Forest from the Trees Lecture, An Overview

In the beginning of the course, I argued that public economics is an important field—indeed an increasingly important field, because public policies have an increasingly large effect on the real economy. RGNP for the United States is approaching 20 trillion dollars and the central government's expenditures are over 4 trillion, state spending is somewhat over 2 trillion, and local expenditures are on the order of 1 trillion dollars, for a total of about 7 trillion dollars, about 35% of US GNP. Many of these expenditures are "transfer" or "insurance" programs in which recipients receive cash or cash equivalents and individuals and firms are free to spend it as they wish. These expenditures change the distribution of private expenditures—with those receiving the transfers having more to spend and those paying the taxes that finance the transfers having less. There are also significant areas of expenditures in which the various levels of governments spend money to produce public services of various kinds, as with the court system, primary and secondary education, national defense, and road network. And, beyond that areas in which various subsidies are provided for purchases of such things as various agricultural products, battery driven automobiles, and airports. Together these expenditures reshuffle more than 1/3 of GNP in the US from one use to another. (The basic law enforcement system consumes only a small fraction of the overall cost of government services, approximated here as 1% of GNP.)

In addition, all three levels of government adopt regulations that affect the pattern of consumption and production. Here one can begin with various health and safety regulations and continue to think about standards for building, electricity transmission, and rules for entering and in some cases leaving an industry. There are a variety of tax laws, effluent regulations, and zoning regulations that indirectly affect how and where production takes place.

Overall, an analysis of trade and production networks that ignores public policy will miss a good deal of what actually determines the prices of goods, services, and the processes of production used to produce, transport, and sell those goods and services.

Organization and Focus of the Course

Positive Public economics is, thus, central to understanding the private economy. This was less true in 1900 when micro economic models were being worked out, but in the period after WWII, ignoring the effects of government policies on the private economy became increasingly problematic. Relatively few markets can be characterized by the usual competitive or monopoly models, where production costs reflect relative input scarcity, technology, and the pattern of demand (grounded in marginal product and tastes) alone.

However, understanding what a market would look like without the intervention of government policies provides a useful point of departure for Public Economics. It allows one to model and identify the effects of government policies in a manner that would be difficult if not impossible without it. So the competitive model is not a waste of time, it is a precondition for working out the effects and demands for public policies. It is such market outcomes that produce the circumstances that lead governments to adopt the policies that they do.

Although we have thought a bit about normative issues, the main focus of the course has been on explaining and predicting the kinds of policies that would be adopted in democracies if voters are reasonably well-informed about the costs and benefits of alternative policies, where those costs and benefits are both grounded in the pre-intervention circumstances and the anticipated consequences of public policies. For example, what normative public economics refer to as externality and public goods problems are normally ones in which voters can at least potentially benefit from a variety of regulations, user fees, taxes, and subsidies. Electoral demand may thus be expected to "demand" or at least support policies that reduce the personal disadvantages of such problems. (No assumption has been made that voters or the government will maximize social net benefits, only that anticipated benefits motivates voters to favor one policy over another.)

The same sorts of anticipated benefits may also be associated with policies that transfer wealth or income to particular groups of individuals. Farmers, for example, tend to favor subsidies and tax-funded crop insurance, because it tends to increase their profits and reduce their risks. Such policies make little or no sense from the perspective of welfare economics, but do make sense for farmers and they will support such policies with their votes and (through various farm cooperatives and similar organizations) contribute to the lobbying expenses associated with petitioning government to enact and continue such programs.

Notice that in both cases, it is the original pre-intervention setting that describes the gains from public policy that voters and interest groups anticipate. The utilitarian normative framework provided by welfare economics could help explain solutions to externality and public goods problems (as with environmental regulations and national defense) but only if voters all had internalized those theories! Instead of benevolent dictators or central-planers, we have simply assumed that elections motivate politicians to discern what pivotal voters want and to attempt to adopt policies that are consistent with those wants—more or less as entrepreurs do when they open and stock a retail outlet. Failures to do so will cause candidates for higher office to lose elections and private entrepreneurs to lose money.

The second step—after the base non-intervention state has been characterized—is to analyze how democratic processes (majority rule-based elections) work if voters and firms behave more or less in the same way as consumers and producers. It is these majoritarian processes that characterize the main directions and general nature details of public policies.

Given the second step, the third step is to take account of the fact that voters are not fully informed about public policies nor electoral competition perfectly competitive. These "imperfections" allow interest groups to determine many of the fine details of public policy. The influence of such groups emerges oddly enough because of public goods problems associated with lobbying. Were it not for such effects, consumers would drive most public policies, because they have interests in every market and are more numerous than producers are. However, consumers free ride on such efforts and so do or fund little direct lobbying. This creates an opening for producers to lobby for preferential treatment. If we take Olson's logic seriously, this tends to favor relatively more concentrated industries who have relatively less free riding to overcome and industrial groups that are organized for other purpose such as farmer cooperatives and labor unions. Such groups can drive public policies away from median voter outcomes by trading campaign support for policy preferences and also by persuading voters, politicians, and/or bureaucrats, that their interests are aligned with industries.

The second and third steps are the public choice or political economy models of public policy formation. They are positive theories (although they can take account of voter norms, ethics and ideology) that explain public policies as joint outcomes of voter and interest group demands under preexisting political institutions. Those theories bring public policy into the analysis instead of leaving it outside the economic system. In econometric terms, it reminds us of the obvious: that such policies endogenous rather than exogenous. And, moreover, that public policies with economic effects are normally motivated by those effects. The effects of public policies are not accidental!

The fourth step in the analysis is to analyze how institutions affect this process. That is to say, the "pre-existing institutions" may have systematic effects on the kinds of policies adopted. In lecture, we found that the incentives of dictators and voters have different preferences over policies for many reasons. Dictators tend to be more interested in "extraction" than in voter welfare. Voters are naturally more interested in their own welfare than in shifting their resources to the ruler or central government. We also noted that incentives for local governments within decentralized systems of government differ from those in more centralized governments. And, moreover that even differences in the way in which majoritarian electoral systems are organized can have effects on public policies (as with the difference between "first past the post" and "proportional representative" systems of elections.) All these effects imply that "institution" or "constitutions" matter.

Together steps two, three, and four provide a systematic framework for thinking about public policy, why voters and interest groups favor some policies over others, and why elected governments and their appointed agents tend to adopt particular kinds of policies. It is these policies that we observe in the real world and which account for about 35% of the pattern of expenditures in the United States along with regulations that direct or incentivize much of the rest. It is providing the micro-foundations of such policies that is the focus of the positive strand of public economics.