

LECTURE 11



Module structure

2

The role of
government &
market failures

- The size of government L1
- Public goods L2
- Externalities L3

Public choice

- Political economy L4

Taxation

- Tax incidence, excess burden L5
- Income tax L6
- Fiscal decentralization L7

Welfare and public
policy

- Health insurance L8
- Income redistribution L9
- Social insurance & labor supply
L10

Growth of the public sector

3

**Background:
Growth of public
spending**



Demand side

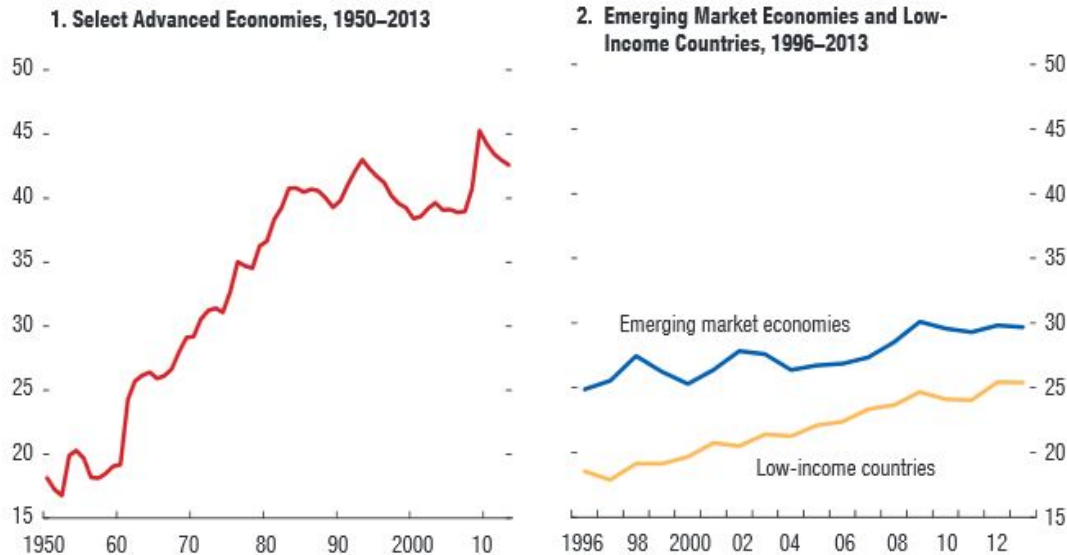
- Demand for public goods
- Regulations
- Costs

Supply side

Political reasons

- Demand for redistribution (inequality, fairness)
- Ratchet effects
- Fairness

Figure 2.1. General Government Expenditure
(Percent of GDP)



Sources: Mauro and others (2013); and IMF staff estimates.

