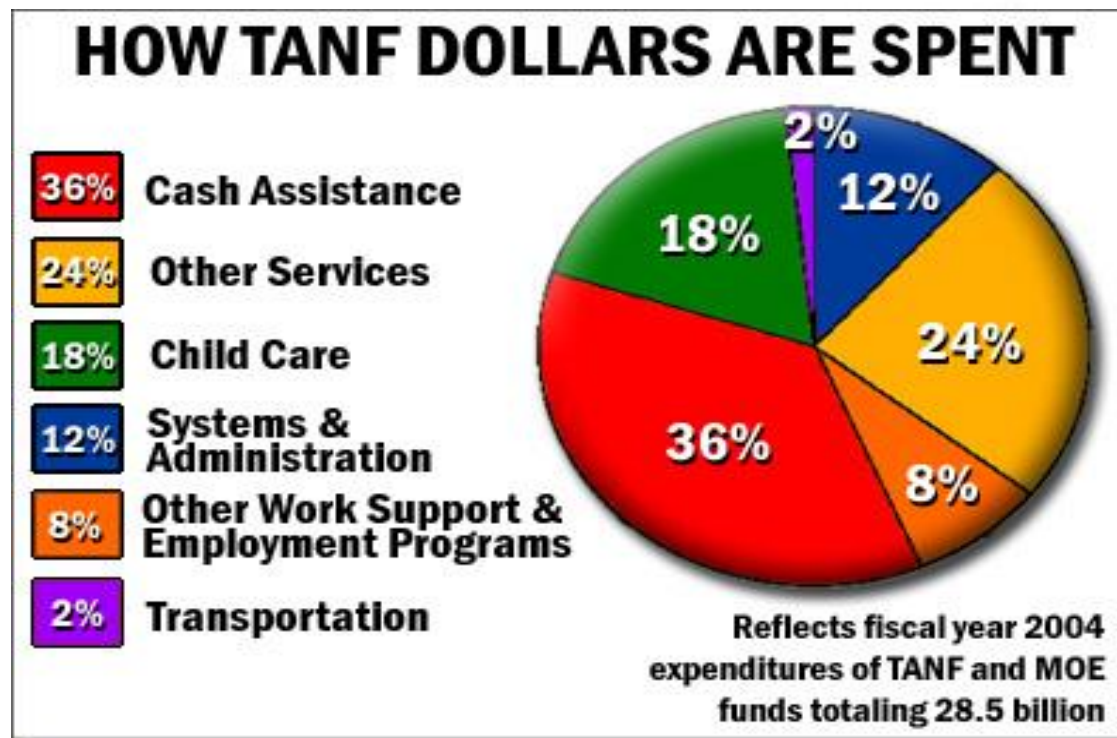


HOW DO THEORETICAL TOOLS OF PUBLIC FINANCE WORK?

