UNIT I STUDY GUIDE
Economic Basis for Government Roles

Course Learning Outcomes for Unit I

Upon completion of this unit, students should be able to:

1. Assess the relationship of historical and contemporary finance-budgeting theory to real-world public administration issues.
   1.1 Explain the relationship between externalities and efficiency.

6. Consider the impact of citizen influence on the budgetary process at various levels of governance.
   6.1 Explain how the needs of certain groups of individuals can determine how government spends its money.

Reading Assignment

Chapter 1:
Individuals and Government

Chapter 2:
Efficiency, Markets, and Governments

Chapter 3:
Externalities and Government Policy

Unit Lesson

Welcome to the course! You have made a huge commitment to improve the community around you by utilizing a comprehensive approach to the use of public funds in such a way as to improve the quality of life for your neighbors and businesses. This course will help you understand the various theories regarding public finance and budgeting and realize the real-world application of these theories. You are going to grow and stretch and become a better leader because of your work here.

In this unit, the economic role of government is explored. Major economic government activities and services include provision for national defense, Social Security, unemployment insurance, court systems, Medicare and Medicaid, public education, infrastructure, and health care. These annual government expenditures and many others would be virtually unobtainable without the assistance of the government. For example, it would cause an extreme financial burden for one individual to fund a public expenditure such as education. Similarly, it would be difficult for an individual to provide 24-hour protection of his or her property. Therefore, conventional wisdom suggests government can better supply these non-market rationings. The government sector has an enormous impact on the economy. Subsequently, resources are needed to finance government functions, activities, and services.

Front of U. S. Capitol Building
(Noclip, 2007)

Government expenditures are financed mainly by taxes (Hyman, 2014). This system of financing illustrates how all parts of society, such as health, education, family, economy, and politics, fit together and are

interdependent. The supply of individuals' demands through the payment of taxes (reducing private goods) creates a relationship between individuals and government organizations. Collectively, individuals make up a society. Democratic societies determine government functions and allocations of resources through a political process. Therefore, government's role represents a dichotomy of providing goods and services as well as regulating private economic activity (Hyman, 2014). Government's role is necessary to provide more services easier to individuals, while redistributing income, reducing waste, and increasing society's health and longevity of life. The role of government lessens the impact of market fallacies and increases market efficiency. For example, President Obama's 2014 education budget proposal incorporated an increase of Pell Grant and work-study revenue to be awarded to universities serving minorities. However, due to budget shortfalls, congressional leaders continue considering cuts to Pell Grants (Dervarics, 2013). Debates and recommendations for streamlining eligibility guidelines place this as a front-burner issue for some members of Congress as well members of society (Gay, 2014).

Chapter 2 provides insights into approaches that can be utilized to evaluate economic performance and market efficiency, measured through positive and normative theories. The positive approach asserts a cause and effect relationship linking to economic activity objectively. The positive approach has the ability to make recommendations that will achieve certain outcomes, while the normative approach cannot. In contrast, the non-objective, normative approach can define relevant issues and policy, while the positive cannot. Therefore, each approach has a dependency on the other.

For example, let's assume congressional leaders want to test the argument that increases in Pell Grant funding are needed by less-affluent college students to achieve their goals. Utilizing a positivist approach, the argument could be supported by analyzing statistical data (quantitative) and measuring the income eligibility of current students receiving Pell Grants. The use of statistical data implies that one can be positive or sure of the objective results.

In contrast, a normative argument supporting the need for the Pell Grant strives to describe the benefits (qualitative) of creating diverse populations in educational environments. Normative arguments can include supporting statements of the benefits and practices that foster collegiate success of underrepresented students. Normative theories rely on opinions and value judgments, while positivist theories can be utilized to test efficiency.

Characteristics of efficiency include avoiding waste in production, thereby achieving optimality. Additionally, efficiency promotes freedom to trade in the market. The criterion of efficiency is based on the idea that individuals should be allowed to pursue their self-interest as long as no one is harmed (Hyman, 2014). Conditions required for market efficiency include establishing benefits and costs analyses.

Markets are organized for the purpose of allowing mutually gainful trades between buyers and sellers (Hyman, 2014). Characteristics of perfectly competitive markets include privately owned resources, market transactions, economic power dispersion, information, and unrestricted resources. However, inefficiency in markets exists, resulting in other options needed to provide goods and services. This inefficiency requires government intervention. Governments can employ numerous instruments to affect private market outcomes, including creating and disseminating information, regulating private activity, mandating actions by individuals or firms, and financing/delivering public services through public facilities and staff (Reksulak & Shughart, 2012).

Let's consider the impact of the housing bubble of 2009. This dilemma resulted in many homeowners being dislocated as well as an increase in bankruptcy filings. Homeowners found themselves virtually unprotected against subprime mortgages in the market (Escobari, Damianov, & Bello, 2015). Spillover effects impacted the value of other homeowners residing in the neighborhoods. This market inefficiency resulted in government intervention. The intervention created a new mortgage product that prevents the abuse of home purchasers.