Public goods

4

**Efficient
provision**

VS

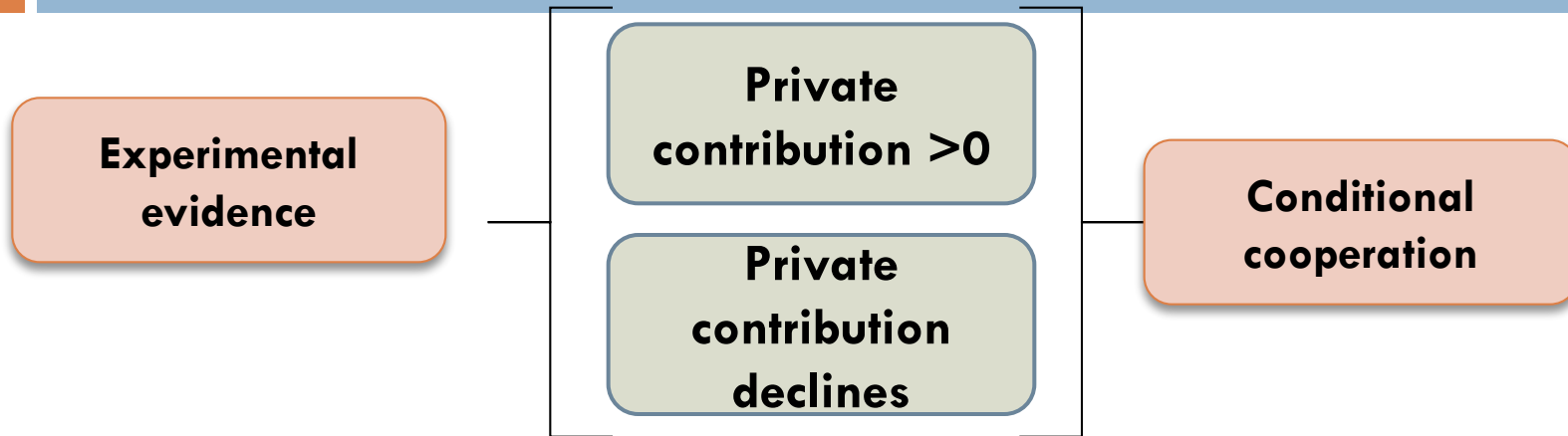
**Market
provision**

$$MRS_{ra}^{Adam} + MRS_{ra}^{Eve} = MRT_{ra}$$

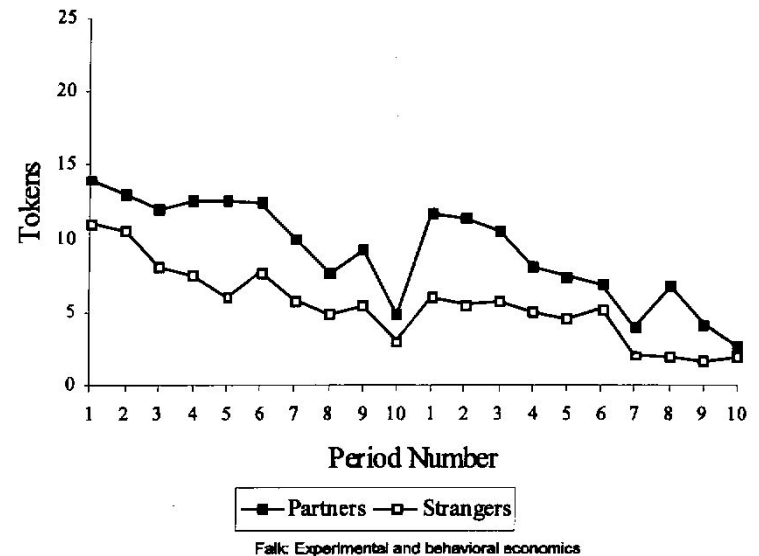
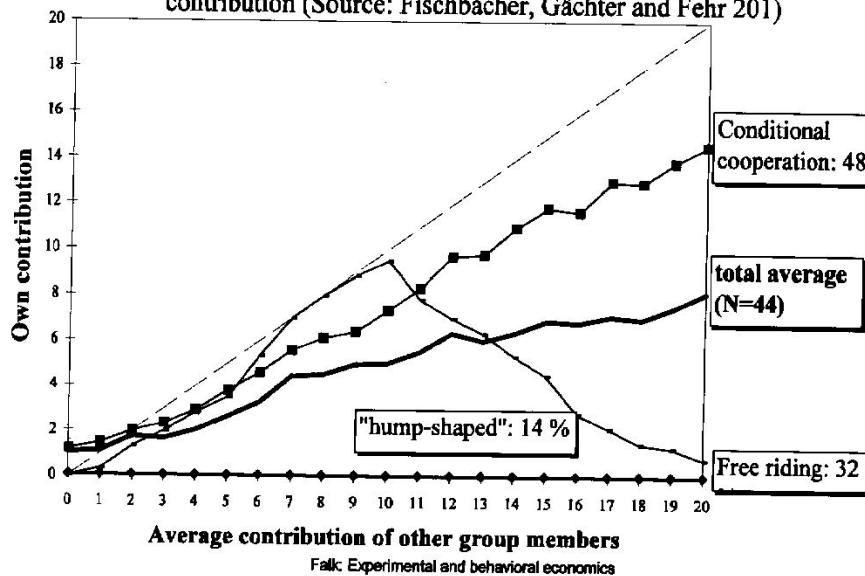
$$MRS_{ra}^{Adam} = MRT_{ra}$$