Group 3

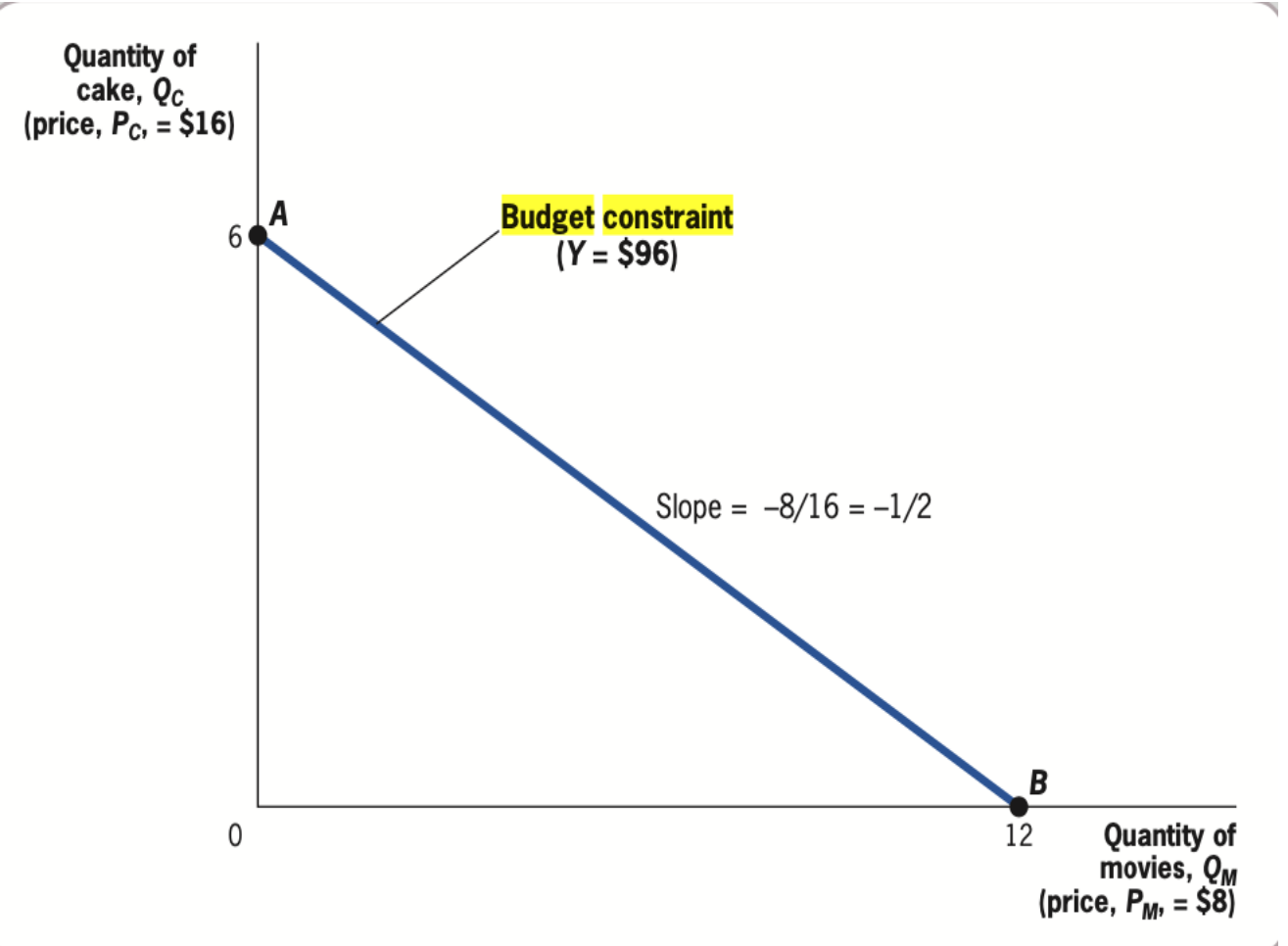


The TANF program was created in 1996 by a major overhaul of the *cash welfare* system in the United States. The cash welfare system distributes money from taxpayers to low-income families.



Budget Constraints

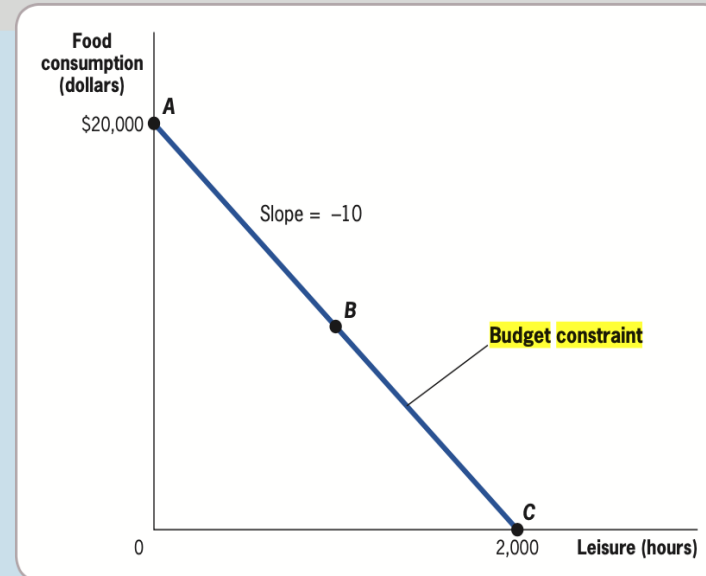
Andrea's budget constraint is represented mathematically by $Y = P_C Q_C + P_M Q_M$, where Y is her income, P_C and P_M are the prices of cakes and movies, and Q_C and Q_M are the quantities of cakes and movies she buys. That is, this expression says that her expenditures on cakes and on movies add up to be her total income.



