

Outline of Public Economics: Principles and Practice

On-Line Edition

Part 1 Nature of Government

Part 1 of the book lays the foundations for a study of government and the economy. This involves understanding the political environment. However, just as politics is important to economics, so economics is important for government. A theme of the book is that standard economic principles apply as strongly to the actions and decisions of government as they do to markets.

Chapter 1 sets out these foundations of public economics. It describes the nature of government, the fundamentals of the economic process and the role of markets, the several major functions of government, and the major principles of economics that underlie the study of public economics.

Chapter 2 outlines how government works. It shows the nature of public expenditure and the main sources of government revenue in Australia. It also describes the basic concepts of government budgets and balance sheets. Some international comparisons are given. Finally, the chapter describes the main factors that drive the growth of government expenditure.

Part 2 Markets and Government

Part 2 discusses the relationships between markets and government. If individuals can achieve their goals through voluntary trades, government intervention in markets is unnecessary and may indeed be counter-productive. Accordingly, we want to know when markets work well and when they do not, so creating a basis for government action.

Chapter 3 shows that when markets are perfectly competitive, complete and informed, they produce efficient outcomes. That is, they produce the goods and services that individuals want at least cost (given individual productivity). But they may not produce fair outcomes.

However, as we see in Chapter 4, markets fail when they do not supply the public goods that people want, they cause unwanted damaging effects such as pollution, competition is imperfect, or markets are not well-informed. Also, markets outcomes are often inequitable. Accordingly, government has several major roles: to regulate markets, to provide public goods, and to provide social welfare to individuals in need. It also has a wide choice of policy instruments. Choosing the appropriate policy instrument is an important element in policy determination.

Whereas Chapters 4 and 5 discuss the allocation of resources at a point in time with a given level of technology, Chapter 5 discusses economic growth and technical change. Market forces are major drivers of economic growth, though the markets may not be perfectly competitive. Government can create economic growth by providing an efficient institutional framework and investing in human capital and economic infrastructure, but it can also reduce growth rates by excessive regulation or taxation.

Part 3 Economic Evaluation and Public Policy

In Part 3, we discuss the economic approach to evaluating public policies. These chapters are a foundation for understanding economic methods of analysis and evaluation of most government decisions.

Principles of valuation underlie all economic evaluation. Welfare economics starts from the premises that the aim of public policy is to maximise the welfare of the individuals who comprise the society and that individuals are the best judges of their own welfare. Accordingly, public policy should reflect the values of these individuals. Chapter 6 describes how economists assess and quantify individual preferences.

However, for collective decisions, these individual values must be combined into an overall measure of social welfare. Chapter 7 discusses how economists seek to aggregate individual values into such a measure. This is not simply a technical matter. It always involves value judgements about the relative importance of welfare changes for the various individuals or groups in society. The chapter also discusses the implications of the principles of social welfare for practical evaluations of policy.

Cost-benefit analysis provides the most common and comprehensive evaluation instrument for all policy and expenditure options. This involves quantifying as many of the costs and benefits of alternatives as possible. Sometimes, when government has a pre-determined objective, cost-effectiveness analysis is the relevant evaluation instrument. Chapter 8 describes the main procedures involved in cost-benefit analysis.

Part 4 Public Choice

Although we may like to think that government aims to maximise social welfare, in practice it may not do this. In Part 4, we examine how governments make decisions. This is known as the study of public choice.

In Chapter 9, we examine how individuals can make collective decisions by voting rather than by acting in markets. This is often described as direct democracy. Of special interest is the question whether voting methods enable individuals to reach collective decisions that maximise their social welfare. It turns out that all voting methods have some undesirable features.

In Chapter 10, we discuss what happens when voters elect representatives to make collective decisions on their behalf (in a representative democracy). The chapter examines the effects of politicians and political processes, of public servants, and of special interest groups. In each case, we find that some element(s) of the process create inefficient outcomes. Therefore, reliance on government to resolve market failures and provide social welfare must be tempered by an appreciation of government failures.