Public goods

5



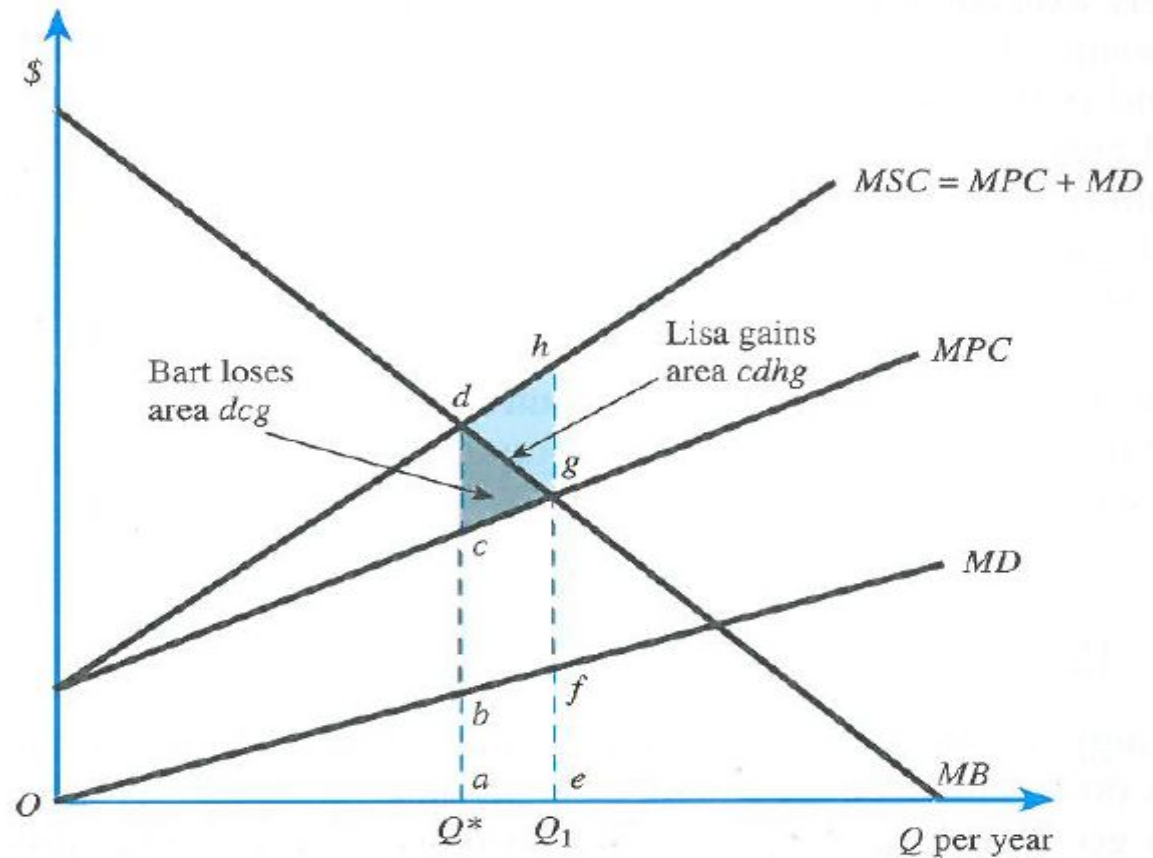
Own contribution as a function of other members' average contribution (Source: Fischbacher, Gächter and Fehr 201)



