

**UNIVERSITY OF ATHENS**  
Department of Economics

**PUBLIC FINANCE**

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<http://eclass.uoa.gr/courses/ECON123>

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**LECTURE 1**

**Government and the Economy**

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**Role of the Government in the  
Economy**

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**Roles of Government in the Economy**

In the Wealth of Nations, **Adam Smith** enumerated four “justifiable” functions of government:

1. the duty of protecting the society from violence and invasion by other independent societies;
2. the duty of protecting every member of society from injustice and oppression of every other member of society;

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**Roles of Government in the Economy**

3. the duty of establishing and maintaining those highly beneficial public institutions and public works which are of such a nature that the profit they earn could never repay the expense to the individuals to provide them and which it, therefore, cannot be expected that they would be supplied in adequate quantities; and
4. the duty of meeting expenses necessary for support of the sovereign

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## Definition of Public Finance

- Public Finance – the field of economics that analyzes government taxation and spending policies
- Public Sector Economics
- Public Economics

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## Definition of Public Finance

- **Public Finance** deals with the **taxing** and **spending** activities of various governmental units.
- However, the resources for all government expenditures ultimately come from the **private** sector.
- So, public sector decisions affect private sector decisions in many ways both large and small.
- The overall impact of public sector decisions must be examined in the context of their **impact** on private sector behavior.

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## Government as a Decision Unit

- Public finance studies the economic activity of the government as a unit.
- In studying this **unit**, in some sense, we treat it as analogous to a person.
- For example in studying the economic activity of a person we would want to know
  - how the person earns his/her income and how much the person earns.
  - how the income is spent.
  - **how the individual makes decisions or choices among alternatives.**

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## Government as a Decision Unit

- Similarly, in studying the public economy, we want to know
  - how factually the government secures its revenues -- both **process** and **amounts** --.
  - how the revenues are spent.
  - **how the government makes decisions or choices among alternatives.** Here the analysis becomes very complicated because, while for an individual we are examining a **single mind**, for governmental decisions we are looking at a **collective mind** or political process. Moreover, an individual's decision is one among many decisions, government decisions can impact the behavior of many individuals.

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## The Field of Public Finance

- **Public Finance** is the area of economic theory devoted to the study of how government policy -- tax and expenditure policy-- affects **microeconomic behavior** as well as aggregate economic activity.
- Public finance does not concentrate on financial arrangements of government but on the economic consequences of public policy on
  - Resource allocation: Allocation
  - Income distribution: Distribution
  - Level of economic activity: Stabilization

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## ALTERNATIVE VIEWS OF GOVERNMENT'S ROLE IN SOCIETY

- ❑ Organic view of government
- ❑ Mechanistic view of government

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## Organic view of government

- ❑ Society is conceived of as a natural organism. Each individual is a part of this organism, and the government can be thought of as its heart and mind.
- ❑ Historically, it has taken extreme forms

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## Organic view of government

- For example, Yang Chang-chi, Mao Tse-tungs, ethics teacher, states that “A country is an organic whole just as the human body is an organic whole. It is not like a machine which can be taken apart and put together again. The individual has significance only as part of the community and the good of the individual is defined with respect to the good of the whole.”
- *In the organic approach, the community is stressed above the individual.*

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## Mechanistic view of government

- The government is not part of the social machine. It is a contrivance -- another machine-- created by individuals to better achieve their individual goals.
- *The individual rather than the group is at the center of the system.* (Government as a democratic process)

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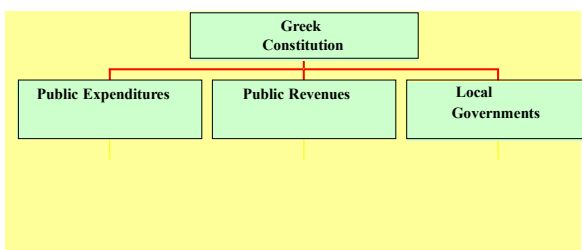
## Legal Framework of Public Finance

- **Political Institutions** constitute the rules and generally accepted procedures that evolve in a community for determining what government does and how government outlays are financed

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## Legal Framework of Public Finance



