

# 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

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**Background:  
Growth of public  
spending**



**Demand side**

- Demand for public goods
- Regulations
- Costs

**Supply side**

**Political reasons**

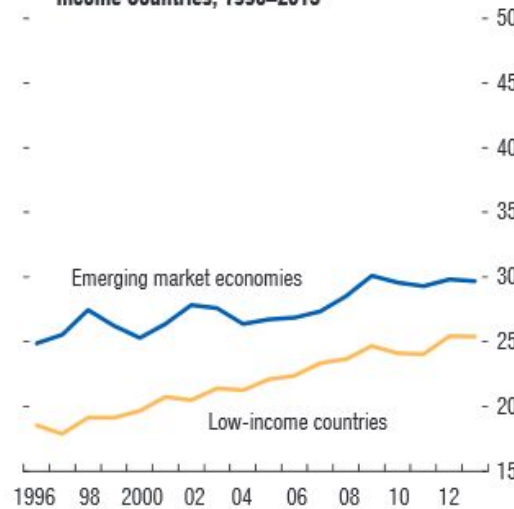
- Demand for redistribution (inequality, fairness)
- Ratchet effects
- Fairness

**Figure 2.1. General Government Expenditure**  
(Percent of GDP)

1. Select Advanced Economies, 1950–2013



2. Emerging Market Economies and Low-Income Countries, 1996–2013