Identifying the Budget Constraint

Suppose that Joelle can work up to 2,000 hours per year at a wage of \$10 per hour, that she has no other source of income, and that there is not yet a TANF program in place.

■ ■ ■ ■ FIGURE 2-8



The Consumption–Leisure Trade-off •
Joelle has a choice of taking more leisure and consuming less or taking less leisure (working harder) and consuming more. If she takes no leisure, she can have consumption of \$20,000 per year; but if she takes 2,000 hours of leisure, her consumption falls to 0. This is represented by the **budget constraint** with a slope of -10 , the relative price of leisure in terms of food consumption.

2. The effect of TANF on the budget constraint.

The TANF program, which is time limited, assists families with children when the parents or other responsible relatives cannot provide for the family's basic needs.



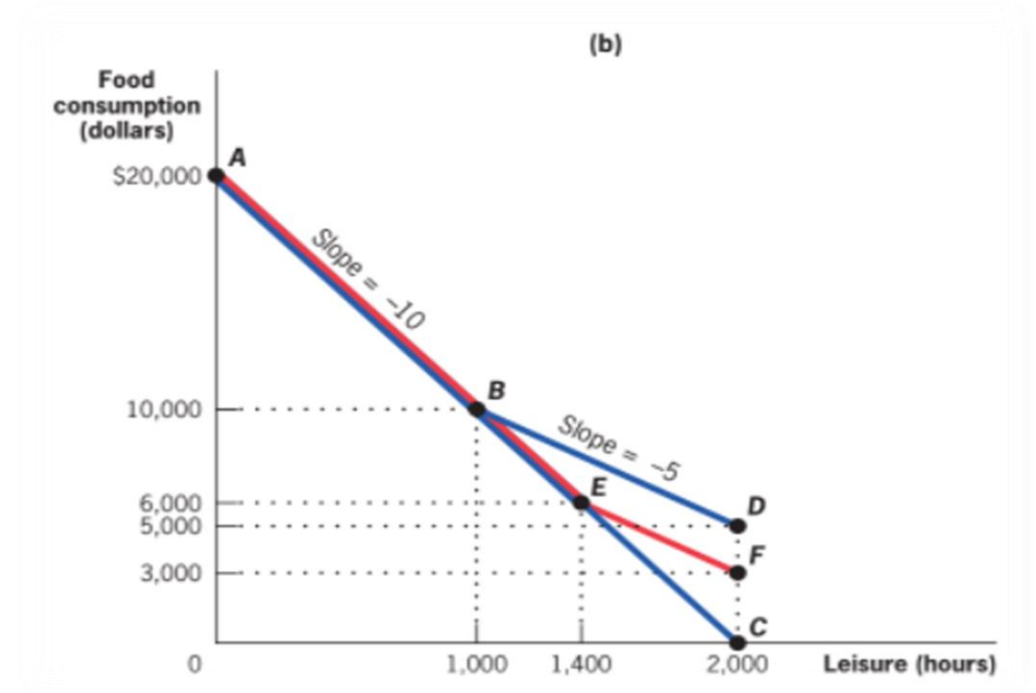
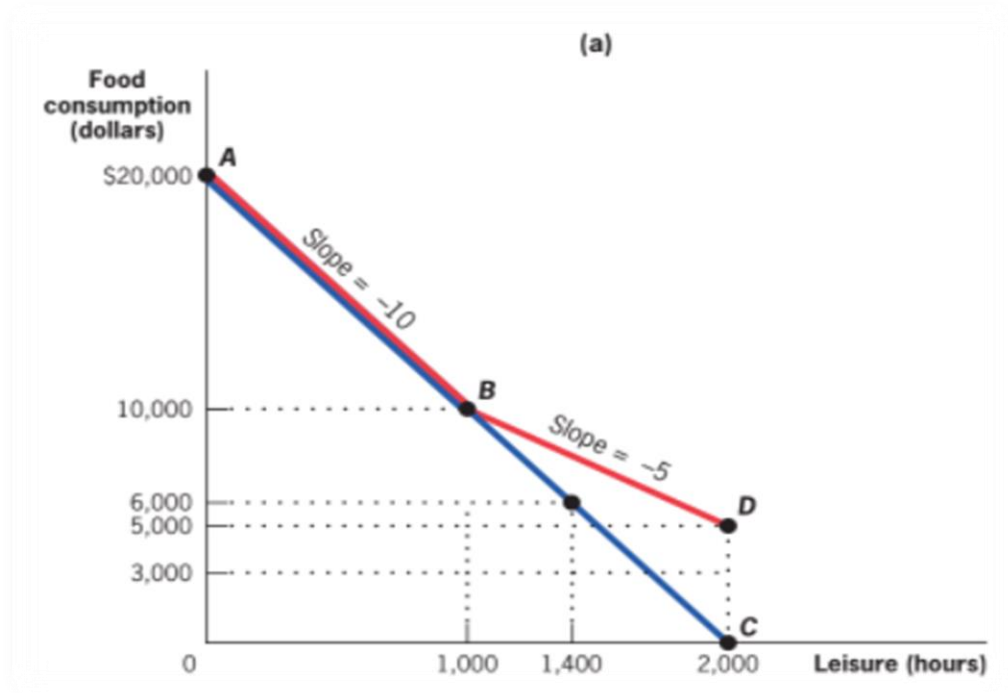
2. The effect of TANF on the budget constraint.