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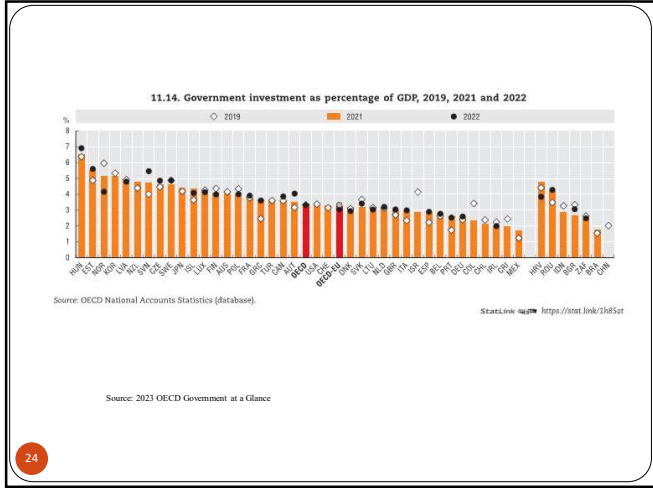
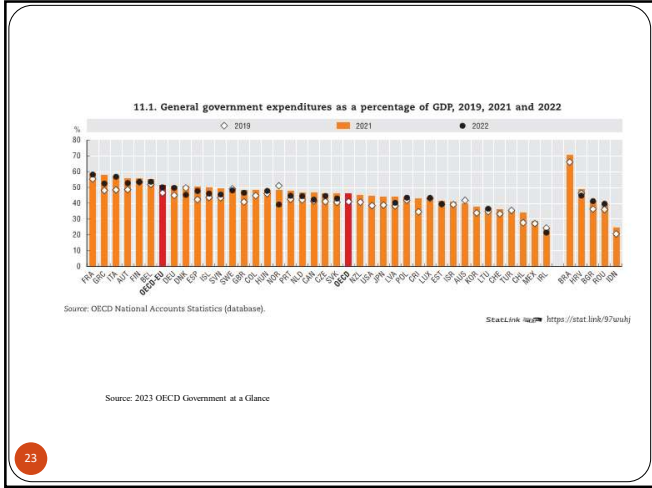
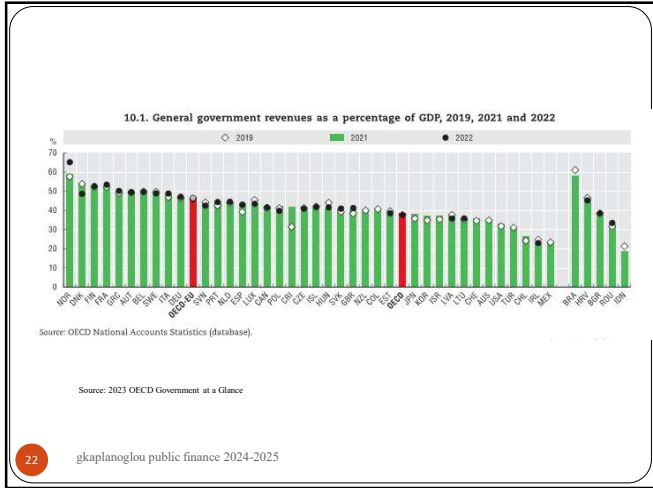
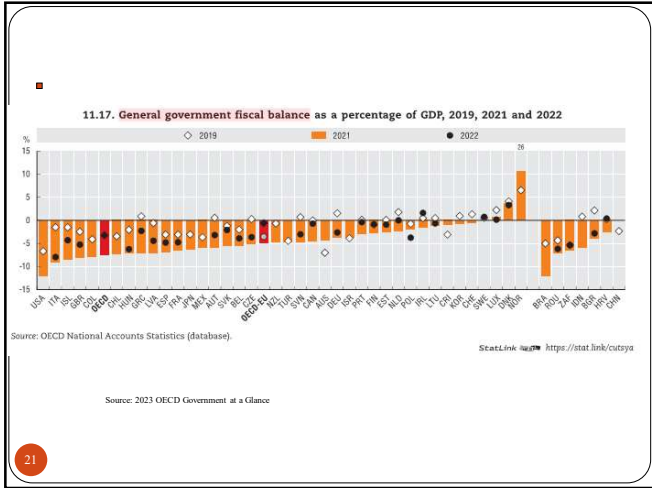
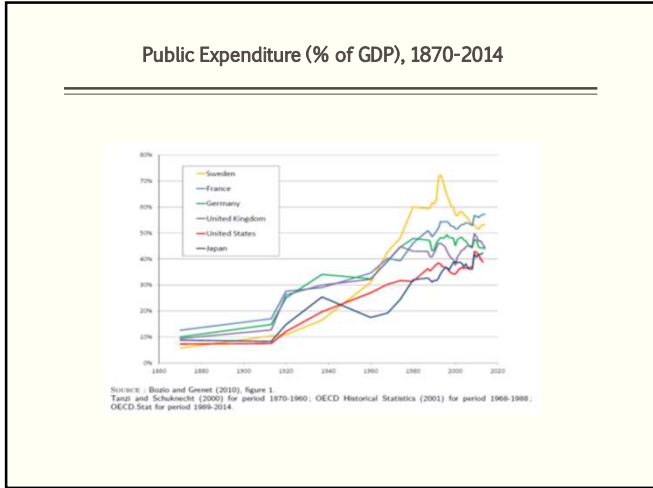
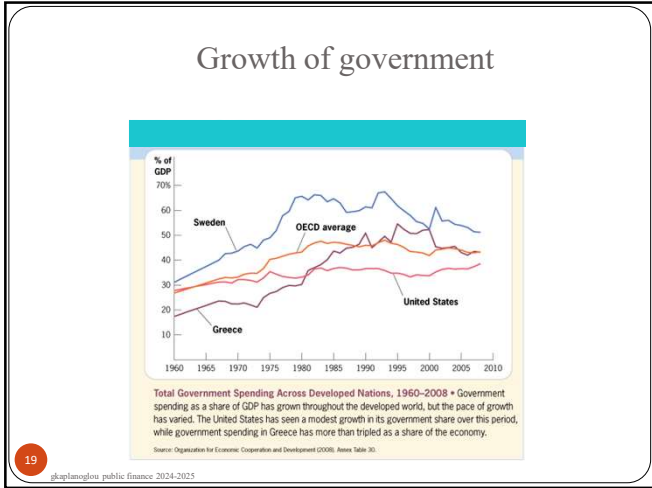
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## GROWTH OF GOVERNMENT

