

Notes from ECO 479, Lecture 1, 8/23/2007

1. Reviewed syllabus
2. Gruber, Chapter 1, "Why Study Public Finance?"

Introduction

- a. Many real-world events highlight the role of government. Nearly 2 years, Hurricane Katrina destroyed New Orleans and brought to the forefront the appropriateness of government action. One public finance question that arises is: *Which level of government should be responsible for the cleanup?* Another question is: *Should New Orleans be rebuilt with government funding?*
- b. Similar questions about the role of government arise in thinking about the current credit crunch in the mortgage market. *Should the government regulate mortgages more, by, for example, forcing borrowers to receive credit counseling before entering into a "non-traditional" mortgage? Should borrowers be forced to qualify for a loan amount based on a higher interest rate in the case of adjustable rate mortgages?*
- c. These sorts of questions fall into the domain of **public finance** – the study of the role of the government in the economy.

The 4 Questions of Public Finance

1. The 4 questions of public finance are:
 - a. **When** should the government intervene in the economy
 - i. The 2 main justifications that economists would bring up related to improving *market efficiency* and *redistribution*.
 - ii. *Market failures* are the problem that causes the market economy to deliver an outcome that does not maximize efficiency. Examples:
 1. Monopolist maximizes profits, but produces too little of the good in question at too high of a price. We drew a graph that showed the differences in quantities between a monopolist and perfect competitor, showed the consumer and producer surpluses in each case, and the *deadweight* loss from underproduction. The issue of market inefficiencies due to market structure (monopoly, oligopoly, duopoly) is part of the focus of industrial organization rather than public finance.
 2. Smokers generate a negative externality. Although we could argue that smokers accurately weigh the long-term benefits and costs appropriately, they (rationally) do not account for how their actions affect others. This means the social cost of smoking is higher than the private cost.
 3. There are positive externalities, too. A student who asks good questions imposes a benefit on others that he or she is not compensated for.
 4. Another instance where markets may fail relates to insurance. Because private insurance companies usually cannot force everyone to buy insurance, an *adverse*

selection problem can emerge where the high risks buy insurance and the low risks don't. The problem emerges when individuals know their true risk, but insurance companies cannot tell. One example is that we don't see a market for "grade insurance". The example of "grade insurance" also highlights the issue of *moral hazard* – the fact that people may behave differently in the presence of insurance than they would in the absence of insurance.

5. **Redistribution** is the shifting of resources from some groups in society to others.
- b. **How** might the government intervene
1. There are lots of possible interventions, some of which are popular with economists, others of which are not.
 2. The government can *change prices* through taxes and subsidies. For example, gasoline is more expensive because of the taxes that are imposed on it.
 3. The government can *change quantities* by mandating or prohibiting certain actions. The government mandates that drivers have car insurance. The local government prohibits those under the age of 21 from buying alcohol.
 4. Public provision – some governments provide a good directly, such as with public schooling.
 5. Public financing of private provision – some services are done through private companies, but paid for by taxpayers. In some places, garbage collection is private, for example.
- c. **What** is the effect of those government interventions on economic outcomes?
1. We can examine the "direct" or "intended" effects of a policy action.
 2. We can also examine the "indirect" or "unintended" effects.
 3. The textbook goes through an example of expanding health insurance to the uninsured. The direct effect would be to lower the number of uninsured. One of the indirect effects is that those who currently pay for private insurance may drop that in favor of the "free" public alternative.
- d. **Why** do governments choose to intervene in the way that they do?
1. **Political economy** is the theory of how the political process produces decisions that affect individuals and the economy.
 2. For example, government spending on the "bridge to nowhere" in Alaska doesn't seem to be motivated by either market failures or redistribution.