Benefit guarantee, or the baseline amount of money to which recipients are entitled when they enroll in the program.

Benefit reduction rate, the rate at which the baseline amount is reduced if recipients have other income.



The Budget Constraint with TANF



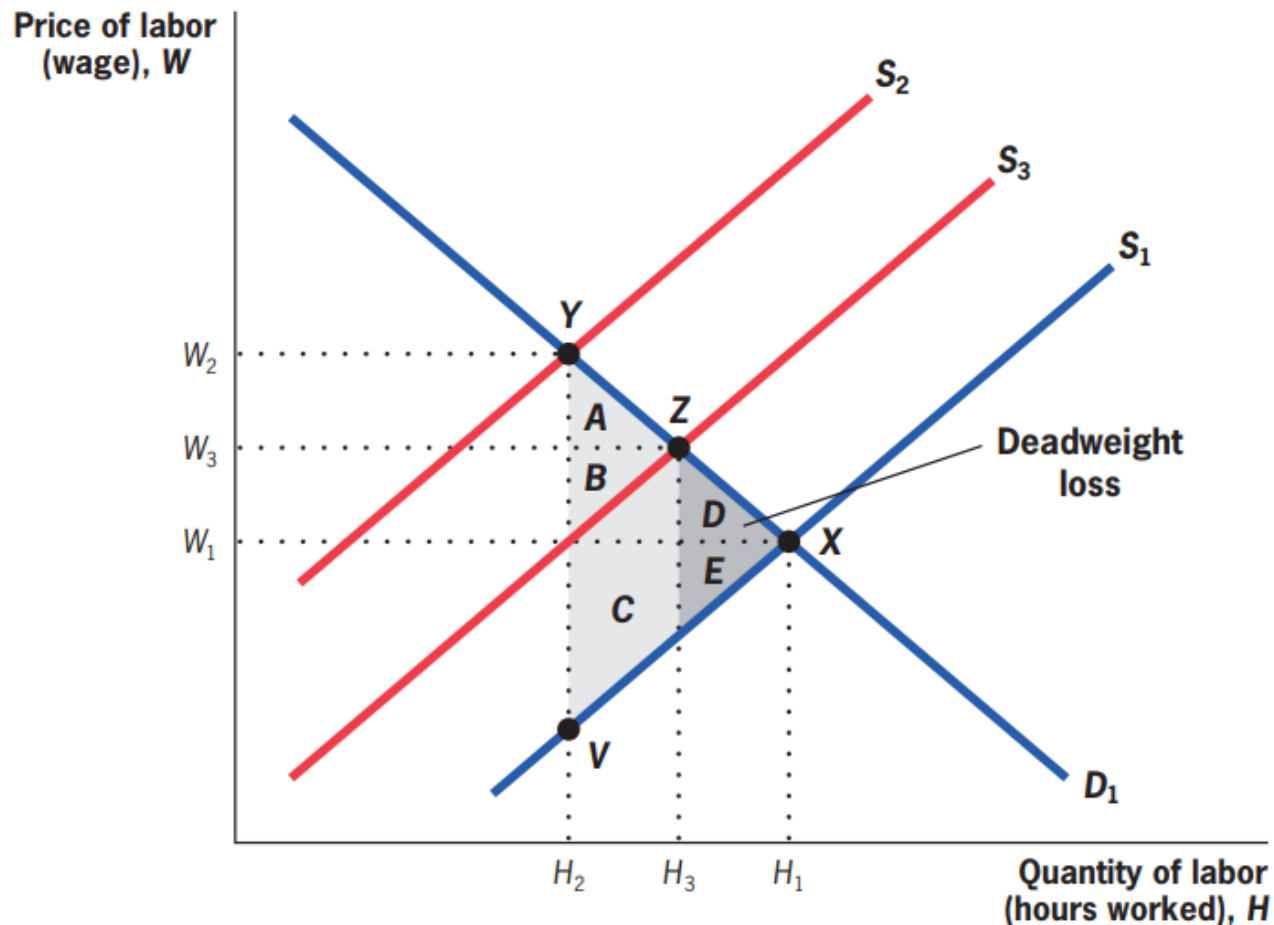
2.4 Welfare Implications of Benefit Reduction: The TANF Example Continued

