outcome, there is the potential for efficiency improvement through government intervention. Since the government can take into account not only my costs and benefits but also the costs and benefits to others as well, the government can more accurately compare the social costs to the social benefits, and induce me to buy insurance[[1]](#footnote-1) if the total benefits exceed the total costs. As we emphasize in answering the fourth question, however, the fact that the private market outcome is not efficiency maximizing does not imply that government intervention will necessarily improve efficiency.

**Redistribution**

The second reason for government intervention is redistribution, the shifting of resources from some groups in society to others. Think of the economy as a pie, the size of which is determined by the social efficiency of the economy. If there are no market failures, then the private market forces of demand and supply maximize the size of the pie; if there are market failures, there is the potential for the government to increase the size of the pie. The government may care not only about the size of the pie, however, but also its distribution, or the size of each person’s slice. Society may decide that the resource allocations provided by the market economy are unfair; for example, society may view another shilling of consumption by a very rich person as less valuable than another shilling of consumption by a very poor person. The primary way to correct such misallocations is through government interventions that redistribute resources from those groups that society has deemed “too well off” to those groups that society has deemed “not well off enough.” In some cases, society can undertake redistributions that change only the distribution of the pieces and not the size of the pie itself. Usually, however, redistributing resources from one group to another will entail efficiency losses. These losses occur because the act of redistribution causes individuals to shift their behavior away from the efficiency -maximizing point. For example, if we tax the rich to distribute money to the poor, then this tax may cause the rich to work less hard (since they don’t get to take home as much money from their work) and the poor to work less hard (since they don’t have to work as hard to maintain their living standards). When these groups work less hard, they don’t produce goods that would be valued by consumers at more than they cost to produce, so social efficiency is reduced. In general, then, there will be a trade -off between the size of the pie and the distribution of the pie, which we call an **equity–efficiency** trade -off. Societies typically have to choose between pies that are larger and more unequally distributed and pies that are smaller and more equally distributed.

1. **How Might the Government Intervene?**

Having decided whether to intervene, the next question is how the government should do so. There are several different general approaches that the government can take to intervention.

**Tax or Subsidize Private Sale or Purchase**

One way that the government can try to address failures in the private market is to use the *price mechanism,* whereby government policy is used to change the price of a good in one of two ways:

* Through *taxes,* which raise the price for private sales or purchases of goods that are overproduced, or
* Through *subsidies,* which lower the price for private sales or purchases of goods that are under produced.

Returning to the example of health insurance, one policy option would be for the government to subsidize the purchase of health insurance to reduce the number of uninsured.

**Restrict or Mandate Private Sale or Purchase**

Alternatively, the government can directly restrict private sale or purchase of goods that are overproduced, or mandate private purchase of goods that are under-produced and force individuals to buy that good. The government for example mandates all motor vehicle owners to buy insurance, and for employers to pay NHIF for employees.

**Public Provision**

Another alternative is to have the government provide the good directly, in order to potentially attain the level of consumption that maximizes social welfare. In Kenya, most people have insurance that is provided to it at least in part by the government (through NHIF); Canada and many other developed nations have publicly provided health insurance for their entire populations.

**Public Financing of Private Provision**

Finally, governments may want to influence the level of consumption but may not want to directly involve themselves in the provision of a good. In such cases, the government can finance private entities to provide the desired level of provision. As you can see, there is a wide spectrum of policy options. When considering how to intervene, policy makers should carefully evaluate alternative options before deciding which option is best. This evaluation leads naturally to the third question: How can we evaluate alternative policy options?

1. **What Are the Effects of Alternative Interventions?**

Answering this third question requires that policy makers understand the implications of each policy option under consideration. This evaluation is the focus of *empirical public finance,* which involves gathering data and developing statistical models to assess how people and firms might respond to policy interventions.

In assessing the effects of government interventions, policy makers must keep in mind that any policy has *direct and indirect effects*.

**Direct Effects** The **direct effects** of government interventions are those effects that would be predicted if individuals did not change their behavior in response to the interventions. For example, suppose that the government wants to try to address the problem of the uninsured by providing free public health care. The government computes that, with 15 million uninsured, and an average cost of treating each uninsured person of Ksh. 2,000 per year, this intervention would cost Ksh. 30 billion per year. This could then be compared with the costs incurred by the government currently (when no free health care is provided).

**Indirect Effects** The **indirect effects** of government intervention are effects that arise only because individuals change their behavior in response to the interventions. For example, being uninsured is something that people can change about themselves; it is not a fixed personal characteristic such as being male or female. By providing free health care to those who are uninsured, the government provides strong incentives for those paying for their own health insurance to drop that insurance and take part in the government’s free health care program.

1. **Why Do Governments Do What They Do?**

Finally, as students of public policy, we must recognize that we cannot simply model governments as benign actors who intervene only to mitigate market failures or assure the proper distribution of social resources. In practice, the government faces the difficult problems of aggregating the preferences of millions of citizens into a coherent set of policy decisions, raising the fourth question of public finance: Why do governments do what they do? Note the important difference between this question and the second (How should governments intervene?). The second question was a *normative* question, one concerned with how things should be done. This is a *positive* question, one concerned with why things are the way they are.

To answer this question, we turn to the tools of **political economy,** the theory of how governments make public policy decisions.Governments face enormous challenges in figuring out what the public wantsand how to choose policies that match those wants. In addition, governmentsmay be motivated by much more than simply correcting market failures orredistributing income. Just as there are a host of market failures that can interferewith the welfare -maximizing outcome from the private market, there area host of *government failures* that can lead to inappropriate government interventions.Politicians must consider a wide variety of viewpoints and pressures,only two of which are the desire to design policies that maximize economicefficiency and redistribute resources in a socially preferred manner.

1. This is why, for example, the government has made it mandatory for motor vehicle owners to buy insurance. [↑](#footnote-ref-1)