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

# Public goods

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**Efficient  
provision**

VS

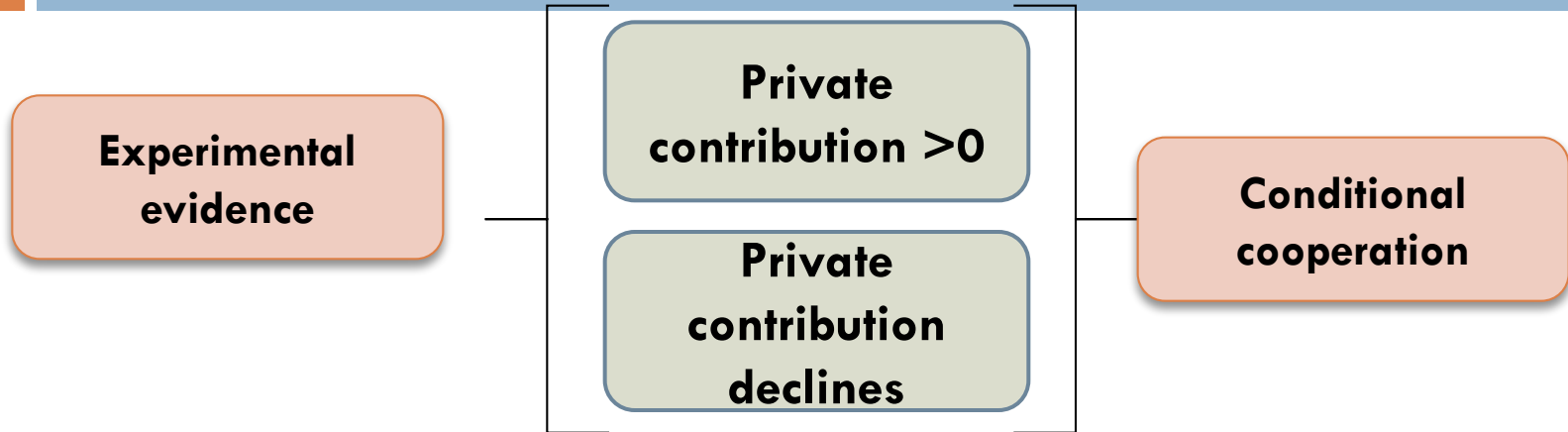
**Market  
provision**

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

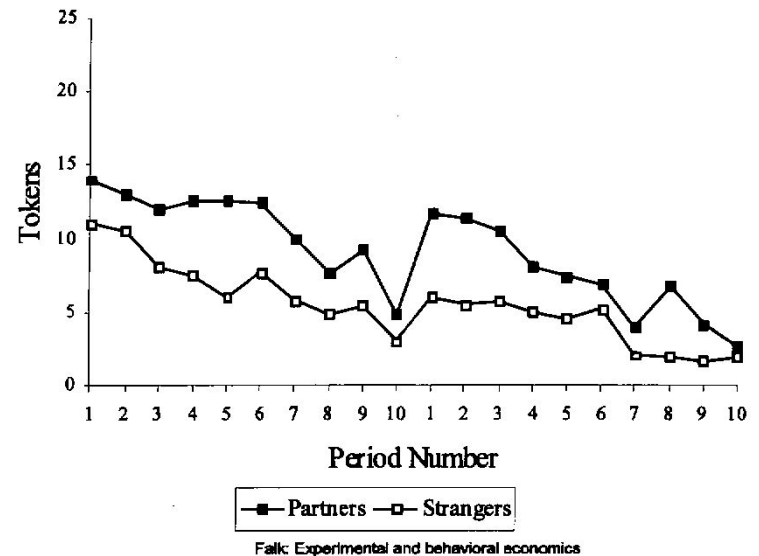
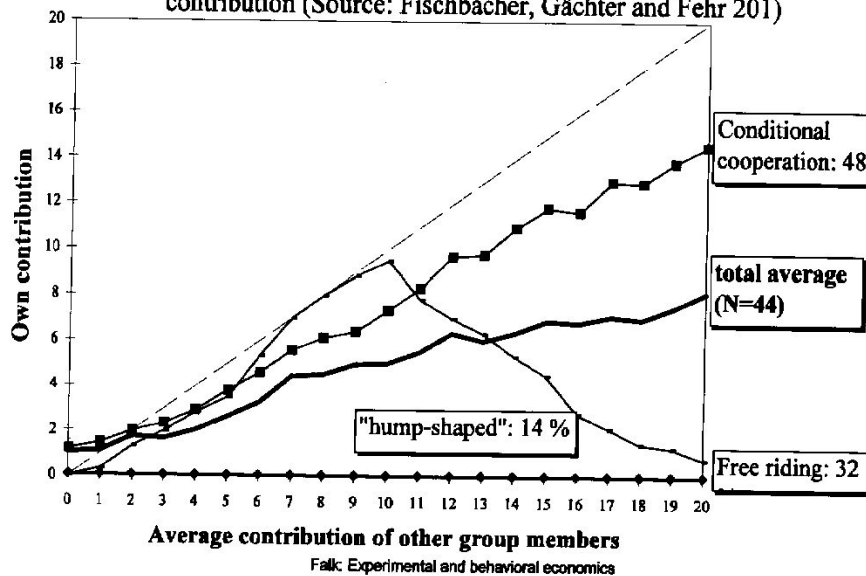
$$MRS_{ra}^{Adam} = MRT_{ra}$$

# Public goods

5



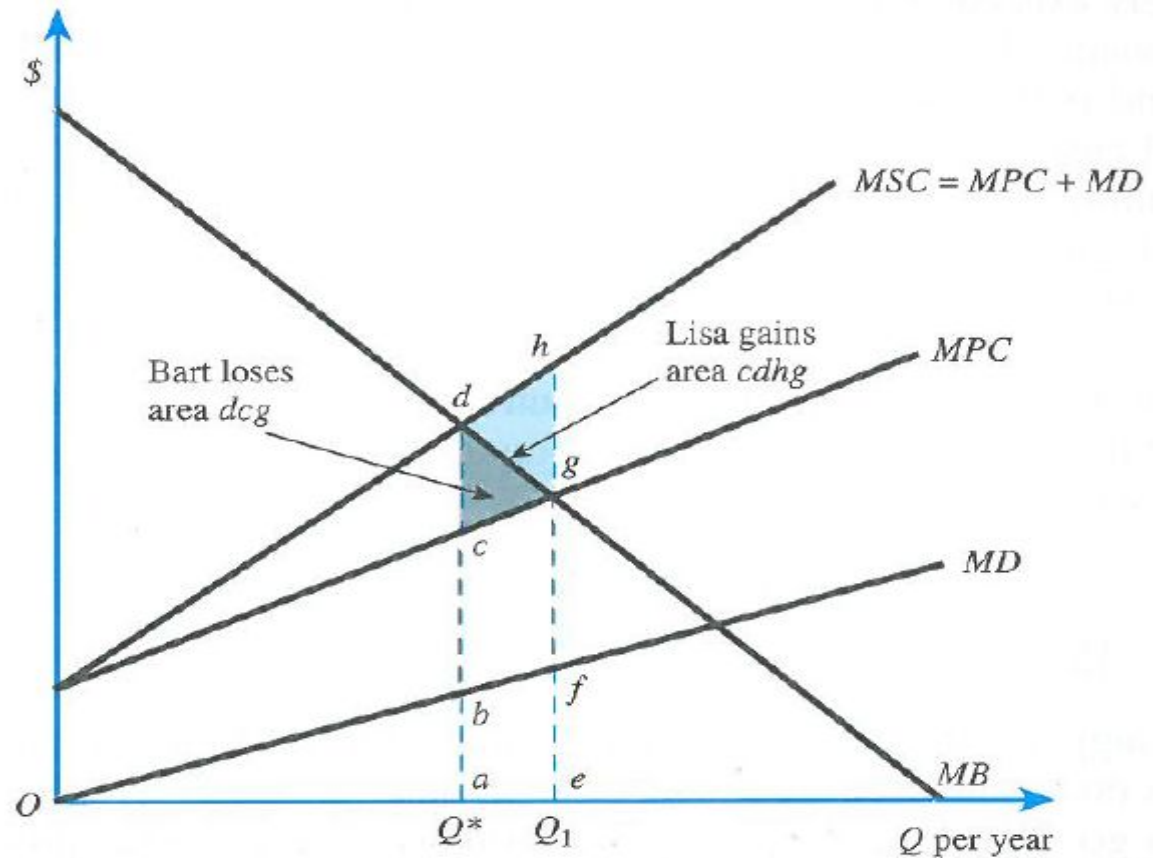
Own contribution as a function of other members' average contribution (Source: Fischbacher, Gächter and Fehr 201)