The equilibrium and social welfare tools developed in Section 2.3 can be applied to evaluate the benefits and costs to society of reducing TANF benefits. The benefits are the improvement in efficiency from removing a barrier to labor supply by single mothers, raising single mothers' labor supply and raising the size of the social surplus.

3. Efficiency

We can apply the tools of welfare analysis to model the welfare implications of cutting TANF benefits. Figure 2-17 shows the market for labor services by single mothers. The price of labor, the wage (W), is on the vertical axis; the amount of hours worked in aggregate in the market (H) is on the horizontal axis





Welfare Implications of TANF

- Without Tanf, the labor market is in competitive equilibrium at point X , the intersection of S_1 and D_1 . When Tanf is introduced, labor supply falls to S_2 , and the market moves to a new equilibrium at point Y , creating a deadweight loss of $A + B + C + D + E$. When Tanf benefits are reduced, supply increases to S_3 , and social efficiency rises by $A + B + C$.

Equity:

Given this large efficiency gain, why not cut TANF benefits? Indeed, why have the TANF program at all? As just noted, governments have programs such as TANF because their citizens care not only about efficiency but also about equity, the fair distribution of resources in society. For many specifications of social welfare, the competitive equilibrium, while being the social efficiency-maximizing point, may not be the social welfare-maximizing point.



4. Size-Maximizing Bureaucracy



Most of the lesson, we assume that Government operates in a way that **MAXIMIZE SOCIAL WELFARES.**

Realistically speaking, that is not the case.