Externalities

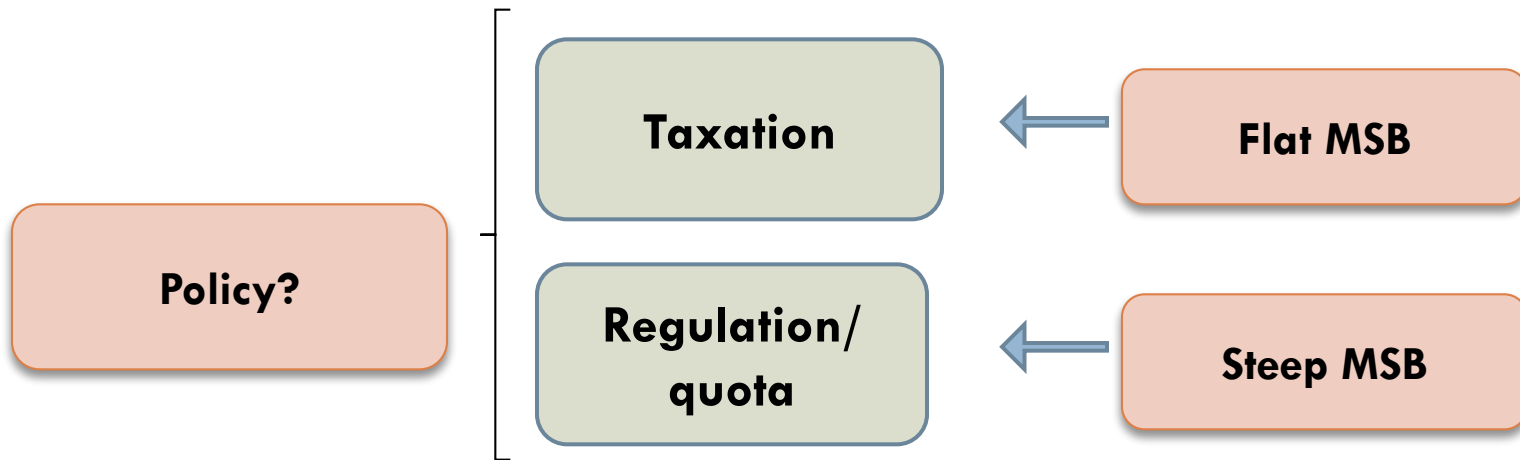
6

Private sector solution, DWL



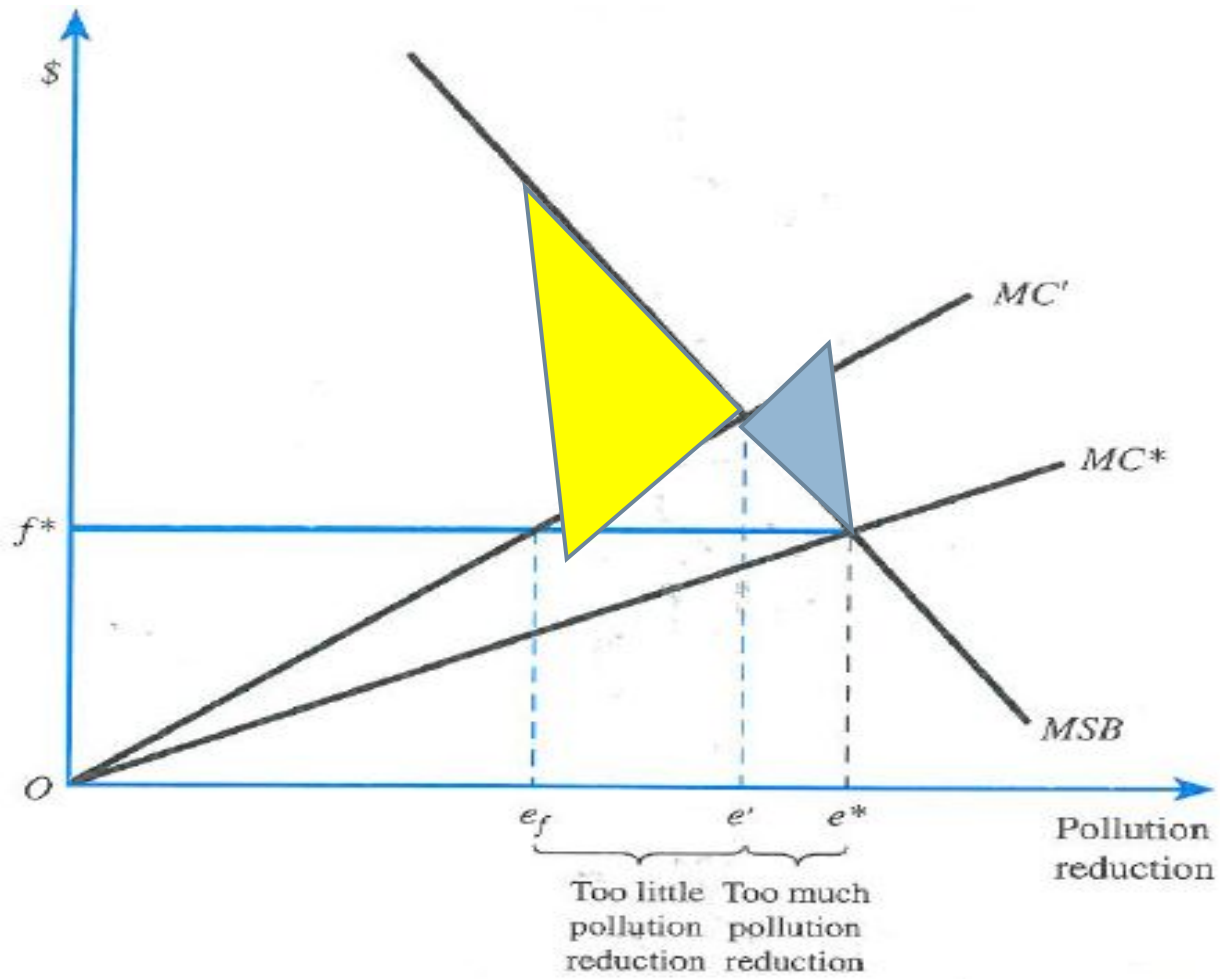
Externalities

7



Example: Global warming

- What policy options exist, how efficient they are etc.



Voting

9

How to aggregate individual preferences?

Majority rule



Condorcet winner

Cycling

Efficiency of the Condorcet winner

| Brad | Jen | Angelina |
|------|-----|----------|
| A | C | B |
| B | A | C |
| C | B | A |

Median voter theorem

Single-peakedness

Implications

Voting

10

**Arrow
impossibility
theorem**

Runoff voting

**Select Condorcet
winner?**

**Increased
popularity and
defeat**

Plurality voting

**Select
Condorcet winner?**

Strategic voting

Borda voting

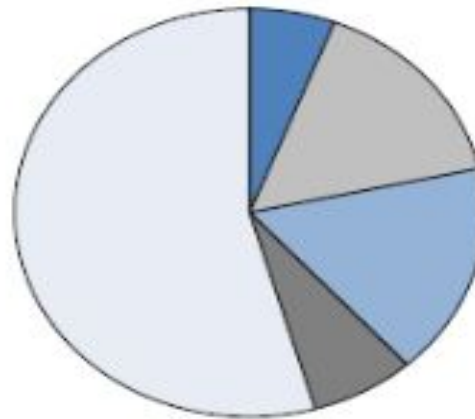
**Select Condorcet
winner?**

Taxation

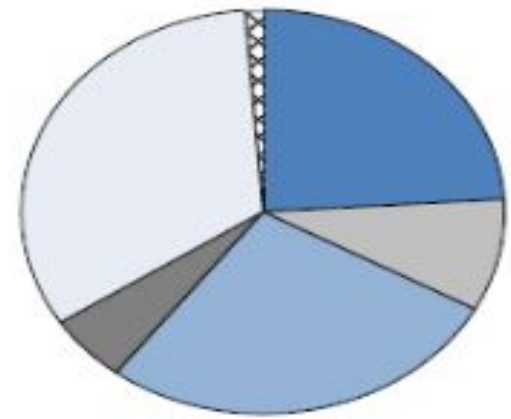
11

How to finance the growing public sector?