- To what extent are society's economic resources controlled by the public sector?
- Has this control over resources been growing over time?

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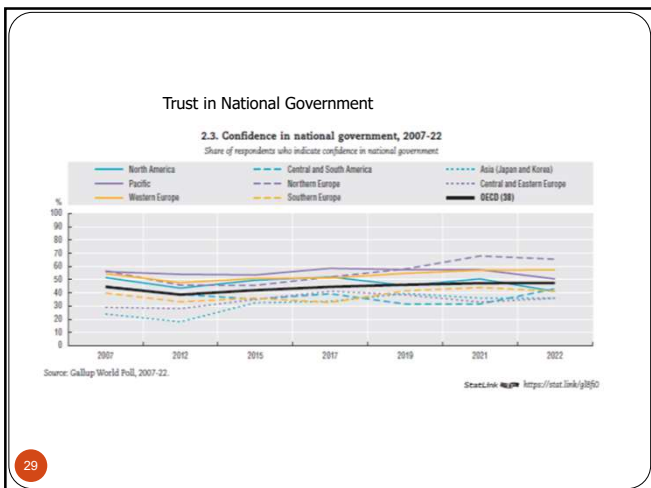
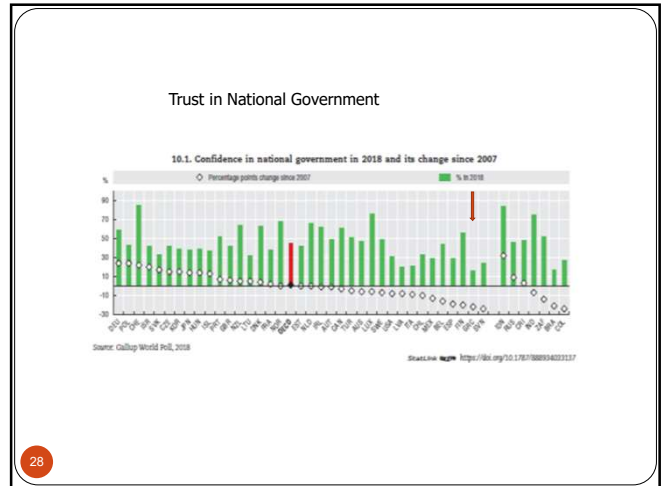
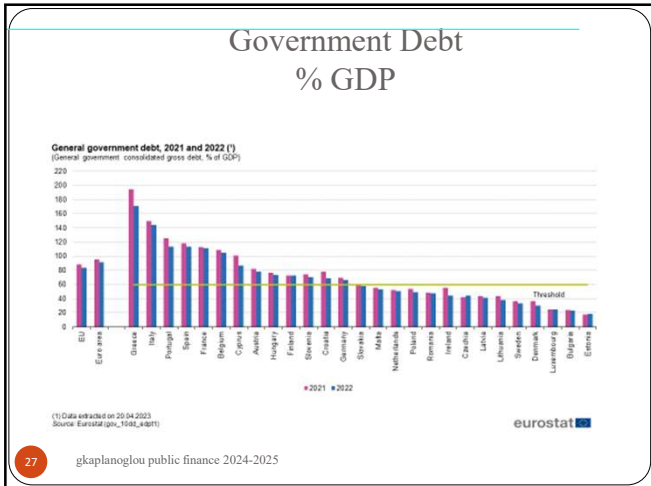
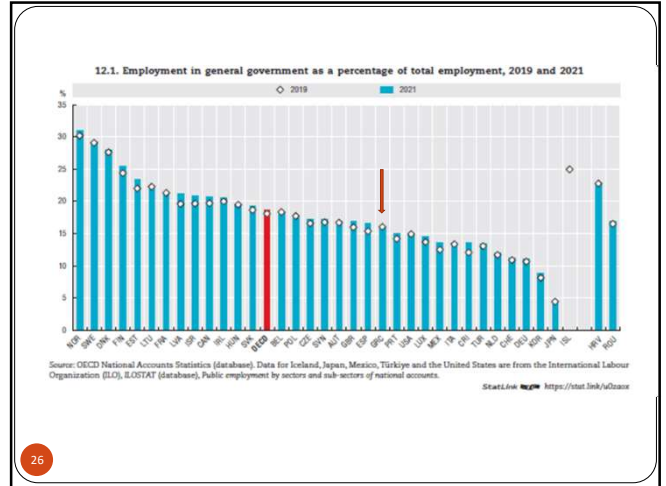
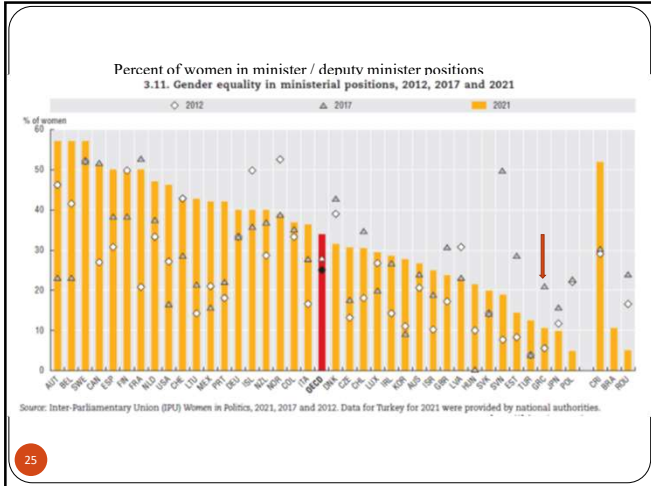
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### PUBLIC ECONOMICS DEFINITION

