I. Review of Course Materials

II. Introduction to Public Finance and Public Economics

A. Public economics is the study of government policies.

i. Public economics analyzes the effects of all government policies on economic activities and the political processes by which those policies come to be in place.

ii. Tax revenues and public debt pay for essentially all of the operations of government: enforcement of laws and regulations, purchases of goods and services from market vendors, and paying for the inputs used for direct public provision of services.

iii. A wide variety of regulations also affect economic decisions by changing incentives at the margin through threats of fines or imprisonment.

iv. Still other polices determine what is owned, how what is owned can be used, and what political, economic, and private rights and duties one has.

B. Public Finance studies the subset of public policies that are fiscal in nature. These include government taxation, debt, and expenditures.

i. Because of time constraints, this course mostly focuses on the public finance subset of public economics.

ii. The US government takes about one third of gross national product to finance its enforcement, purchasing, transfer, and production activities.

- The central government's overall effect on the distribution of goods and services is larger than this, because its rules and regulations (and tax preferences) affect returns at the margin and thereby the allocation of a good deal more of the gross national product produced within its territories.
- A larger part of government spending within the U. S. takes place at the state, county, and town levels of government.

iii. The field of Public Finance studies the effects of alternative taxes and expenditures by all levels of government.

iv. Public Economics also attempts to explain why government policies are what they are.

- There are, for example, circumstances in which markets may fail to provide particular services, and thus why voters may ask the government to provide them to supplement those provided by markets.
- This partly explores why a majority of voters (and interest groups) support many government services.
- That is to say, part of the reason that governments in western Europe and North America are large is that governments provide desired public services, services that would otherwise by under-provided by the private sector.
- However, not all services are widely demanded, as with narrow tax loop holes. The effects and origins of such policies are also analyzed by public finance.

v. The main aim of this course is to show how microeconomic tools and concepts can be used to (1) understand the impacts of its tax, subsidy, and borrowing policies and (2) to account for their origins.

vi. To account for the origins of a government's fiscal policies, we will use models and concepts from microeconomics and public choice to analyze the political pressures that generates fiscal and tax-based regulatory policies.

- That part of the course will attempt to explain why some fiscal policies are adopted and not others.

C. Public Economics within Market Economies

i. Economics is often said to be the study of the allocation of scarce resources. And much of economics proceeds as if all resources were allocated by market forces.

a. A century ago, it might have been reasonable to ignore the resources directly and indirectly controlled by national governments because relatively little of a typical industrialized nation's national income was allocated by government decision making, perhaps 10%.

b. However, this is no longer the case. The typical national government of an industrialized nation now directly controls between 35 and 60 percent of national income.

c. On the other hand, those political decisions are constrained by a number of economic considerations, many of which are economic.

ii. Governments use taxes and debt to finance their services in part because governments have nearly always done so (at least at the margin) and in part because taxes and debt are often the least costly method of shifting resources from the private sector to the governmnet sector.

- Tax polices often reduce some economic activities while subsidies and tax preferences increase others.

iii. In spite of very significant taxes that are much higher than they were in 1950 or 1850, it is interesting to note that the industrialized democracies are the wealthiest on earth by essentially all physical measures of welfare: real income per capita, housing size, longevity.

- Thus, it would be wrong to conclude, at least in the short and medium term, that increases in the magnitude of government, necessarily leads to economic decline.
- To ignore public finance would be to ignore between a third and half of a modern democratic nation's economic activity.

iv. However, both taxes and expenditure policies have direct effects on the private sector, many of which tend to reduce the level and scope of private sector activities.

a. For example, as we will see in detail later in the course, there are both direct and indirect effects associated with the burden of taxation.

b. Most tax revenues are used to purchase goods and services in private markets and/or to subsidize various market activities. (That is to say, government revenues are not "kept" by the government, but spent in one way or another.)

v. Many of your own decisions today were affected by government fiscal policies.

a. For example: GMU is (still) a publicly financed university.

- (About a third of GMU's expenses are paid by Virginia tax payers, and much of the research conducted here is also supported by tax dollars.)

b. You are here, in part, because the cost of a college education at GMU is relatively less expensive than an equivalent private education.

- You probably used highways and/or public transit to make your way to class.

c. You probably paid sales tax on your lunch, and also paid a variety of state and federal excise taxes on the gasoline that you used to drive here.