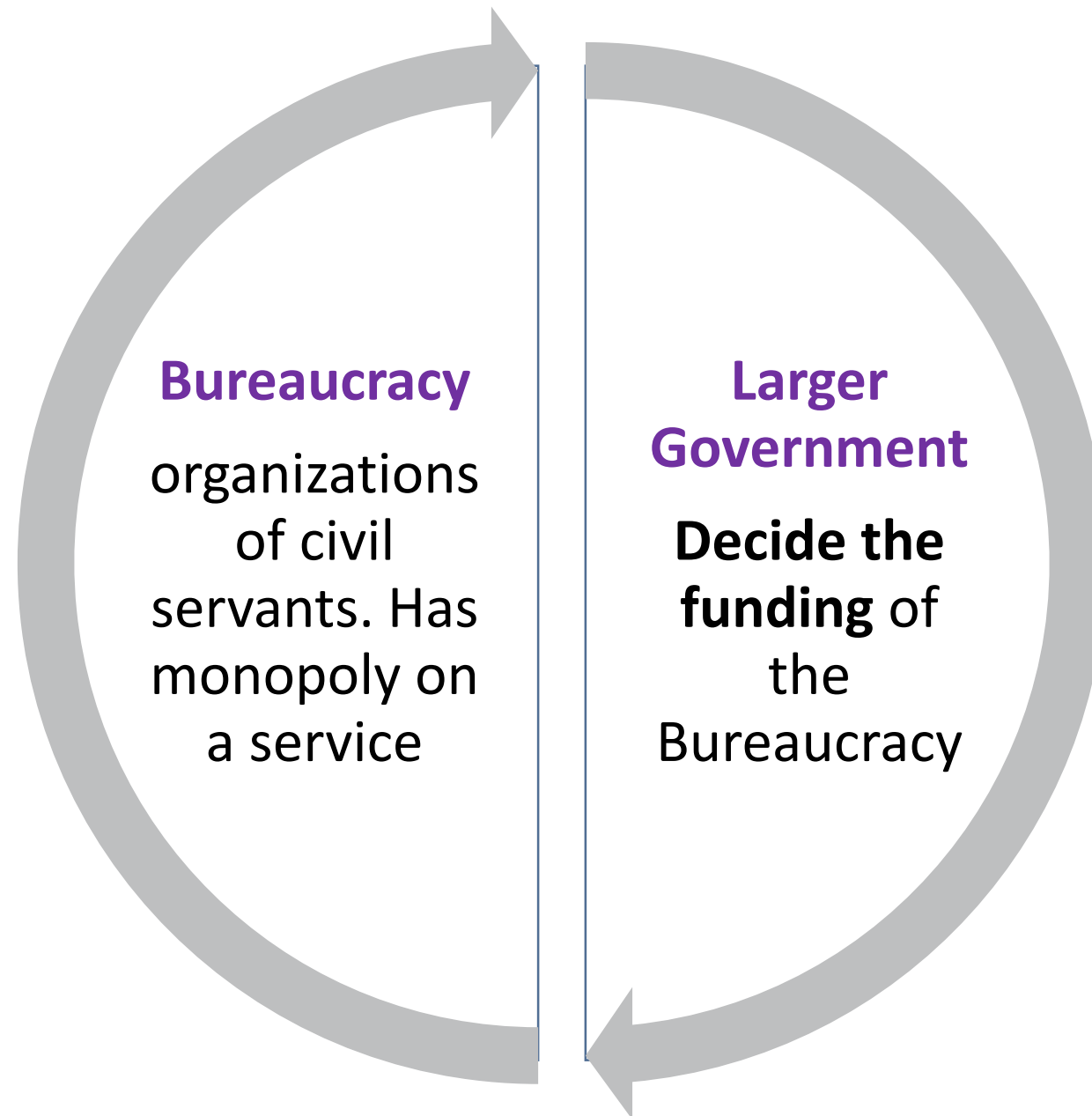
→ *Government failure*

Government failures:

- The *inability or unwillingness* of the government to act primarily in the **interest of its citizens**.

Sources of government failure that we will discuss today:

- Size-Maximizing Bureaucracy
- Leviathan Theory
- Corruption



Size-Maximizing Bureaucracy *(William Niskanen)*

Bureaucracy prioritise maximizing its own budget, over *social efficiency*

- The more services the department supplies, the higher will its budget be
- Takes on inefficient project, where the **marginal benefit is lower than marginal cost** (project with huge budget but only a tiny amount of benefit)

Size-Maximizing Bureaucracy:

In other words:

- Normal firms expand until **marginal revenue = marginal cost**
- While for Bureaucracies, **Total cost = Total benefit** instead

(Sources: Wikipedia)

Some examples of Size-Maximizing Bureaucracy

5. Leviathan theory



Niskanen's theory assumes that individual bureaucrats try to maximize the size of their own agencies and that a larger government tries to rein them in.

In contrast, Brennan and Buchanan (1980) see these two entities (bureaucrats and large government) as one monopolist (which they call "Leviathan") that simply tries to maximize the size of the public sector by taking advantage of the electorate's ignorance.

This view of government can explain the many rules in place in the United States and elsewhere that explicitly tie the government's hands in terms of taxes and spending.

Likewise, a number of U.S. states have passed laws limiting the ability of local communities to raise property taxes (taxes imposed on the value of homes and businesses and the land they are built on)





There is no reason to have these types of “roadblocks” if a benevolent government is maximizing social welfare, but with a Leviathan government, they may be a means of putting a brake on inefficient government growth



Another way to combat the Leviathan tendencies of government is to ensure that politicians face electoral pressure to deliver public services efficiently, as suggested by a study by Besley et al. (2005). These authors studied the impact of the increased “political competition” in the southern United States during the twentieth century due to the enfranchisement of blacks and other groups.

6. Corruption



The abuse of power by government officials in order to maximize their own personal wealth or that of their associates

Corruption can take many forms, but the common theme is that government officials accept bribes or profit from public funds.

Corruption is an international phenomenon





Corruption is more common in countries with less developed economies. In these countries, people often intend to hold high positions in the leadership to corrupt. For some economically developed countries with high per capita income, individuals with large assets have just started participating in politics to become leaders..



Corruption also appears more rampant in political systems that feature more red tape, bureaucratic barriers that make it costly to do business in a country..