Public Economics = study of the Role of the Government in the Economy

Government is instrumental in most aspects of economic life:

- 1) Government in charge of huge **regulatory** structure
- 2) **Taxes**: governments in advanced economies collect 30-50% of National Income in taxes
- 3) **Expenditures**: taxes fund **public goods** (infrastructure, public order and safety, defense) and **social state** (Education, Retirement benefits, Health care, Income support)
- 4) Macro-economic **stabilization** through central bank (interest rate, inflation control), fiscal stimulus, bailout policies

⇒ We pool a large share of our incomes through government

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### Bigger view on government (Saez 2021)

Economists have a narrow minded view of individual behavior: purely selfish and economically rational interacting through markets ⇒ limitation to fully understand **public economics**

Social interactions are critical for humans: cooperation at many levels: families, workplaces, communities, nation states with very strong/versatile in-group attachments

We produce in teams and then we have to split production ⇒ We are cooperative and very sensitive to distribution

Archaic human societies depended on social cooperation for protection and taking care of the young, sick, and old

⇒ Explains best why our modern nation states provide defense and education, health care, and retirement benefits

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### More modest role for economists

Replacing social institutions by markets does not always work:

Education is primarily government funded: student loans work in economic theory but in practice end up being a huge lifetime burden. For-profit education has a tendency to become a scam

Retirement benefits: Saving for your own retirement works in theory but in practice most people unable to do so unless institutions (government/employers) help them

Health care: Health care relies heavily on government/employers support everywhere. People are not able to afford or shop rationally for health care

Economists can still play a useful role in understanding when markets can help and how individualistic forces can undermine institutions

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### Three 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 that they do?

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### When should the government intervene in the economy? Economists' traditional view:

**1) Market Failures:** Market economy sometimes fails to deliver an outcome that is efficient

⇒ Government intervention may improve the situation

**2) Redistribution:** Market economy generates substantial inequality in economic resources across individuals

Inequality is an issue because we are "social beings"

⇒ People willing to pool their resources (through government taxes and transfers) to help reduce inequality

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### Inequality and Redistribution

Even if market outcome is efficient, society might not be happy with the market outcome because market equilibrium might generate very high economic disparity across individuals

Governments use taxes and transfers to redistribute from rich to poor and reduce inequality

Redistribution through taxes and transfers might reduce incentives to work (**efficiency costs**)

⇒ Redistribution creates an **equity-efficiency trade-off**

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### What Are the Effects of Alternative Interventions?