China (2010)



OECD (2010)



■ Personal income tax

■ Social security contributions (including payroll taxes)

□ Taxes on goods and services

□ Corporate income tax

■ Property taxes

▣ Other taxes

Taxation

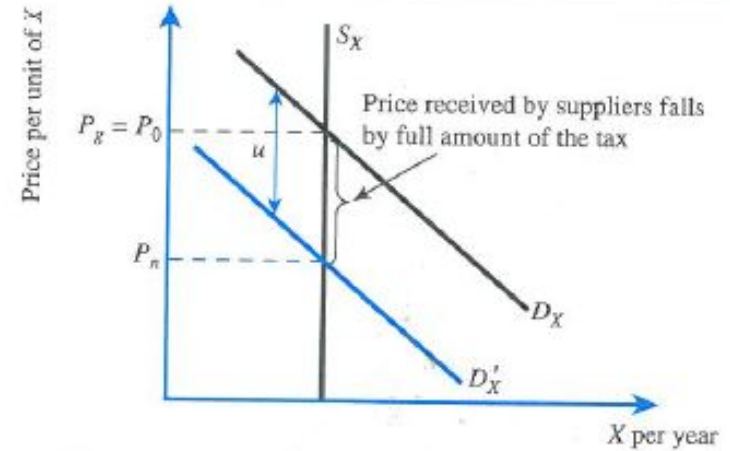
12

**Consumption
taxation**

Tax incidence

Excess burden

Ramsey rule



$$fid = \frac{1}{2} \eta P_b q_1 t_b^2$$

$$\frac{t_x}{t_y} = \frac{\eta_y}{\eta_x}$$

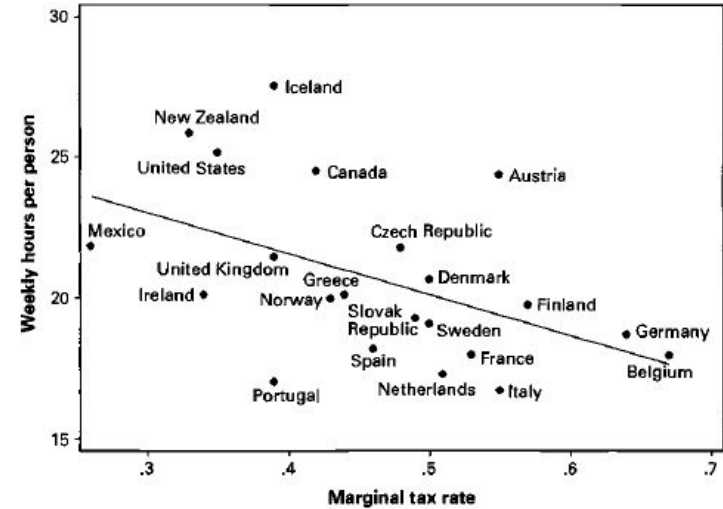
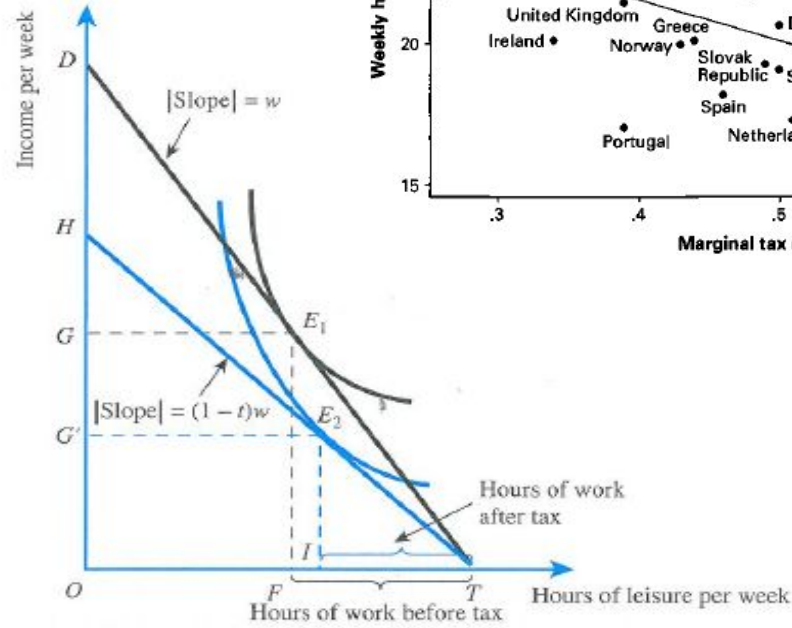
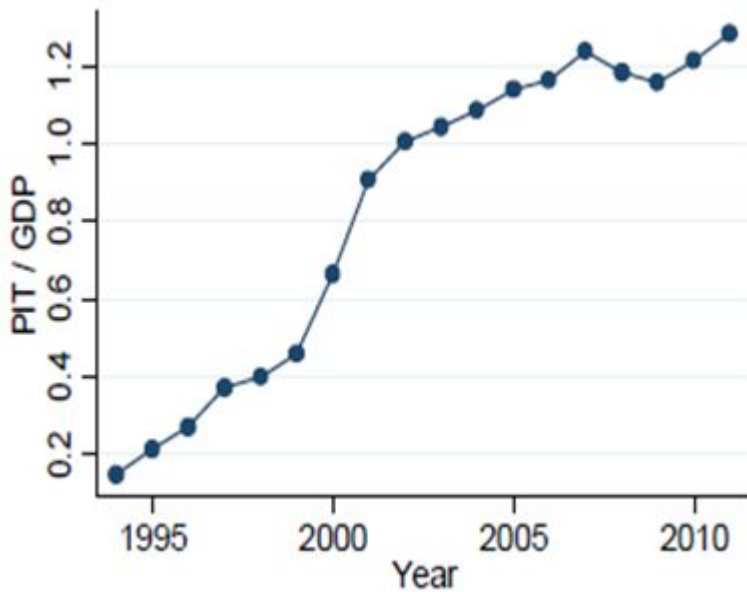
Taxation