Part 5 Building Economic Foundations

Part 5 discusses the role of government in building the foundations of an efficient economy. It is structured around government responses to the four major forms of market failure: the failure of markets to supply public goods, externalities, imperfect competition, and information failures.

Chapter 11 discusses the provision of public goods. It describes how to determine an efficient quantity of such goods. This depends on the benefits and costs in each case. However, valuation is a problem because most public goods are not market goods. Accordingly, much of the chapter discusses how to estimate values for public goods.

In Chapter 12, we discuss the provision of a major public good, namely education. Again, a key issue is how to estimate the benefits of education and hence the quantity of education services that should be provided. We also discuss equity issues in provision of education, methods of financing education, and how to supply education cost-effectively.

Chapter 13 discusses how government should deal with non-market impacts known as externalities, and especially with environmental problems. As we will see, economists generally employ cost-benefit analysis to determine efficient solutions to externality problems and often advocate the use of market-based instruments to achieve efficient as well as equitable outcomes.

In Chapter 14 we discuss why and how government should promote competitive markets and regulate uncompetitive markets. It discusses how to assess the costs of imperfect competition and conversely the benefits of competition policy. The chapter describes government policies towards industry structure and the general conduct of firms. It also describes methods for regulating dominant firms.

Chapter 15 discusses policies for dealing with information failures. Here occupational and product safety are often important issues. The chapter shows that maximising social welfare in this sphere, as in others, is based on an assessment of the costs and benefits of alternative policies.

Part 6 Public Supply of Goods and Services

Part 6 discusses how to deliver public goods and services efficiently. Chapter 16 sets the scene with a description of the general principle of efficient public administration. These principles draw on such economic concepts as the importance of meeting consumer rather than producer needs and the role of specialisation in efficient production. The chapter then describes how to estimate production costs to ensure cost-efficient production and the choice between in-house production of services and outsourcing.

Chapter 17 discusses how to price public services. Efficient pricing is not only the key to efficient markets. It is also an important instrument in the efficient supply of many public services, especially public utilities but increasingly for other services as well.

In Chapter 18, we discuss the role of public ownership in the delivery of services. Economists generally view public ownership as one way to provide services rather than as an end in itself. The chapter discusses the major advantages and disadvantages of public and private ownership for the delivery of services.

Chapter 19 discusses public policy in the provision and use of transport. Every economy needs four basic infrastructure networks: water and sewerage, energy, communication networks, and transport. Because these networks have substantial natural monopoly and public goods characteristics, Government has a major role in their supply and use. This chapter on the transport sector exemplifies some of these issues.

Part 7 Social Welfare and Income Redistribution

Part 7 includes chapters on the principles and practice of social welfare and income redistribution. The discussion of welfare policies is complex because policy objectives typically include both poverty alleviation and the equitable treatment of various other disadvantaged households. Inevitably, also, social welfare policies are constrained by budgetary and efficiency considerations.

Chapter 20 sets the scene with a discussion of the meaning and measurement of poverty and inequality. It also briefly discusses the extent of poverty and inequality in Australia and other countries and their prime causes.

Government can attempt to address poverty and inequality in two main ways—by intervening in markets to create fairer market outcomes or by redistributing market incomes. Chapter 21 discusses how government can regulate markets with the aim of creating fairer outcomes. The major focus is on

regulation of labour markets, which are the prime source of income. The chapter also discusses industry assistance and the regulation of product markets.

In Chapter 22 we discuss methods of income redistribution by cash and in-kind transfers and through social insurance. Income redistribution is generally funded from current tax payments (from consolidated revenue). Social insurance payments are generally funded from purpose-designed public insurance schemes. The chapter discusses the major equity and efficiency effects of the various kinds of income redistribution and insurance schemes.

Chapter 23 discusses the three most important sets of welfare programs in most countries. These are programs that support persons of workforce age who have little or no income, families, and the elderly. In each case, similar issues arise. These are how to identify needs, how to support those in need while minimising incentives to adverse behaviour such as not working and other economic distortions, and the roles of the government and the private sector.