# Externalities

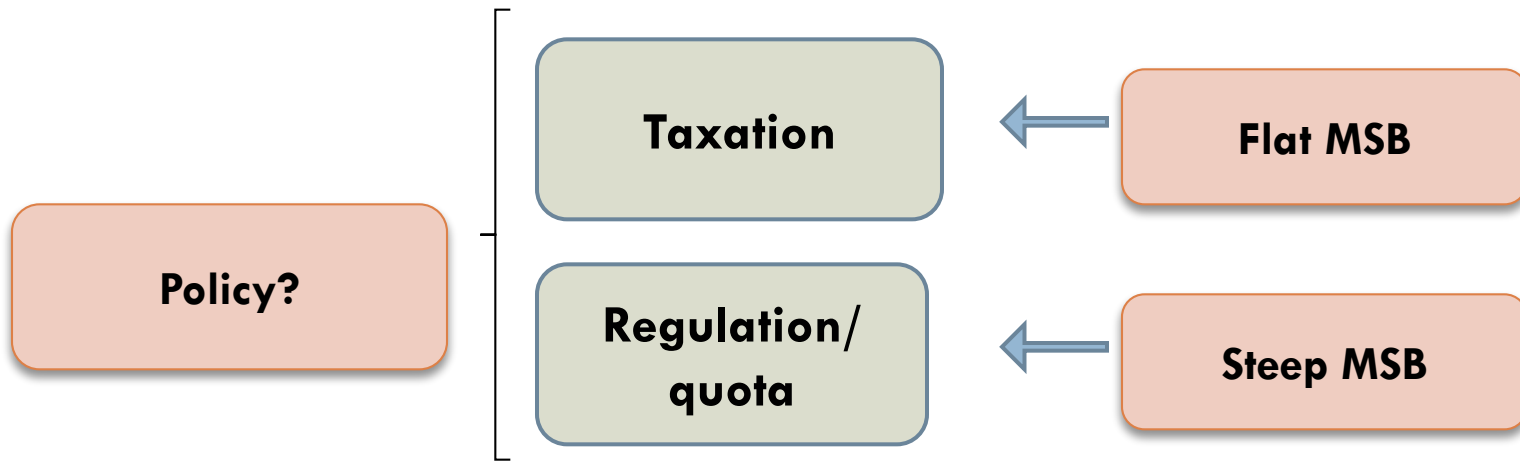
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Private sector solution, DWL