Income taxation

Situation in China

Theory

Evidence



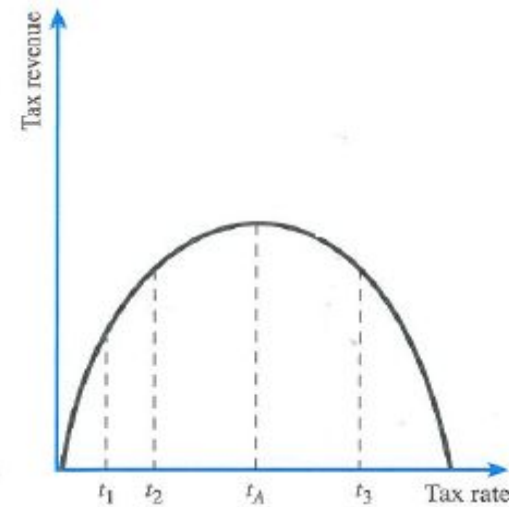
Taxation

14

Income taxation

Laffer curve

Housing decisions



Income tax vs. consumption tax

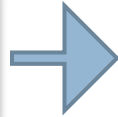
Inequality and growth

| | GDP growth | Inequality |
|---------------------|-------------------|-------------------|
| Personal Income tax | -- | ++ |
| Consumption tax | - | -- |

Fiscal decentralization

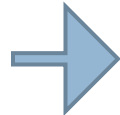
15

**Arguments
for/against
decentralization**



- **Tiebout**
- **Local preferences**
- **Competition**
- **Experimentation**
- **Economies of scale**
- **Equity / tax competition**

