Chapter 18 McConnell, Brue and Flynn 20th

Public Finance: Expenditures and Taxes

As discussed in Chapter 2, the U.S. economy relies heavily on the private sector (households and businesses) and the market system to decide what gets produced, how it gets produced, and who gets the output. But the private sector is not the only entity in the decision process. The public sector (federal, state, and local government) also affects these economic decisions.

Government influences what is produced and how it's produced with laws regulating the activities of private firms and, also, by directly producing certain goods and services, such as national defense and education. As discussed in Chapter 4, many of these government-produced goods and services are public goods that the private sector has trouble producing, because of free-rider problems. Also, government influences who receives society's output of goods and services through tax policies and welfare and income-transfer payments that redistribute income.

Government-provided goods, services, and transfer payments are funded by taxes, borrowing, and proprietary income—the income that governments receive from running government-owned enterprises such as hospitals, utilities, toll roads, and lotteries.

Public finance is the subdiscipline of economics that studies the various ways in which governments raise and expend money. In this chapter we view the economy through the lens of public finance. Our main goal is to understand how taxes and income transfers not only pay for government-produced goods and services, but also affect the distribution of income between rich and poor.