Module 1
INTRODUCTION

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Module 1

Lecture 1

Topics

1.1 WHAT IS PUBLIC ECONOMICS?

1.1.1 PUBLIC ECONOMICS: DEFINITION OF PUBLIC

- Governments are organizations formed to exercise authority over the actions of persons who live together in society and to manage the provision of essential services.
- The everyday life of citizens is affected by public policies decisions made by Governments.
- In the study of public economics we are concerned about the Role of the government,
- ***When*** should the government intervene in the economy?
- ***How*** might the government intervene?
- ***What*** is the effect of those interventions on economic outcomes?
- ***Why*** do governments choose to intervene in the way that they do?

1.2 WHY DO WE NEED GOVERNMENTS?

The existence of governments stems from the necessity of finding a mechanism to undertake decisions that affect a group of people

How does a group of people come to decide on an issue that affects them all BUT in different ways. For example heterogeneity of preferences might lead some people to benefit from a policy & some to lose.

[Amartya Sen (Nobel Price 1998): “the choices of the people, by the people, for the people” is broadly speaking the subject of “social choice’’]

1.3 WHAT DO GOVERNMENTS DO?

- Direct state involvement in economic activity
- Governments provide several goods and services. Some of those goods are “public” other are “private”. We will later discuss the difference between private and public goods and the rationale for their government provision.

- Expenditure side: provision (and in some cases production) of goods and services.
- Revenue Side: price setting, determining taxes & subsidies. In addition, determine price of goods produced by state run enterprises.
- Regulation eg. Laws and assignment of property rights.

- Revenue and expenditure / represent the traditional partition for economists in public economics

1.4 TAXATION

Governments have near monopoly power to tax, subsidize and regulate.

Taxes, subsidies and regulation alter individual incomes and incentives via budget constraint.

1.5 WHAT IS THE ROLE OF GOVERNMENT?

1.5.1 EXPENDITURE SIDE

What services should the government provide?

- Organization of economic activity
- Contract enforcement
- Collection of revenue

1.5.2 TAXATION SIDE

How should the government raise its money?

- Efficient mean of collection revenue (least cost way).

1.6 WHEN SHOULD THE GOVERNMENT INTERVENE IN THE ECONOMY?

- Think of the economy as a series of trades between producers and consumers. A trade is efficient if it makes at least one party better off without making the other party worse off. In micro economics you may have learnt that competitive market equilibrium is the most efficient outcome for the society. It is the outcome that maximizes the gains from efficient trades, the one where supply & demand curves intersect.

- If the competitive market equilibrium is the most efficient outcome for the society why do governments intervene in the operation of some of these markets?

- Two main justifications for government intervention are:
  - Market failures
  - Redistribution

1.7 MARKET FAILURES

- Market failures cause a market to not deliver an efficient outcome.

- Example: Consider Car Insurance in India.[There are a large number of road accidents in India caused by rash driving. However, even though insurance is available with every purchase of car these days not many people buy insurance to drive a car.]

- This by itself, however, does not reflect market failure. It just means that many people do not value the insurance enough to buy it at current market prices. As far as the individual decision (bold) maker is concerned you can still argue that it is an efficient outcome for him/her.

- However, is this equilibrium the most efficient outcome for the society?

- Suppose that I am uninsured and am a rash driver all the same. However, even if I don't care about an accident that would affect me, I might be dangerous to fellow drivers and pedestrians on the road. Hence the total economic cost incurred might be much higher than that incurred by myself. The gains from owning the insurance would be much higher than the cost of the insurance borne by myself. That is why having car insurance should be compulsory.
- However, when I make my insurance decision I don't consider the total social value but only the value to myself. So that I don't buy the insurance. Thus the competitive outcome does not maximize total social efficiency in this case.

- Lack of insurance could cause *negative externalities* from–the uninsured may not take account of their impact on others.

  - Government may induce individuals to buy insurance.

- If competitive equilibrium does not lead to efficiency maximizing outcome, there is potential for efficiency improvement through government intervention. The government can compare the social cost and benefit as a third party and induce me to buy the insurance for myself.

- However, this is an example of negative externality. It is not necessary that the government intervention would always increase efficiency when private market outcome is not efficient.