**Decentralization
reforms in China**



Critical assessment

**Decentralization
and economic
growth**



Incentive effects

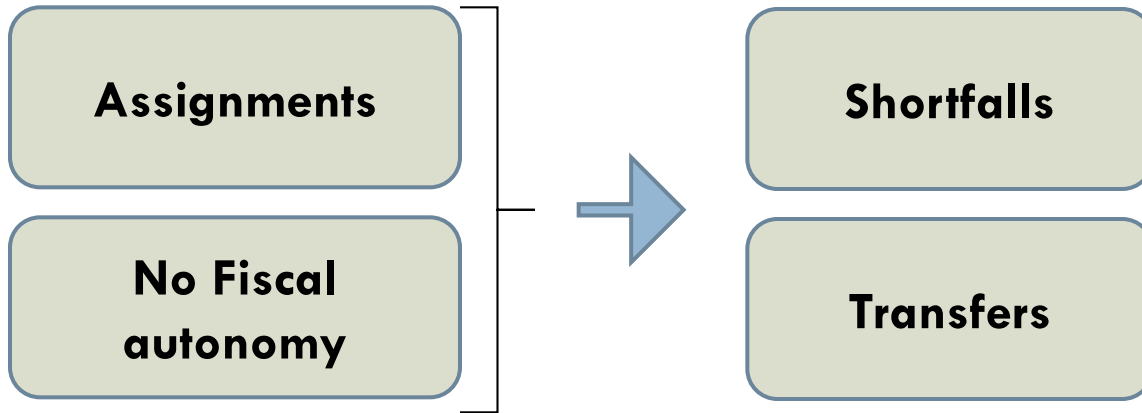
**Decentralization
and inequality**



- **Unequal tax base**
- **Fiscal competition**

Fiscal decentralization

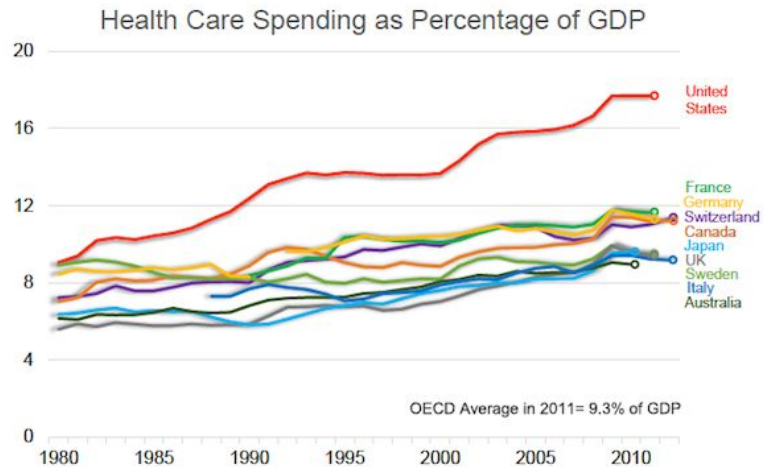
16



Health insurance

17

Growth in health spending



Private sector

Adverse selection

Paternalism

Equity considerations

The uninsured

Health insurance

18

Design of health insurance

Moral hazard

Costs

**Flat-of-the-curve
medicine**

Income redistribution & social insurance

19

Inequality measurement and trends

Social welfare function

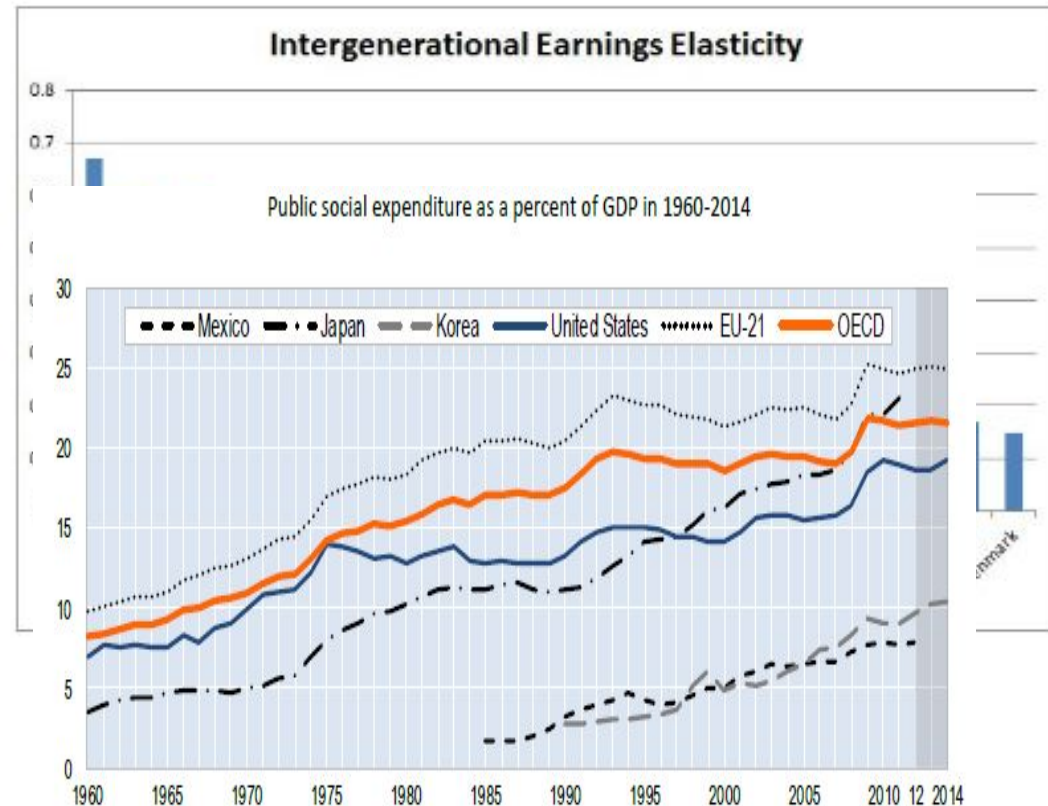
Low social mobility

Social spending: EU vs. USA

Out of the bottle

Gini coefficients, Maximum income inequality=1
Latest

0 0.1 0.2 0.3 0.4 0.5 0.6 0.7



Income redistribution & social insurance

20

Impact of SI

Redistributive Impact of Fiscal Policy in Advanced Economies, mid-2000s



Income redistribution & social insurance

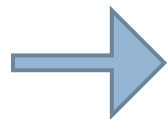
21

Social insurance programs

TANF

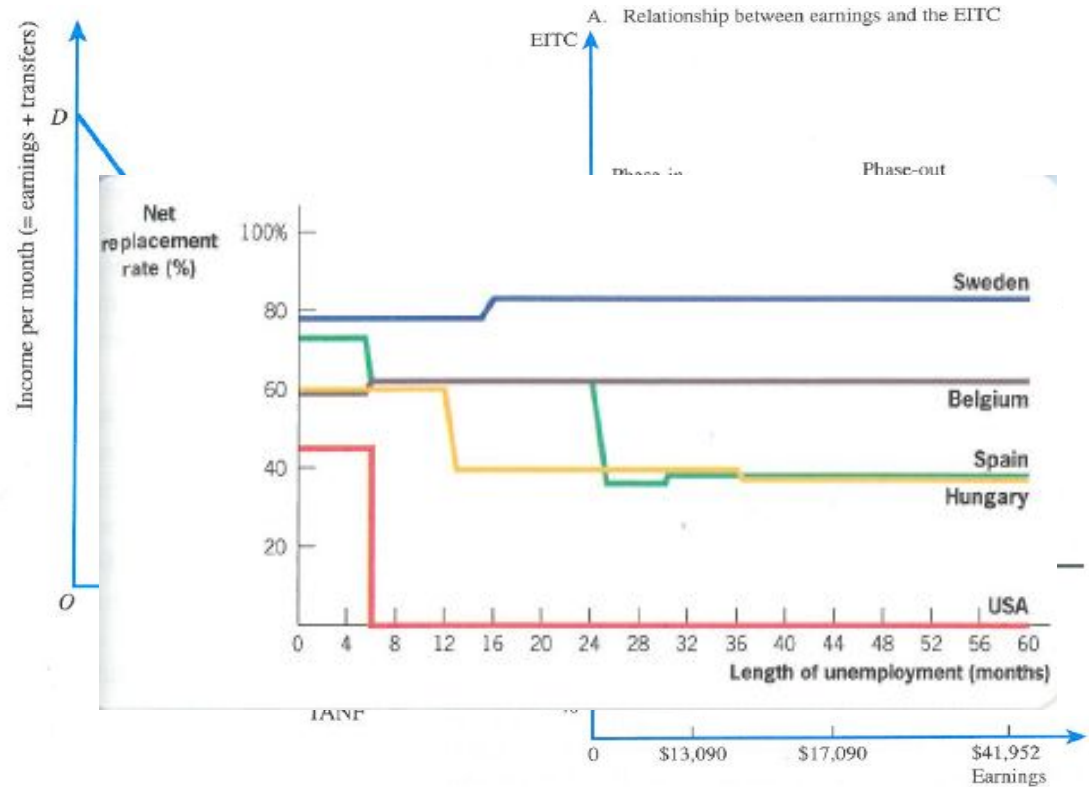
EITC

Unemployment insurance



Moral hazard

Flexicurity



What we have learned

22

- Theory + empirical evidence (with data)
- Contradiction between some theories and empirical evidence
 - Externalities
 - Public goods
 - Ramsey rule
 - Social insurance and moral hazard
- Implications for China

Exam structure

23

- 2-hour exam.
- Answer 2 essay questions from 5.
- Broad questions
 - 1 hour/Q

Exam 2016

24

1. Discuss the arguments for and against income redistribution, and explain the reasons for the differences in redistribution policies between Europe and the United States.
2. Critically discuss the achievements and limitations of fiscal decentralization in China, and discuss how further reforms could improve the current fiscal decentralization system.