- If you worked during the summer, you paid a variety of federal, state, and local income taxes.

d. If you think about retiring some day, your decision is influenced in part by the magnitude of Federal Social Security payments--and risks associated with their provision by the federal government (and, of course, future tax payers!).

III. Positive and Normative Public Economics

A. The *positive* strand of public economics analyzes very large fraction of the economic activity that we observe in modern industrial economies: how does it affect the economy, why are such policies in place?.

i. (DEF: A **positive statement** is a statement about what "is" "will be" or "has been." It is an attempt to describe the world.)

B. The *normative* strand of Public Finance is also important because it helps us to evaluate government tax and expenditure policies: are the polices that we observe the best that we can imagine, are there cases in which reforms or new policies would generally "improve" the existing situation? If so, in what sense?

i. (DEF: A **normative statement** attempt to evaluate alternative policies or alternative states of the world. Is one policy "better" than another? Is one state of the world "better" than some other. Most normative statements are based upon normative theories of some kind that attempt to determine what are "good" or "bad," "just" or "unjust," "fair" or "unfair" public policies.)

ii. Normative public finance addresses such questions as:

a. Are taxes too high or too low?

b. Can tax burdens be reduced without affecting the level of government services?

c. Are government services being efficiently provided or not?

d. And if not, how can services and service levels be improved?

e. Which services are best produced by government, and which levels of government can most effectively produce those services.

f. Moreover, it is difficult to vote sensibly without having some understanding of the economic effects of fiscal policies

iii. One does not have to believe that government expenditures should be large or small to study public finance, one simply has to appreciate that they **are**, in fact, large and important in modern industrialized nations.

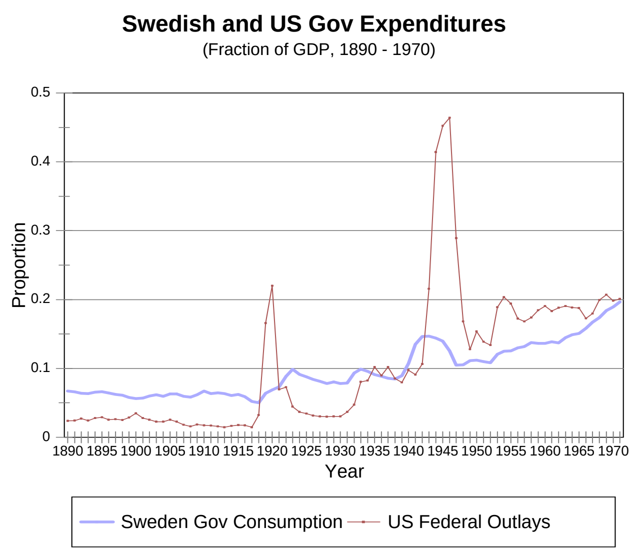
- (Your opinion of whether government services are too large or too small is in large part, as we will see, a matter of your tastes and fiscal circumstances, as with your demand for other services! However, it is also affected by your normative theories.)

IV. A Brief Overview of US and European Fiscal History

A. One striking feature of the past century of government finance is the extent to which more and more national resources **are directly** allocated by government decisions.

i. This increase took place for the most part in the 20th century particularly in the period between W.W.I and W.W.II and during the period between 1960 ad 1985.

Figure A2 (from Holcombe)



B. Some Recent Trends in Government Fiscal Policies

Table A3 (from Congleton, 2003)
Central Government
Consumption, Tax Receipts and Expenditures
As Percent of GDP (1960 -1996)

