

ECO 225 - Introductions

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Some Background on Me



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An Introduction to Public Finance and Public Policy

- **Goal of public finance/economics:** To understand the proper role of government in the economy.
- Some questions we may ask:
 - What kind of services should the government provide, if any?
 - How much should the government tax its people?
 - Should the government be spending hundreds of billions of dollars to provide health insurance?
- Much debate...

A Sidenote on Positive versus Normative Analysis

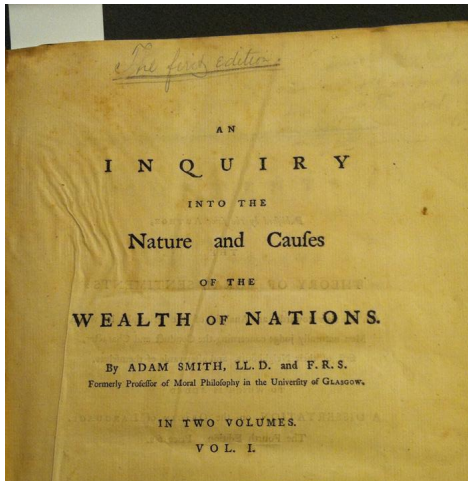
- Recall **positive** and **normative** analysis from ECO 101.
- Positive analysis - what is, no value judgement
- Normative analysis - what should be, value judgement
- Example:
 - Positive: A reduction in income tax will incentivize unemployed individuals to find work.
 - Normative: The government should increase minimum wage to help low-income individuals.
- Use positive analysis but acknowledge that policy recommendations are often normative.
- Many views on the role of government.

Adam Smith

- Father of modern economics.
- Scottish Enlightenment figure.
- Magnum opus: *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776).
- Free market theory; political economy; invisible hand of the market; specialization of labor

Adam Smith

If you ever visit Duke's Rare Book Room....



A Selfie with Adam Smith



Adam Smith on the Role of Government

From *Wealth of Nations*, IV.9.51:

According to the system of natural liberty, the sovereign has only three duties to attend to.....

- 1** *first, the duty of protecting the society from violence and invasion of other independent societies;*
- 2** *secondly, the duty of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it, or the duty of establishing an exact administration of justice;*
- 3** *thirdly, the duty of erecting and maintaining certain public works and certain public institutions which it can never be for the interest of any individual, or small number of individuals, to erect and maintain;*

The Four Questions of Public Finance

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

When should the government intervene in the economy?

- Recall from ECO 101: **competitive market equilibrium is the most efficient outcome for society** – it maximizes gains from efficient trades.
- A trade is **efficient** if it makes at least one party better off without making the other worse off.
- Competitive market \implies supply = demand, everybody who values the good above the price they must pay obtains the good.
- So is competitive market equilibrium is the most efficient for society, why should governments intervene?

When should the government intervene in the economy?

Two reasons for government intervention:

1 Market failure

- A problem that causes the market economy to deliver an outcome that does not maximize efficiency.
- Example: Health insurance in the US.
 - In 2010, there were 49 million persons without insurance.
 - What if a worker without health insurance gets sick?
 - Negative externality - my decisions impose on others costs that I do not bear.

When should the government intervene in the economy?

2 Redistribution

- The shifting of resources from some groups in society to others.
- Imagine the economy as a pie, the size of which is determined by the social efficiency of the economy.
- No market failures \implies pie is largest it can be. Market failures \implies potential for the government to make pie larger.
- Government may not only care about how large the pie, but also the size of each person's slice.
- Sometimes society may redistribute in such a way that does not affect the size of the pie; but usually redistribution will lead to efficiency losses (i.e. the pie gets smaller).
- This is because individuals may shift their behavior away from the efficiency-maximizing point.

How might the government intervene?

- 1 Tax or subsidize private sale or purchase
 - Government can address market failures in the private market by using price mechanisms (taxes or subsidies).
 - ACA subsidies for low-income families
- 2 Restrict or mandate private sale or purchase
 - ACA mandates all individuals purchase health insurance or face a tax penalty.
- 3 Public provision.
 - Medicaid/Medicare.
- 4 Public financing of private provision
 - Governments may want to influence the level of consumption but may not want to involve themselves directly in the provision of a good.
 - Example: 2003 addition of a prescription drug benefit to Medicare.

What are the effects of alternative interventions?

In general, any government policy has two effects:

- 1 **Direct effects** - The effects of government interventions that would be predicted if individuals did not change their behavior in response to the interventions.
 - There were 49 million uninsured in 2010.
 - What if the government wants to make sure all these uninsured have insurance by providing it to them at no cost?

What are the effects of alternative interventions?

- 2 Indirect effects** - The effects of government interventions that arise only because individuals change their behavior in response to the interventions.
- Imagine the rest of the US population in 2010 who had insurance (and so, paid for it).
 - By providing uninsured people with free health care, the government has created a strong incentive for privately insured individuals to drop their health insurance and get fully subsidized by the government.

Why do governments do what they do?

- **Political economy** - the theory of how the political process produces decisions that affect individuals and the economy.
- It's hard (unsurprisingly) for governments to figure out what the public wants and choose policies to address those wants.
- In reality, government may want to intervene for reasons other than market failures and redistribution.
- There are also **government failures** that can lead to inappropriate government intervention.

Regulatory Role of the Government

Government also regulates economic and social activities:

- 1 Food and Drug Administration (FDA)
- 2 Occupational Safety and Health Administration (OSHA)
- 3 Federal Communications Commission (FCC)
- 4 Environmental Protection Agency (EPA)

Why study public finance? Hot topics

1 Social Security

- Today's young workers pay the retirement benefits of today's old retirees.
- As baby boomers (75 million, born 1946-1964) age, system is running into trouble.
- Working taxpayers to elderly ratio – 8:1 (1950), <3:1 (2050)
- Funds run out in less than 30 years.
- Liberals - System has worked well, raise more resources by taxing more.
- Conservatives - Replace the system with one in which individuals save for their own retirement.

How large of a role should government play in mandating/regulating retirement savings?

Why study public finance? Hot topics

2 Health care

- 2010 - 49 million Americans without any health insurance.
- Research suggests their medical treatment and health outcomes are significantly worse as a result of their being uninsured.
- Health care costs rising to almost half of GDP within the next century.
- Left - 'Single-payer' system, government-financed universal coverage.
- Right - private market solution, solve health care problems through tax subsidies and more competition.

Is the expansion of insurance coverage mandated under the ACA the best way to bring medical security to uninsured Americans? Or should we encourage competition amongst private firms?

Why study public finance? Hot topics

3 Education

- US lags behind other countries in terms of student performance.
- Liberals - not enough resources put into funding education
- Conservatives - public schools are local monopolies, should create competition and increases choice set.

Can more spending solve the problems of the US educational system? If not, can competition help? How do we deal with students who are left behind in such a system, where there are bad schools and lack of choice?

Why study public finance? Hot topics

4 Vaccinations

- In 2000, measles was declared eliminated from the US.
- 2013 - measles outbreak (NYC, NC, TX)
- This past spring saw the first death from measles in the US in 12 years.
- Pertussis outbreaks, California 2014

Should the government mandate vaccinations for all of its citizens?