

UNIVERSITY OF ATHENS
Department of Economics

PUBLIC FINANCE

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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
- What is not part of public finance

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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 such as national socialism in Germany in the interwar years. Individualism is subservient to the “natural” goals of the state. Government as a utility maximizing entity or government as a ruling clique.

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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

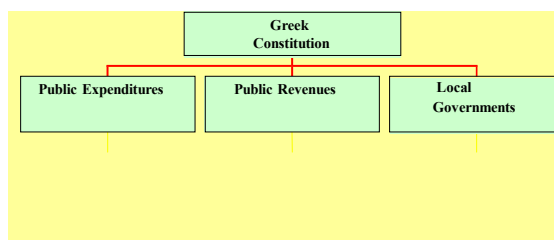
- **Political Institutions** constitute the rules and generally accepted procedures that evolve in a community for determining what government does and how government outlays are financed

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Legal Framework of Public Finance



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GROWTH OF GOVERNMENT

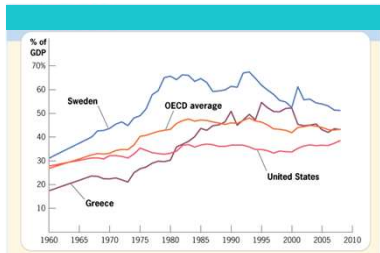
- To what extent are society’s economic resources controlled by the public sector?
- Has this control over resources been growing over time?

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Growth of government



Total Government Spending Across Developed Nations, 1960-2008 • Government spending as a share of GDP has grown throughout the developed world, but the pace of growth has varied. The United States has seen a modest growth in its government share over this period, while government spending in Greece has more than tripled as a share of the economy.

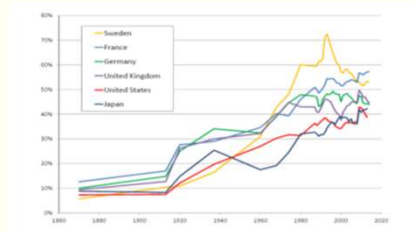
Source: Organisation for Economic Co-operation and Development (OECD), Annex Table 30.

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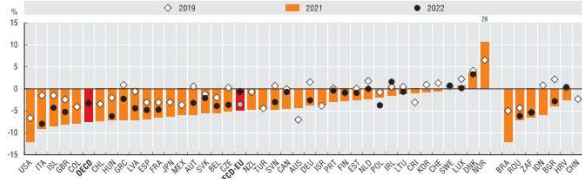
Public Expenditure (% of GDP), 1870-2014



Source: • Blots and Goren (2010), Figure 1. Tanzi and Schabaschki (2002) for period 1870-1960; OECD Historical Statistics (2011) for period 1960-1989; OECD Stat for period 1989-2014.

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11.17. General government fiscal balance as a percentage of GDP, 2019, 2021 and 2022



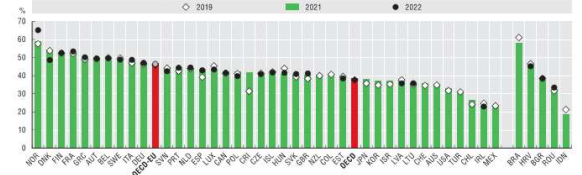
Source: OECD National Accounts Statistics (database).

StatLink <https://stat.link/cut5ya>

Source: 2023 OECD Government at a Glance

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10.1. General government revenues as a percentage of GDP, 2019, 2021 and 2022



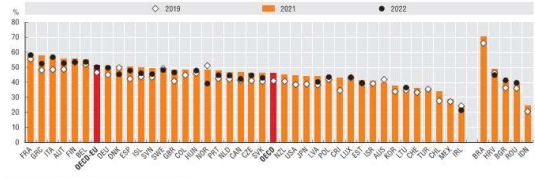
Source: OECD National Accounts Statistics (database).

Source: 2023 OECD Government at a Glance

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11.1. General government expenditures as a percentage of GDP, 2019, 2021 and 2022



Source: OECD National Accounts Statistics (database).