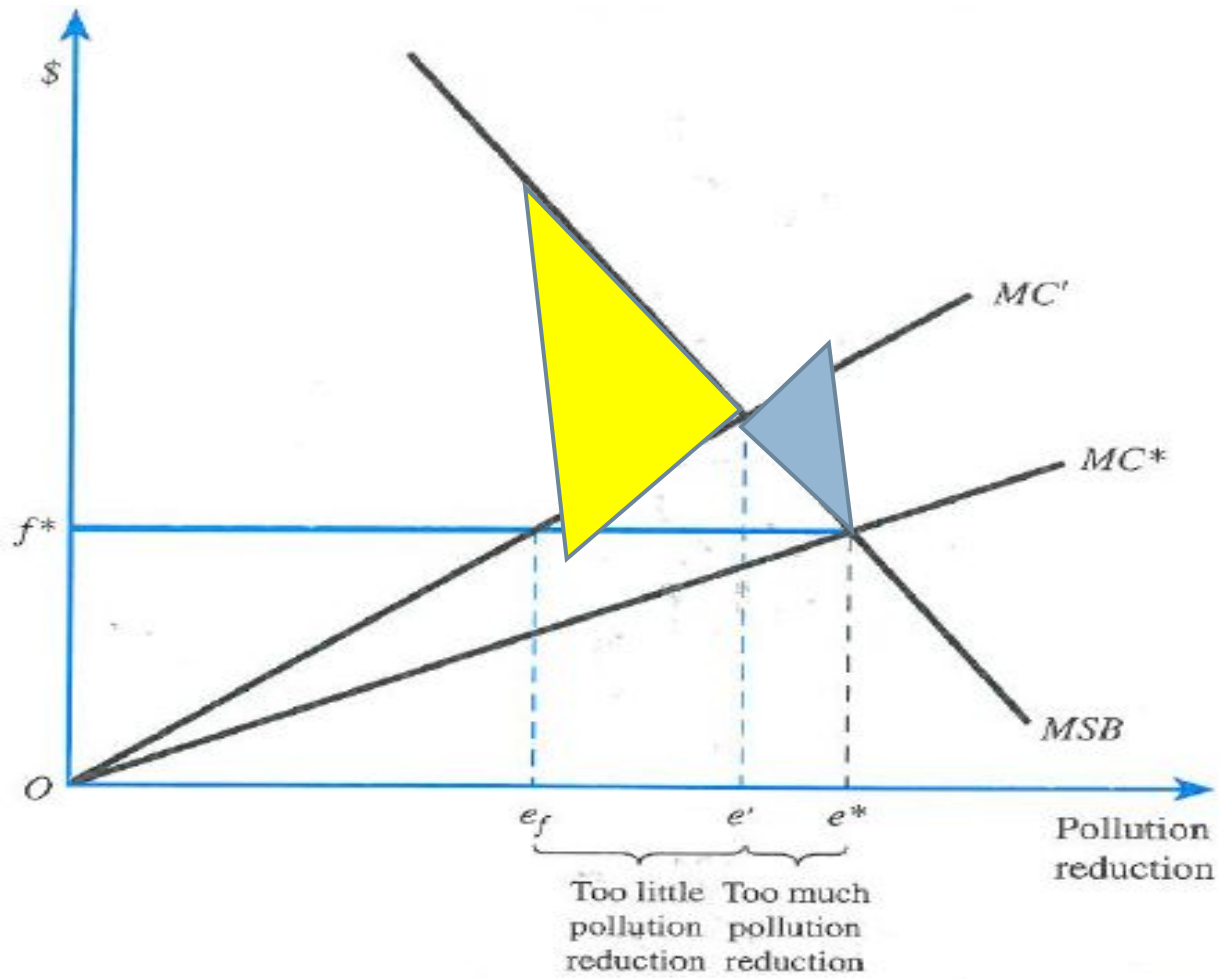
# Externalities

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Example: Global warming

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





# Voting

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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

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**Arrow  
impossibility  
theorem**

**Runoff voting**

**Select Condorcet  
winner?**

**Increased  
popularity and  
defeat**

**Plurality voting**

**Select  
Condorcet winner?**

**Strategic voting**

**Borda voting**

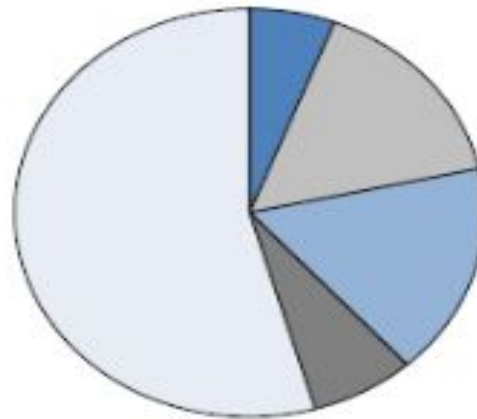
**Select Condorcet  
winner?**

# Taxation

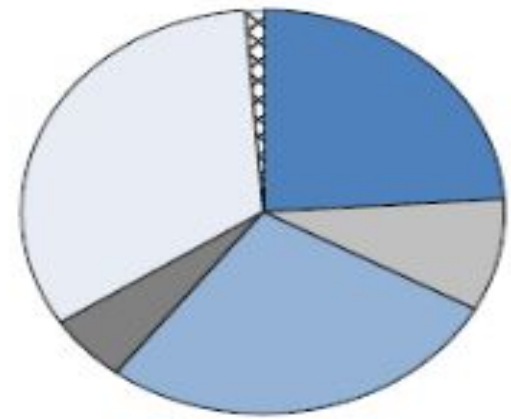
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**How to finance the growing public sector?**

