Unit 6: Public sector

1. The financial activity:

The public sector is the main player in modern economic systems. The vast majority of current economies are affected by state **intervention** in markets through **regulation** or participation in them as a **producer** or service **provider**. Hence, the State - or, rather, the public sector - has the need to carry out a complementary activity: financial activity, understood as the set of processes under which the State obtains resources that it will later use in its economic policies.

1.1 Justification of State intervention:

The mainstream that argues the need for State intervention in the economy supports the existence of what has come to be called "market failures." Next, we will expose some of them or, in other words, some of the most widespread justifications that postulate the active participation of the State in economic systems as necessary:

- **Provision of public goods and services:** Who finances lighting, roads, health, and education? The answer could be in the market, although, in that case, part of the population may not consume this type of services (education, health) in its optimal quantities. Once we understand that a trained and healthy population generates advantages for all citizens (positive externalities), we can deduce that States will try to offer these services in a generalized manner, and not leave their provision exclusively to the market.
- **Defense and protection of the environment:** rules, regulations, sanctions, taxes to modify the behaviour of companies as long as they do not damage our environment. Could societies by themselves respect the environment and prevent the actions of some economic agents from damaging the environment (negative externalities)? The orthodox current here finds a strong reason to defend the intervention of the public sector, while there are other studies (Ostrom and Williamson, Nobel Prize in Economics in 2009) that suggest that certain types of goods (the so called common goods) can be managed efficiently by communities of individuals, and not by the State.
- **Regulation of market structures:** in order to prohibit and delimit the scope of certain forms of aggressive market with consumers, such as oligopolies and monopolies.
- **Income distribution**: in order to guarantee a certain equilibrium at the starting point of the individuals of a company.

Liberal thinkers do not agree on the intervention of the markets and defend the private initiative as the best solution to the previous problems, denying the existence of market failures and exchanging the expression to speak about failures of the State.

1.2 The financial activity of the State

The main functions of the public sector, which derive from the previous justifications, need, in order to be carried out, the existence of financial activity. As we have introduced at the beginning of the section, we will understand this as the activity that leads the State to capture economic resources (public revenues) and, according to principles that legally regulate this activity, use these resources (public expenditure) to avoid or mitigate the 'Market failures'.

Activities:

1. Classify the following situations as negative externality or positive externality and suggest a way to solve them.
Debate in class later.
a) A roommate smokes all the time in the room.
b) A tannery pours its waste into the river bed, causing the death of fish from a fish farm located at its mouth.
2. Imagine that you run a bread shop and that no one else in 50 kilometres around sells this product.
a) At what price would you sell the bread?
b) Would you charge the same price to everyone? Why? Explain your answer.
c) Do you think that this monopoly situation would be maintained for a long time? What do you think will happen over time?
d) In what way could you prevent the competition from appearing? Do you think that such practices would be allowed by the State?

2. Public income

So that the public sector can be able to intervene in economic activity, it is necessary to have some income with which to face the expenses derived from its performance in the economy. Now, what are the sources of this income? In what way do you get them? We will try to answer these questions in the present epigraph.

- **Social contributions:** They are contributions of employed people and companies (individuals and companies) to the Social Security system, to finance the coverage of the system (pensions, unemployment…) A contribution is required by every adult, and its amount is determined by applying a percentage to the remuneration.
- **Taxes (contributions):** They can be classified:
    - **Tax:** Taxes required without any consideration can be divided into:
        - Direct: They take into account the individual personal situation. Eg IRPF for individuals. IS legal persons.
        - Indirect: They do not take into account the situation of people. Ex IVA.
    - **Fees;** Taxes that are paid in consideration to a service received from the state. Eg DNI fees or study fees.
    - **Special contributions:** Taxes demanded from the citizens who benefit from the performance of some action. Ex Fixing of roads.
- **Other sorts of income:**
    - Current transfers
    - Patrimonial income
    - Realisation of investments
    - Capital transfers

3. Public expenditure:

Public expenditure is the set of expenditures made by the public administration. With regard to the state, and depending on its destination, it is possible to classify public expenditures in:

- Current expenses: These are general expenses intended to provide society with public services such as health, education, justice and many others. Ex Salaries of officials and buying in companies.
- Investment expenses: These are those destined to maintaining and expanding the productive capacity of the country. Ex Infrastructure.
- Transfers and subsidies: Resources that the State redistributes trying to achieve greater well-being for all, and a fairer and more egalitarian society, which is what is known as the Welfare State. Eg Pensions (transfers), Agricultural subsidies (subsidies)

4. Budget balance:

The financial activity of the state generates a flow of income and expenses with a temporary dimension. The public sector makes an estimate of the public revenue it expects to obtain and, in relation to it plans the spending policies, assigning a quantity to each of them. This document is called General State Budgets. There are three possibilities regarding budgets and their consolidation:

- Income = Expenditures → Budget balance.
- Income> Expenses → Budget surplus.
- Income <Expenditures → Budget deficit.

4.1 Types of public deficit:

- **Cyclical deficit:** It occurs during the inevitable phases of recession in the economic cycle when the government borrows to stimulate economic activity. They have a transitory nature and appear naturally in any economy.
- **Structural deficit:** When the deficit becomes permanent, it is a drag on economic development due to the costs of the debt that the country must constantly assume.

4.2 How to finance the public deficit:

There are three possibilities to finance the public deficit:

- Issuing public debt: This is the way the government borrows money (bills, notes and bonds).
- Increasing taxes: With the problem of curbing the demand of people in the economy, with what this implies in the economic situation.
- Increasing money circulation: This tool that is only accessible to the monetary authorities. European Central Bank in the Eurozone.

5. Fiscal policy and income redistribution:

The fiscal policy is that economic policy that for the attainment of its ends, acts with the instruments of income and public expenses.

On the other hand, the State in the action will seek the redistribution of income to ensure the principle of equity. Understanding this as equal opportunities regardless of the resources that each person has.

The fiscal policy tools with which a state can combat this inequality will be:

- Taxes: Especially direct taxes that act on the income of some and other individuals in a different way.
- Public expenditures of preferential goods: To promote equal opportunities (in education and health especially).
- Current transfers: Cash flows without valuable consideration (aid) received by the poorest citizens in order to cover the needs considered vital.
- Public investments in infrastructure: In order to promote economic development and data to the state of a solid scaffolding (structure) for the development of the economic activity.