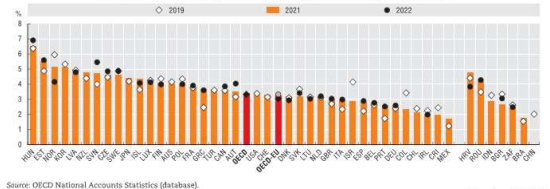
StatLink <https://stat.link/97wshj>

Source: 2023 OECD Government at a Glance

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11.14. Government investment as percentage of GDP, 2019, 2021 and 2022

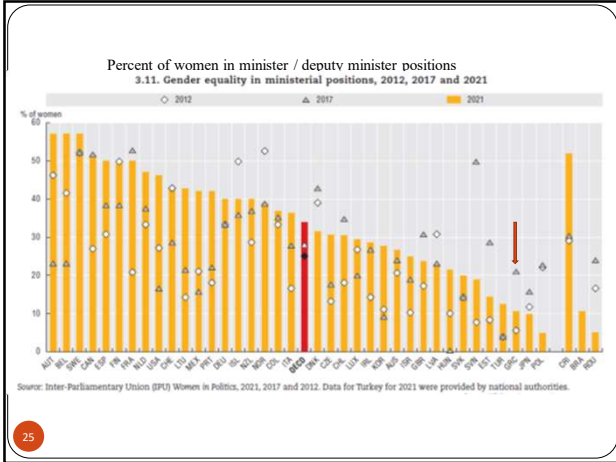


Source: OECD National Accounts Statistics (database).

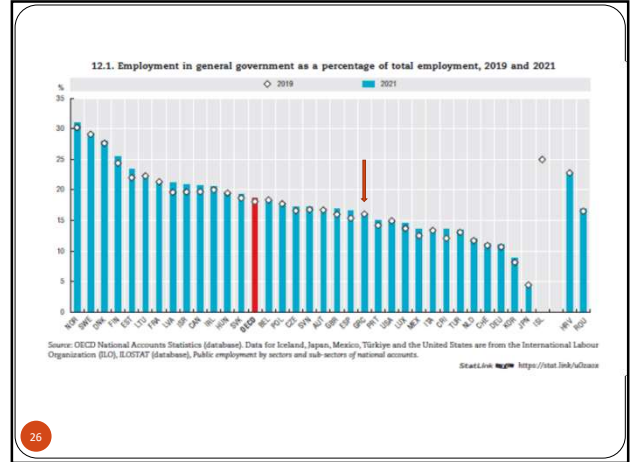
Source: 2023 OECD Government at a Glance

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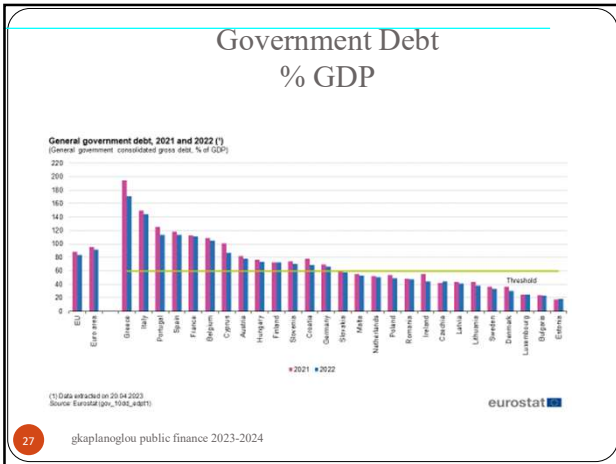
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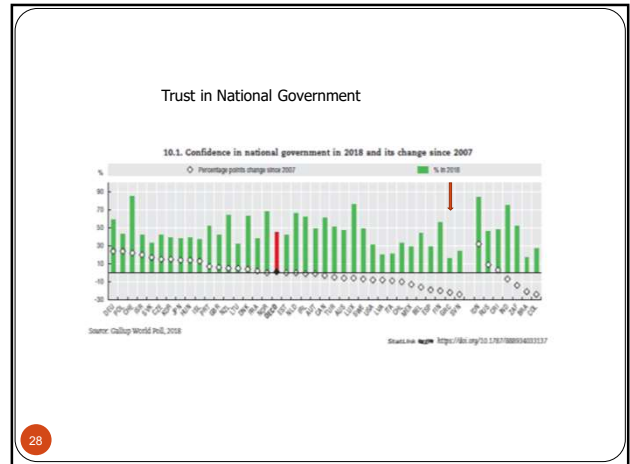
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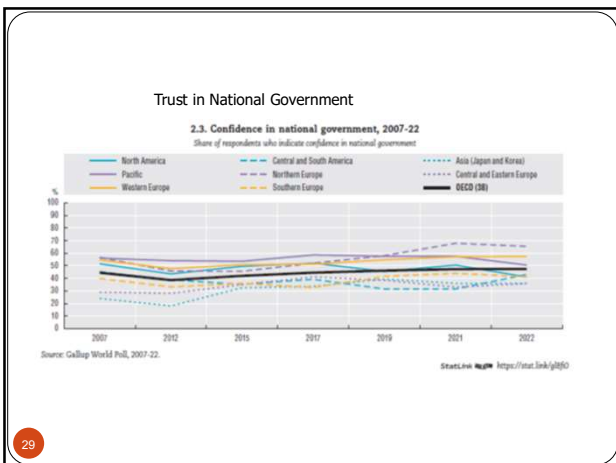
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Explanations for the Size and Growth of Government