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

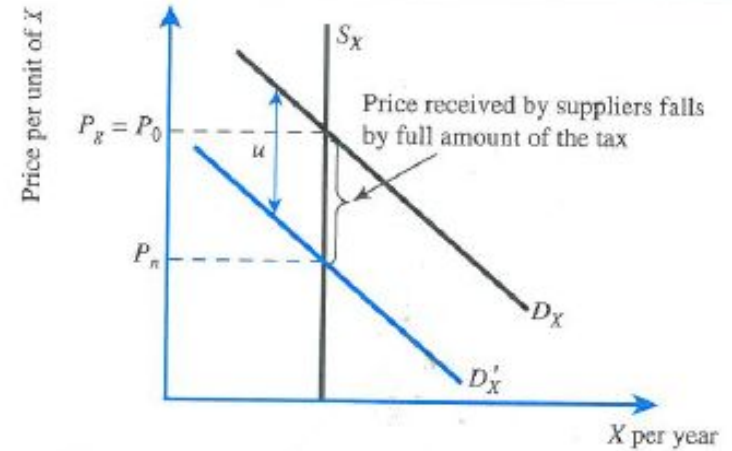
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**Consumption  
taxation**

**Tax incidence**

**Excess burden**

**Ramsey rule**



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

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

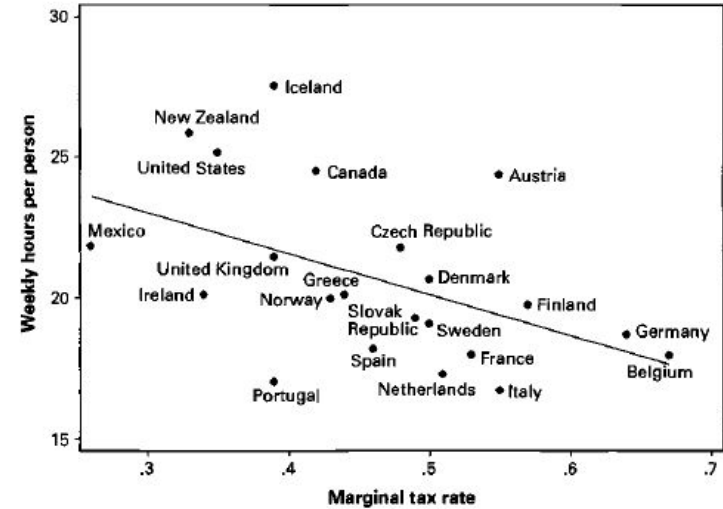
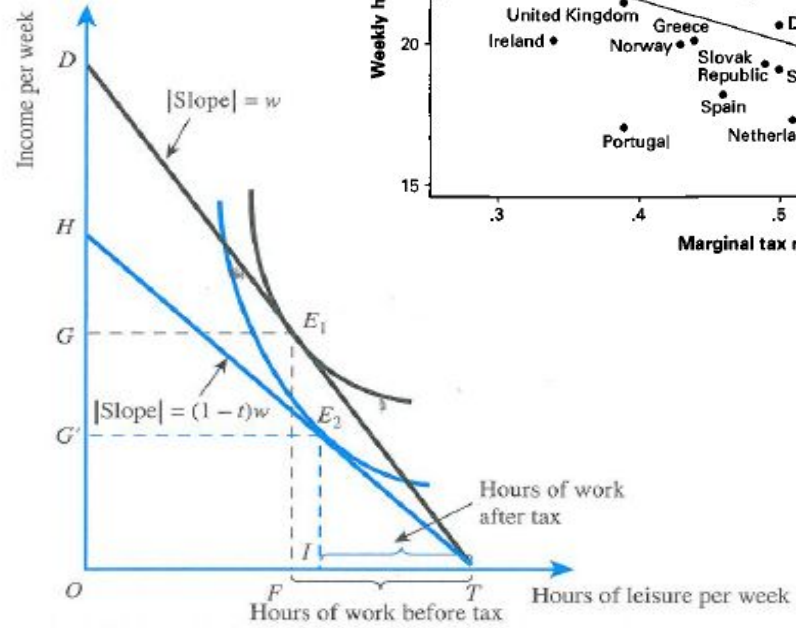
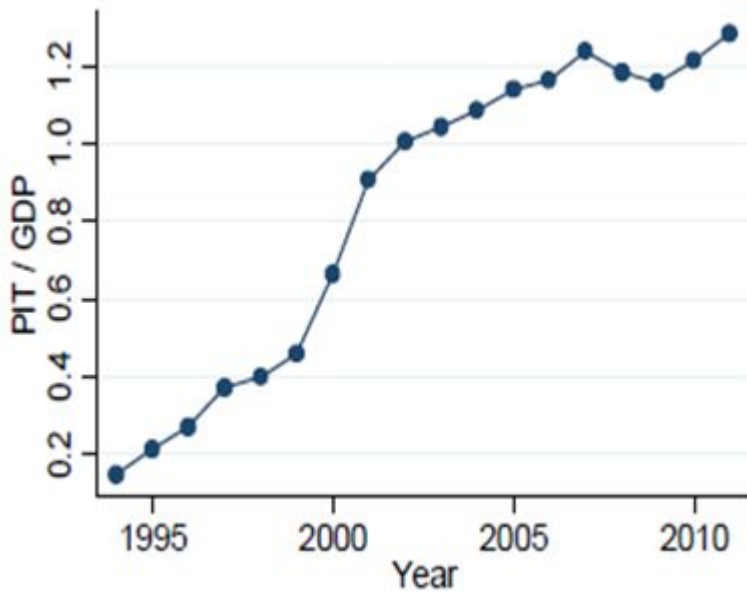
# Taxation