**1) Direct Effects:** The effects of government interventions that would be predicted if individuals did not change their behavior in response to the interventions.

Direct effects are relatively easy to compute

**2) Indirect Effects:** The effects of government interventions that arise only because individuals change their behavior in response to the interventions (sometimes called **unintended effects**)

Empirical public economics analysis tries to estimate indirect effects to inform the policy debate

**Example:** increasing top income tax rates mechanically raises tax revenue but top earners might find ways to evade/avoid taxes, reducing tax revenue relative to mechanical calculation

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### Why Do Governments Do What They Do?

**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

Public choice is a sub-field of political economy from a Libertarian perspective that focuses on government failures (=situations where the government does not act in the benefit of society).

### Key Facts on Taxes and Spending

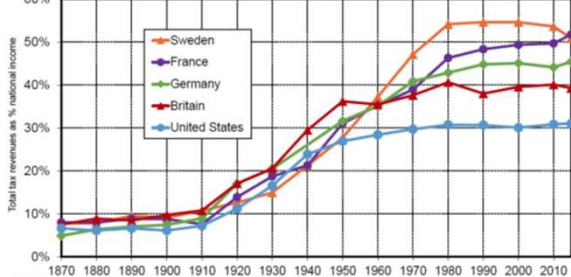
**1) Government Growth:** Size of government relative to National Income grows dramatically over the process of development from less than 10% in less developed economies to 30-50% in most advanced economies

**2) Government Size Stable** in richest countries after 1980

**3) Government Growth** is due to the expansion of the **social state**: (a) public education, (b) public retirement benefits, (c) public health insurance, (d) income support programs

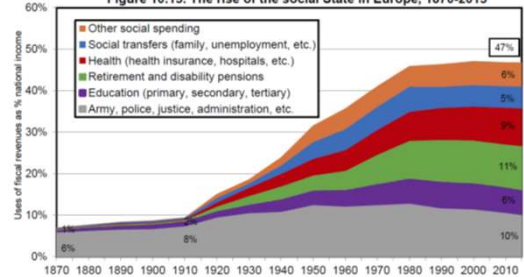
**4) Govt spending > Taxes:** Most rich countries run deficits and have significant public debt (relative to GDP), particularly during Great Recession of 2008-10 and Covid 2020-21

Figure 10.14. The rise of the fiscal State in rich countries 1870-2015



**Interpretation.** Total fiscal revenues (all taxes and social contributions included) made less than 10% of national income in rich countries during the 19th century and until World War I, before rising strongly from the 1910s-1920s until the 1970s-1980s and then stabilizing at different levels across countries: around 30% in the U.S., 40% in Britain and 45%-50% in Germany, France and Sweden.  
**Sources and series:** see [plenty pei on fiskology](#).

Figure 10.15. The rise of the social State in Europe, 1870-2015



**Interpretation.** In 2015, fiscal revenues represented 47% of national income on average in Western Europe et were used as follows: 10% of national income for regular expenditure (army, police, justice, general administration, social infrastructure: roads, etc.), 0% for education, 11% for pensions, 9% for health, 5% for social transfers (other than pensions), 0% for other social spending (housing, etc.). Before 1914, regular expenditure absorbed almost all fiscal revenues. **Note.** The evolution depicted here is the average of Germany, France, Britain and Sweden (see figure 10.14). **Sources and series:** see [plenty pei on fiskology](#).

## REGULATORY ROLE OF GOVERNMENT

- Another critical role the government plays in all nations is that of regulating economic and social activities. Examples:
  - 1) EU Minimum Wage Directive adopted in October 2022 and must be transposed into national law by November 2024. One of its key goals is to establish a framework that sets adequate levels of statutory minimum wages, aiming to ensure decent living and working conditions
  - 2) The **European Medicines Agency** is a decentralised agency of the **European Union** responsible for the evaluation, supervision and safety monitoring of medicines
  - 3) The **European Food Safety Authority (EFSA)** provides **independent scientific advice on food-related risks**. EFSA issues advice on existing and emerging food risks. This advice informs European laws, rules and policymaking – and so helps **protect consumers from risks in the food chain**
  - 4) The **European Environment Agency (EEA)** is an agency of the **European Union** that delivers knowledge and data to support Europe's environment and climate goals. To what extent are society's economic resources controlled by the public sector?