- Dennis Mueller in “The Growth of Government” list five explanations for public sector growth.
 1. The government as provider of public goods and eliminator of externalities
 2. The government as redistributor of income and wealth
 3. Interest groups as a cause of government growth
 4. Bureaucracy as a cause of government growth
 5. Fiscal Illusion

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Some explanations on the growth of the public sector

- Law of Ever Increasing State Activities
 - Wagner's Law
 - Engel's Law
- Baumol Unbalanced Growth Model
- Displacement, Inspection, and Concentration Effect
- Critical Limits Hypothesis
- Theory of Bureaucracy

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Wagner's hypothesis of increasing state activities

- As per capita income and output grow in **industrialized** countries, the public sector of these countries **necessarily** grow as a **proportion** of aggregate economic activity. Wagner indicated this was a **natural law** of ever increasing state activity.
- Why?

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Wagner's hypothesis of increasing state activities

- Economic growth and social progress lead to an increase in governmental functions.
- The increase in necessary functions leads to pressure for absolute and relative growth of government activities
- What functions?

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Wagner's hypothesis of increasing state activities

- **Provide Law and Order:** The need to provide a stable framework for economic activity.
- Greater economic growth or industrialization leads to greater labor specialization causing increased complexities (e.g., in the contracting process) and interdependencies in economic and social life.
- Greater interdependencies foster the need for government resolution of conflicts and the need to maintain continually more specialized services (e.g. regulating derivative financial claims and mediate cultural conflicts as well).

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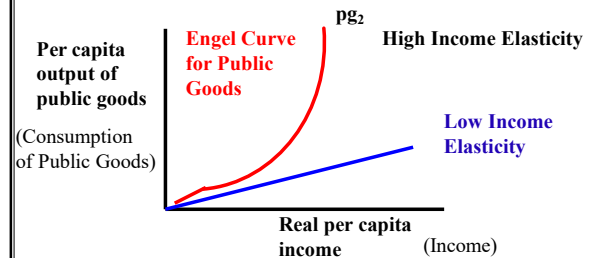
Wagner's hypothesis of increasing state activities

- **Need for Government Participation in the Production of certain Goods and Services**
 - produce public and quasi-public goods
 - For example,
 - Goods requiring large fixed investment: infrastructure projects
 - Natural monopolies and externalities
 - Communications, education, and banking / payments industries
 - Goods with a degree of publicness

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Wagner's hypothesis of increasing state activities



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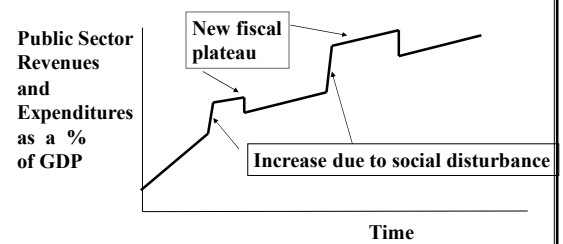
Peacock and Wiseman Approach to Growth of the Public Sector

- The relative growth of the public sector is “steplike” rather than continuous.

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Peacock and Wiseman Approach to Growth of the Public Sector



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Peacock and Wiseman Approach to Growth of the Public Sector

- **DISPLACEMENT EFFECT:** War and depression create a displacement effect by which previous (lower) tax and expenditure levels are replaced by new higher budgetary levels. New levels of *tax tolerance* (*deficit tolerance*) support a new fiscal plateau where tax burdens are higher. On the new plateau some old expenditures by government are eliminated and new ones are substituted for them. Some of the substitutes may have been produced by the private sector in the past. Perhaps R&D or retirement benefits.