## Income taxation

Situation in China

Theory

Evidence



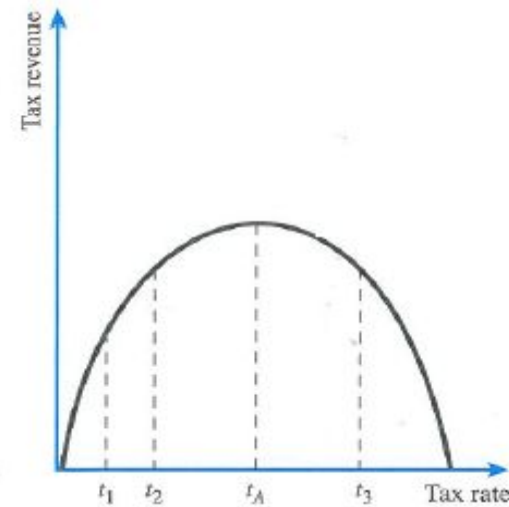
# Taxation

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**Income taxation**

**Laffer curve**

**Housing decisions**



**Income tax vs. consumption tax**

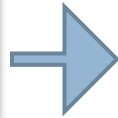
**Inequality and growth**

	<b>GDP growth</b>	<b>Inequality</b>
Personal Income tax	--	++
Consumption tax	-	--

# Fiscal decentralization

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**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**