Health care services are the subject of Chapter 24. While there are many market failures in provision of health services, social welfare is a dominant motive in the public provision of health services. This chapter discusses the nature of health services, welfare objectives and market failures and the role of government, and efficient and equitable provision, financing and delivery of health services.

Part 8 Public Finance and Taxation

Public expenditure exceeds a third of gross domestic product in most developed countries. In Part 8, we discuss how this expenditure is financed and the major principles of public finance.

Chapter 25 introduces the subject. It outlines the major sources of public finance and forms of taxation. It describes the basic elements of tax systems—tax bases, tax units, tax rates and tax exemptions. It also discusses how tax systems can be evaluated using equity and efficiency criteria.

Taxes create burdens for firms and households. But taxes are not necessarily borne by the firms or individuals who pay the taxes. Taxes on production may be passed forward to consumers. Taxes on consumption may be passed back to producers. Chapter 26 discusses who bears the real burden (the incidence) of various kinds of taxes.

In Chapter 27, we examine the efficiency impacts of taxation. Nearly all taxes distort economic activity and create inefficient outcomes and economic losses (known as deadweight losses). Taxes on labour distort labour supply; taxes on capital distort savings; taxes on consumption may distort both consumption choices and labour supply. This chapter describes how to estimate the deadweight losses.

Given that every tax creates a burden for someone and that most taxes also create a deadweight loss, we want to find the tax system that minimises the burdens and the deadweight losses. As usual, there are trade-offs between equity and efficiency considerations. Chapter 28 discusses the design of an optimal tax system that maximise social welfare. It also discusses the more modest, but still demanding, requirements, of tax reform.

Finally, in this section, Chapter 29 discusses the use of debt to finance public expenditure. The chapter discusses the equity and efficiency implications of debt finance and the separate applications of debt finance to recurrent and capital expenditure.

Part 9 Taxation in Practice

In Part 9, we turn to the major practical applications of taxation. Most tax revenue is derived from four tax bases—personal and corporate income, consumption (or expenditure), and wealth. Accordingly, we discuss the use of each of these tax bases. We examine how the taxes work and their equity and efficiency implications, with main but not exclusive focus on Australian practice.

Chapter 30 discusses taxation of personal income. It describes both basic income tax concepts, such as the definition of taxable income, and general issues in income taxation such as the choice of tax unit and tax rate. It also discusses the effects of taxes on personal income from labour and capital and the international taxation of personal income.

Chapter 31 turns to corporate taxation. We describe basic concepts such as taxable corporate income and the basic variety of company tax systems around the world. Major sections then discuss the main equity and efficiency issues in corporate taxation and international taxation of company income. There is some discussion of appropriate corporation tax rates.

In Chapter 32, we discuss the taxation of the other two major tax bases—consumption and wealth. We examine the nature of these tax bases, applications in Australia and elsewhere, and the efficiency and equity implications of taxing consumption and wealth. We also discuss the effects of tax exemptions for not-for-profit organisations that typically comprise 3 to 4 per cent of the economy.

Part 10 Multi-Government Systems

The final part of the book discusses how national governments interact with sub-national governments and with other national governments. It also examines the effects of increasing globalisation of markets and economies.

In nearly all countries, whether unitary or federal countries, government functions at several levels. In Chapter 33, we discuss how government functions and taxation powers should be allocated most effectively to different levels of government, how sub-central government may be organised most efficiently, and intergovernmental financial relations.

The final chapter discusses how globalisation affects government. The chapter discusses how the growth of worldwide factor and product markets affects output and income distribution across and within countries. We then discuss how global economic pressures influence government revenue, expenditure and policies. We conclude, nevertheless, that national governments are here to stay.

Epilogue

In *Alice's Adventures in Wonderland*, the Dodo announces that 'Everybody has won (the Caucus race) and that all must have prizes'. This story was widely viewed as a satire of the political process, where politicians spend their time promising gifts. Economics, on the other hand, is the science of choice. We try to show how individuals make choices in markets and how governments do, and could, make choices over the use of resources for the well-being of individuals and for society collectively.