The loss of efficiency or market failure can result from monopolistic power, taxes, and government subsidies. The market activities of dominant players, altering market participation, and distortions in market behavior trickle down through the system and cause market failure. All give rise to government's role in the market to maintain efficiency and effectiveness. However, some argue that equity and efficiency should be evaluated when analyzing resource allocation. Additionally, critics argue that the market system caters to those with the ability to pay (Hyman, 2014).

Chapter 3 demonstrates market based approaches and the costs or benefits of transactions not reflected in prices, known as externalities (Hyman, 2014). Positive externalities are benefits not considered by buyers or sellers. Participants in the market sometimes fail to consider the negative impact on third parties.

For example, environmental pollution can have negative impacts on public health. In 1990, the Exxon Valdez oil spill was visible, and the effects of it were immediate, resulting in oily carcasses of wildlife along the beach shore. However, the reported long-term impact was that increased mortality of wildlife could linger on for four years or more, while other reports indicated some wildlife could be impacted up to 30 years. As a result, the Oil Pollution Act of 1990 set a liability cap of $75 million for damage caused by oil spills (Plummer, 2010). Therefore, government's role in externalities is to implement laws to protect the public from harmful market activity.

Workers cleaning up after Exxon Valdez oil spill
(National Oceanic and Atmospheric Administration, 2005)

Let us consider the Deepwater Horizon Gulf Oil Spill of 2010. This environmental incident exacerbated debates on removing the cap from the 1990 Oil Pollution Act (Plummer, 2010). Supporters of removing the cap ignited discussions comparing risks to benefits of offshore drilling. Ultimately, BP agreed to pay $20 billion to repair damage and for clean-up for their negligence in the oil spill.

Market activity that negatively impacts or costs members of society and is not considered by buyers or sellers hinders efficiency. Therefore, internalization of externalities results in adjusting the goods, services, or prices (BP oil spill $20 billion vs. $75 million). Internalization allows changes in penalties to be reflected in the full marginal social cost of a service or good (Hyman, 2014). For example, in the case of the Deepwater Horizon oil clean-up efforts, wildlife activists and others questioned whether or not the chemical dispersants BP used to clean up the oil spill will have long-term, toxic effects on marine life in the Gulf (Knudsen, 2014). The Coase theorem, as discussed by Hyman (2014), is a method of internalization. This theorem suggests that government can internalize negative externalities by establishing rights to use resources, corrective taxes, and corrective subsidies. A corrective tax or subsidy can be applied toward the loss of natural resources. For example, commercially harvested fish, oysters, or shrimp impacted by the BP oil spill may take years to recover and stimulate growth. Government may choose to implement a tax, subsidy, moratorium, or some form of equivalent public compensation of the natural resources lost (Force, Davies, & Force, 2011).

This unit establishes the economic basis for government activity and the concept of efficiency. Hyman (2014) asserts that public finance emphasizes the codependency between government and the people. Explanations of government functions, financing, and market approaches were identified in this unit. Payment of taxes sustains government efforts to allocate resources efficiently and redistribute goods and services. This process creates a mixed economy whereby government acts as a buyer and seller in the market. However, market inefficiencies occur that can be adjusted through cost benefit analyses.

References

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Escobari, D., Damianov, D., & Bello, A. (2015). A time series test to identify housing bubbles. *Journal of Economics & Finance*, *39*(1), 136-152. doi:10.1007/s12197-013-9251-5

Force, R., Davies, M., & Force, J. S. (2011). Deepwater Horizon: Removal costs, civil damages, crimes, civil penalties, and state remedies in oil spill Cases. *Tulane Law Review*, *85*(4), 889-982.

Gay, G. H. (2014). Pell Grant program continues to be challenged. *U.S. Black Engineer & Information Technology*, *38*(3), 13-14.

Hyman, D. N. (2014). *Public finance: A contemporary application of theory to policy* (11th ed.). Stamford, CT: Cengage Learning.

Knudsen, S. H. (2014). The long-term tort: In search of a new causation framework for natural resource damages. *Northwestern University Law Review*, *108*(2), 475-541.

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Noclip. (2007, April 3). *Capitol building full view* [Photograph]. Retrieved from http://commons.wikimedia.org/wiki/File:Capitol_Building_Full_View.jpg

Plummer, J. (2010, July 29). Who should pay for the Gulf oil spill? Liability and incentive issues raised By the Deepwater Horizon incident. *CEI On Point, 169*. Retrieved from http://cei.org/sites/default/files/James%20Plummer%20-%20Who%20Should%20Pay%20for%20the%20Gulf%20Oil%20Spill.pdf

Reksulak, M., & Shughart, W. (2012). What should government do? Problems of social cost, externalities and all that. *Public Choice*, *152*(1/2), 103-114. doi:10.1007/s11127-011-9850-7

Suggested Reading

Using the Business Source Complete database within the Waldorf Online Library, locate and read the following article that discusses whether or not the Pell Grant needs to utilize a base award formula that keeps pace with the rising cost of tuition.

Hageman, A. M., Arnold, V., & Sutton, S. G. (2009). Starving the beast: Using tax policy and governmental budgeting to drive social policy. *Accounting & the Public Interest*, *9*, 10-38.