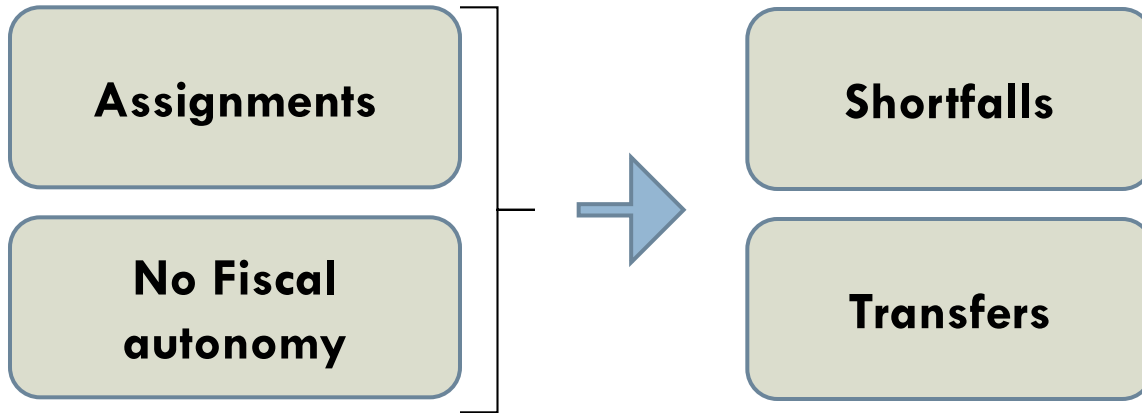
**Decentralization  
and inequality**



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

# Fiscal decentralization

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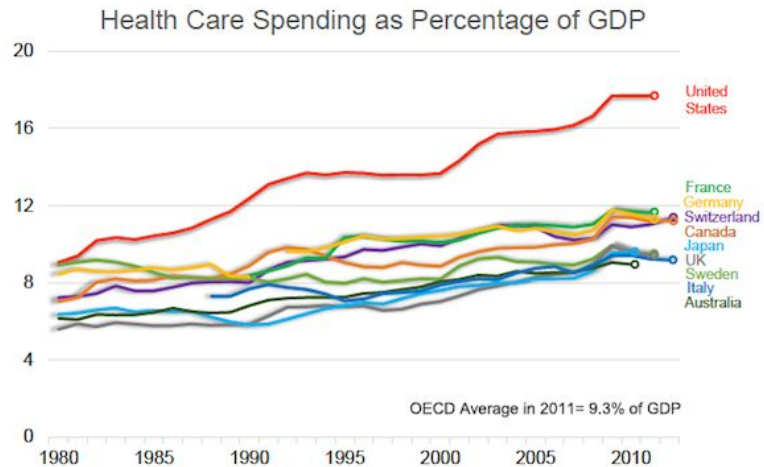




# Health insurance

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**Growth in health spending**



**Private sector**

**Adverse selection**

**Paternalism**

**Equity considerations**

**The uninsured**

# Health insurance

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**Design of health insurance**

**Moral hazard**

**Costs**

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

# Income redistribution & social insurance

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**Inequality measurement and trends**