3. Critically discuss the statement that “voting can always consistently aggregate individual preferences”, and explain the limitations of the different voting rules.
4. “Government intervention is required to efficiently provide public goods, and the underprovision of public goods by the private sector demonstrates that individuals are selfishly motivated.” Discuss this statement with reference to the theory and evidence.
5. Discuss the advantages and disadvantages of public health insurance. Explain what factors may influence the design of public health insurance policies.

Before you answer...

- Choose to answer only those questions you fully understand

Do not reproduce prepared essays without regard to what the question asks

Your Answer...

- Should have a clear structure
- The Introduction should act as a signpost to the reader
- The Main Body of argument should follow, with evidence, examples etc. used to support statements
- A (brief) conclusion should end the essay

Good Practice

- Define technical terms as you introduce them, especially any such terms that are specified in the question
- Use examples whenever possible to support arguments
- Credit is usually given for examples and evidence that goes beyond lecture notes
- Use equations, graphs, figures etc. where relevant

More Good Practice

- Explain diagrams or figures

- Label graph axes etc.

- Equations/figures etc. that are merely reproduced without comment do not improve answers

- There is no need to do a list of references

Bullet Points Answers?

- Reproducing bullet points does not constitute a good answer, even if the points are relevant
- Try to write a coherent explanation
- If you really run out of time on the last question, brief notes indicating how the answer should have developed may help.

Final Considerations

- Where contradictory arguments exist, it may be useful to indicate their respective strengths.

- Personal opinions are fine, but cover the received views first.