	Sweden (Central Government)			United States (Central Government)			Denmark		U. K.	
Year	Swd Gov Con	C. G. Tax Rev.	Cent. Gov Exp.	US Gov Con	C. G. Tax Rev.	Cent. Gov Exp.	D Gov Con	Cent Gov Exp.	C. Gov Con..	Cent. Gov Exp.
1960	16	..	..	17	..	..	13		16	
1961	16	..	..	17	..	..	14		17	
1962	17	..	..	18	..	..	15		17	
1963	17	..	..	17	..	..	15		17	
1964	17	..	..	17	..	..	16		17	
1965	18	..	..	16	..	..	17		17	
1966	19	..	..	17	..	..	17		17	
1967	20	..	..	19	..	..	18		18	
1968	21	..	..	19	..	..	19		18	
1969	21	..	..	18	..	..	19		17	
1970	22	26	25	18	..	..	20	32	18	32
1971	23	28	26	18	..	..	22	32	18	32
1972	23	28	28	18	17	19	22	32	19	32
1973	23	27	28	17	17	19	22	29	19	32
1974	24	27	29	18	18	19	24	33	20	36
1975	24	27	29	18	17	21	25	34	22	39
1976	25	31	32	18	16	21	25	33	22	39
1977	28	33	35	17	17	21	24	33	21	37
1978	28	32	37	17	17	21	25	34	20	37
1979	29	31	39	16	18	20	26	35	20	36
1980	29	30	39	17	18	22	27	39	22	38
1981	30	32	42	17	19	23	28	41	22	41
1982	30	32	43	18	19	24	29	43	22	41
1983	29	32	45	18	17	25	28	43	22	40
1984	28	33	44	17	17	23	26	42	22	40
1985	28	34	45	18	18	24	26	40	21	40
1986	27	34	43	18	17	24	24	37	21	38
1987	27	37	41	18	18	23	26	37	21	37
1988	26	37	40	18	18	23	26	39	20	35
1989	26	37	39	17	18	23	26	39	20	34
1990	27	38	41	18	18	23	26	39	21	38
1991	27	36	43	18	18	25	26	39	22	40
1992	28	35	46	17	18	24	26	41	22	43
1993	28	31	52	17	18	24	27	42	22	42
1994	27	29	49	16	18	23	26	43	22	42
1995	26	34	49	16	19	23	26	41	21	42
1996	26	37	46	16	19	22	26		21	

Source: World Development Indicators, 1999, (CD) World Bank, ISBN 0-8213-4375-0.
(Shaded cells indicate years where nonsocialists formed the Swedish government.)

(Notice the difference between tax receipts and government consumption. The difference largely "transfer payments" such as welfare and social security, which GNP accounts do not include as government consumption. In fact, central government expenditures including transfers is **generally a bit larger than tax revenues** , because most run significant deficits. Also remember that state and local taxes are ignored by these numbers.)

C. Government Growth and Some Indicators of Individual Welfare

Table A9 (From Congleton (2003))
Government Growth and National Performance
1960 and 1995 (Sorted by 1995 Central Gov Con)

	Government Consumption as % RGDP		Life Expectancy		Income Share Bottom 40%		Unemployment Rate	
	1960	1995	1960	1995	1960s	1980s	1960	1996
Sweden	16	25.8	74	79	15.1	21.2	1.4	8
UK	16.4	21.4	71	77	19.2	17.3	1.7	7.4
Norway	12.9	20.7	73	78	17.1	19	2.5	4.9
Canada	13.4	19.6	71	79	19.7	17.5	7	9.7
Germany	13.4	19.5	70	76	14.8	19.5	1.3	10.3
France	14.2	19.3	71	78	10	18.4	6.2*	12.4
Australia	13	18.8	69	77	19.7		3.5	6.2
Austria	11.2	17.5	71	77	20.1	15.5	2.4	8.5
Spain	8.3	16.6	70	77	16.5	19.4	11.5*	22.7
Italy	12	16.3	70	78	15.6	18.8	4.2	12.1
USA	19.4	16.2	70	77	15.9	15.7	5.5	5.4
Belgium	12.4	14.8	71	77		21.6	5.4	12.9
Ireland	12.5	14.7	70	77			6.7	11.3
New Zealand	10.5	14.3	71	76	20.9	15.9	2.5*	6.1
Netherlands	12.3	14.3	73	78	14.5	20.1	1.2	6.7
Switzerland	8.8	14	72	78		16.9	0.2*	4.7
Japan	8	9.7	69	80	15.3	21.9	1.1	3.3
Average	12.629	17.265	70.941	77.588	16.743	18.58	**4.8**	10.173
Source	Table II.1		Table IV.8		Table IV.10		(*1980) Table IV.3	

Assembled from Tanzi and Schuknecht (2000) various tables.
(Most of their data is from various OECD reports.)

(Notice that the rise of the welfare state has not materially increased longevity. The increase in longevity in Denmark and Sweden between 1960 and 1995 is actually less than occurred in the US during the same period. However, note that there appears to be an effect of the growth of welfare state expenditures on average unemployment rates.)