**Social welfare function**

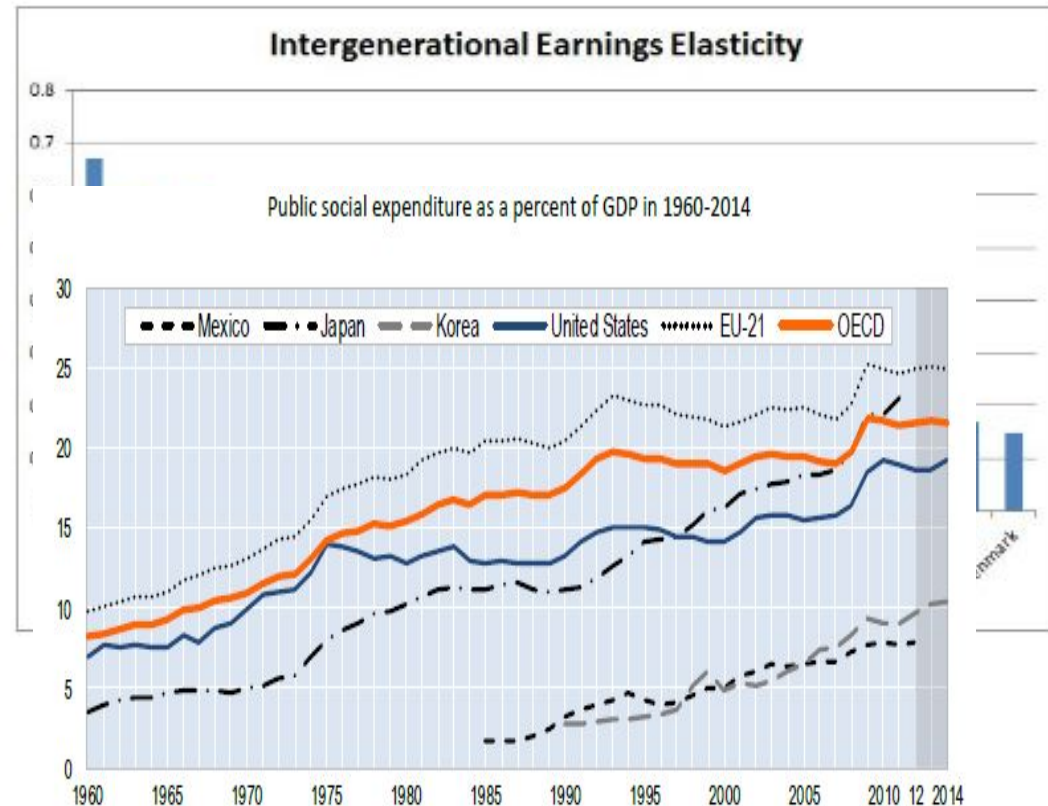
**Low social mobility**

**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

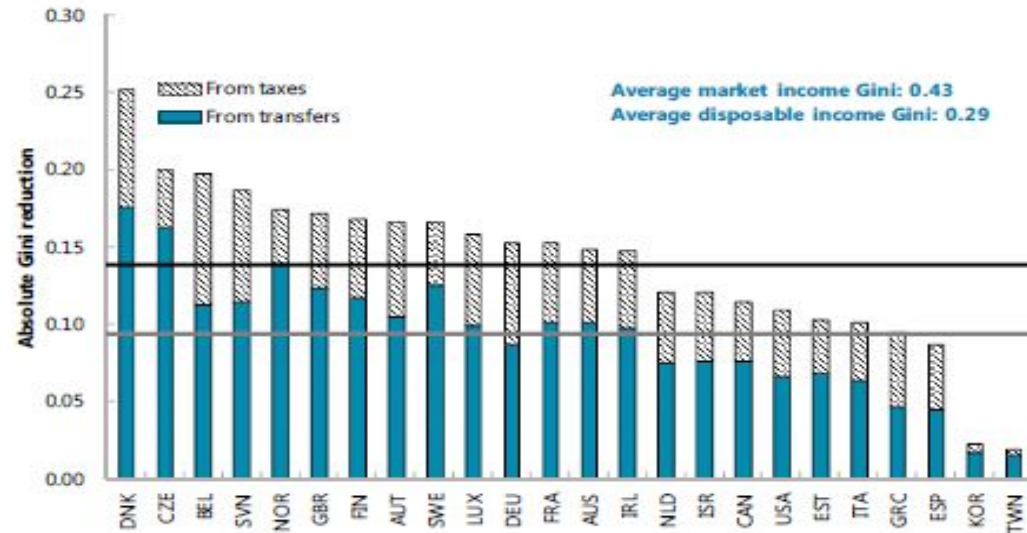


# Income redistribution & social insurance

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## Impact of SI

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



# Income redistribution & social insurance

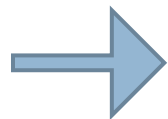
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**Social insurance programs**

**TANF**

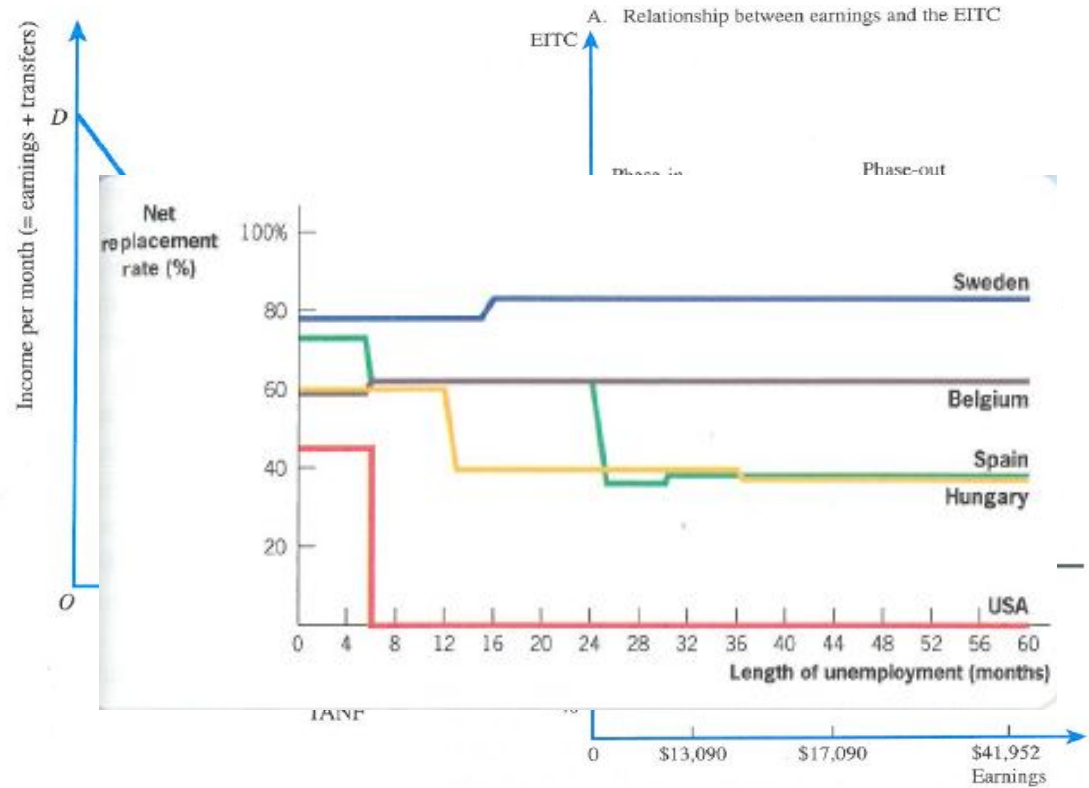
**EITC**

**Unemployment insurance**



**Moral hazard**

**Flexicurity**



# What we have learned

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- 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

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

# Exam 2016

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.