Introduction to Public Economics

Governments play a crucial role in much economic life.

- Regulatory structure (financial markets, pharmaceuticals, labor markets, civil rights).
- Taxes.
- Public goods and social welfare spending.
- Macroeconomic stabilization.

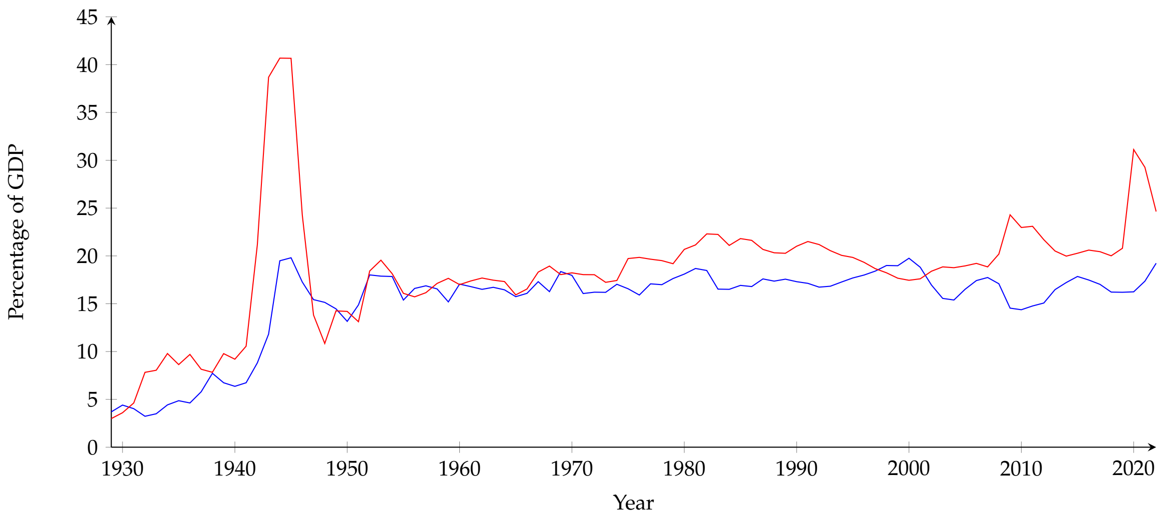
Public finance is the study of the role of government in a market economy, primarily focusing on taxes and spending.

Reasons to study public economics:

- Governments have a lot of power in the realm of economic welfare.
- Nearly every economic transition is mediated by the government.
- It can inform debates about the appropriate role of government regarding taxes, healthcare, climate change, etc.
- The government is large.
  - It employs 1/6 of the US Workforce.
  - Tax revenue is approximately 27% of the United States's Gross Domestic Product.

The government (as measured by tax revenue/GDP) greatly increased in size between 1910 and 1940 (due to the establishment of the welfare state and various wars).

Federal Spending (red) and Tax Receipts (blue) as a proportion of GDP



### Two Motivations for Government Intervention

- Market Failure
- Redistribution

The First Welfare Theorem states that *in the absence of market failure*, markets will yield a result along the **utility possibilities frontier** (i.e., the set of all maximized utilities given the current market).
However, there are a lot of market failures:

- Externalities (pollution, network effects from vaccination)
- Public Goods (public safety)
- Asymmetric Information (market for lemons)
- Individual Mistakes (failure to save)
- Imperfect Competition (oligopoly, cartelization)

Policymakers also have to consider the *equity-efficiency tradeoff* in redistribution (i.e., some redistributive acts might reduce total utility)

### Government as Social Cooperation

- Economists tend to have a narrow view of human behavior, but social cooperation undergirds much of the levels of societal coordination beyond individuals (i.e., families, communities, countries, global superstructures)
- Human societies of old depended on social cooperation for protection and taking care of the young, sick, and old.
- Modern states are the primary form of coordination today.
- Humans reveal their social nature (or social solidarity) via the size of the government (informal and formal).

Activity 1

# Activity: Introduction to Public Economics

## Econ 308

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Dani Rodrik and Stefanie Stantcheva (2021) begin their recent working paper as follows:

> One of the biggest challenges that countries face today is the very unequal distributions of opportunities, resources, income and wealth across people. Inclusive prosperity — whereby many people from different backgrounds can benefit from economic growth, new technologies, and the fruits of globalization — remains elusive. To address these issues, societies face choices among many different policies and institutional arrangements to try to ensure a proper supply of productive jobs and activities, as well as access to education, financial means, and other endowments that prepare individuals for their participation in the economy. In this paper we offer a simple, organizing framework to think about policies for inclusive prosperity.

1. This framework is illustrated with the 3x3 matrix below. Where might the following public policies fit in this matrix?

   (a) cash transfers to low income people
   (b) estate/inheritance taxation (based on estate of deceased)
   (c) healthcare; primary education
   (d) minimum wage; apprenticeships
   (e) on-the-job training; labor laws; protectionist trade policy
   (f) progressive income taxation; wealth taxes; corporate taxes
   (g) public higher education
   (h) R&D tax credits; antitrust policy
   (i) social insurance (e.g., unemployment insurance, disability insurance, Social Security)
   (j) universal basic income

| | | At what stage of the economy does policy intervene? | | |
|---|---|---|---|---|
| | | **Pre-Production Stage:** shape the endowments with which people enter the workforce | **Production Stage:** shape the employment, investment, and innovation decisions of firms | **Post-Production Stage:** redistribute income and wealth after they have been realized |
| **Which income group is the target of the policy?** | **Bottom** | c | d | a f i j |
| | **Middle** | c g | d e | f i j |
| | **Top** | c | h | b f i j |

2. At which stage do you think it is most important for policy to intervene? Why?

   Pre-production: helps to equalize endowments to equalize opportunity