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Peacock and Wiseman Approach to Growth of the Public Sector

- **INSPECTION EFFECT:**
- War and other social disturbance force people and their government to seek solution to important problems which previously had been neglected or perhaps unnoticed. For example, the need for an interstate highway system or re-engineering of the hospital system.

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Peacock and Wiseman Approach to Growth of the Public Sector

- **CONCENTRATION EFFECT:**
- This effect notes the tendency for *central government* economic activity to become an increasing proportion of total public sector economic activity when a society is experiencing economic growth.

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Government Bureaucracies

- As Mueller notes government bureaucracies are an independent force explaining the growth of the government sector. (Peacock-Wiseman Approach)
- Empirical studies in this area have usually reasoned as follows.
- The *larger* the bureaucracy, the more difficult it is for outsiders to monitor its activity, and the more the insiders there are who are working to increase the size of the bureaucracy.
- Thus the growth of bureaucracy is likely to depend on its absolute size.

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Government Bureaucracies

- Studies have found that growth in the size of a bureaucracy's budget is expected to increase with the absolute size of the budget.
- As Mueller indicates this result is broadly consistent with the pattern of growth of government expenditures observed in many countries over the past two centuries: slow but steady initial growth, gradually shifting into more rapid rates of growth.

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Government Bureaucracies

- The idea that bureaucratic power increases the size of government presumes that the bureaucracy can deceive the legislature about the true costs of supplying different levels of output.

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Fiscal illusion

- The fiscal illusion presumes that the legislature can deceive the citizens about the true size of government.
- The fiscal illusion explanation for the growth in the size of government assumes that citizens measure the size of government by the size of their tax bills.

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Fiscal illusion

- To increase the size of government beyond what people want, the tax burden has to be disguised so as to create an *illusion* that the government is smaller than it actually is and so the government can grow beyond the level citizens prefer.
- The fiscal illusion has been empirically tested in various forms.
 1. A tax structure is more difficult to judge the more complex the tax structure.
 2. Renters are less able to judge their share of property taxes in the community than are homeowners.

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Fiscal illusion

3. The implicit future tax burdens inherent in the issuance of debt are more difficult to evaluate than equivalent current taxes.
 4. Built-in tax increases because of the progressivity of the tax structure are less clearly perceived than are legislated changes.
- Mueller, quoting a review of the empirical literature by Oates, concludes that “the fiscal illusion provides plausible hypotheses, none of which have very compelling empirical support.

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Expansion of suffrage: redistribution factor

- Meltzer and Richard suggest that one explanation for the secular growth in government around the world over the past two centuries has been expansion of suffrage.
- Those added to the voting rolls are more often than not those with incomes and productivity below the median.
- Thus the median voter changes to someone more prone toward the redistribution of income by the government.

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Expansion of suffrage: redistribution factor

- Meltzer and Richard gave increased inequality of income as well as increased suffrage as the primary causes for the growth of government and presented some empirical support for their hypothesis.
- Peltzman has also presented an explanation for the growth of government that depends on the shape of the distribution of income.
- Peltzman did not however makes use of the median voter theorem in developing the argument.

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Expansion of suffrage: redistribution factor

- Rather, he envisioned a form of representative government in which candidates competed for votes by promising to redistribute income for those voters or groups of voters that agreed to join the candidates coalition of supporters.
- Peltzman reasoned that the more equal the distribution of income among the potential supporters of the candidate, the more bargaining strength they would have.

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Expansion of suffrage: redistribution factor

- Thus the candidate must promise a greater amount of redistribution the more equal is the initial distribution of income among voters
- Peltzman pointed to the spread of education as an important factor increasing the equality of pre-transfer incomes and thus leading to a growth in the size of government.

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Expansion of suffrage: redistribution factor

- What about redistribution ?
- Mueller concludes that “ it is difficult to suppress the impression that an important component of the explanation for the growth of government lies in government’s redistribution activities, so substantial has been the growth in the transfer component of government budgets.”
- “However, to explain the growth of government in simple redistributive terms is inadequate.”

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INTEREST GROUPS

- Mueller and Murrell presented empirical evidence that interest groups effect the size of government.
- They described a political process in which parties supply interest groups with favors in exchange for the interest groups support.

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INTEREST GROUPS

- When these favors take the form of goods targeted to specific interest groups, but with spillovers for other groups, government grows larger.
- The number of organized interest groups in a country was shown to have a *positive and significant* effect on the relative size of the government sector in a cross sectional sample of OECD countries.

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