

Show Us the Money!

Public Finance Explained

MIND - O P E N E R # 1 :

Public Goods, Public Financing, and Minnesota's Economy

Art Rolnick, Director of Research, Federal Reserve Bank of Minneapolis

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The goal of this session is to provide an economic framework to enhance public understanding of the state and local governments' role in Minnesota's economy.

What is the government's role in a market driven economy?

Government interventions should generally be to make markets work better. Although there is much debate about how government should be financed, the size of government and what government is doing are more important than how it is financed. If government is too big or too small, or is intervening in ways that harm the market, it can have a dramatic effect on economic growth.

Public Goods

A public good is something that is not scarce and easily accessible. This means that once it is produced, citizens can benefit from it without affecting another's ability to do the same. The classic example is a lighthouse. One ship using the light to find safe harbor does not affect the ability of another ship to do the same. Other examples are the legal system, clean air, public health, democracy, and national defense. Public goods are hard to price because once they are produced, it is hard to prevent people from consuming them.

History has shown that the market does a good job of producing and allocating private goods. The market creates incentives to work and incentives for economic growth. Public goods, however, provide the necessary framework for the market system to function properly and the market often fails to produce the right amount of public goods.

Governments have a role in correcting these market failures. Constructing bridges and roads to provide the high level of mobility and access that we have in Minnesota is an example of a public good that the market would be unlikely to sufficiently produce. In practice, the public/private distinction is not always clear; goods fall on a continuum from pure public goods to pure private ones. Education, for example, has both public and private benefits. The problem then becomes how much education should be publicly financed and how much should be privately financed.

Externalities

Externalities are impacts that are experienced by a larger part of society than the individuals or group that caused the impact. Education has positive externalities; it benefits society beyond the benefits to the individual. Pollution is the classic example of a negative externality; it harms society beyond the harm to the individual. The private market will usually fail in pricing externalities because of the difficulty negotiating the impact of something that is spread out over a broad mass of people. Government has a role in guiding the market to efficient pricing of externalities.

Monopolies

Monopolies are inefficient because they tend to produce too little of something at too high a price because of a lack of competition. There is an important role for government to promote competition where monopolies exist.

Asymmetric Information

Markets do not work well when buyers and sellers have unequal amounts of information. Health care is an example of a market where asymmetric information diminishes efficiency. It is very difficult in today's health care market for citizens to be effective buyers of health care. The role of government is to foster efficient ways for markets to provide as much information as possible for the buyers and the sellers and make everything as transparent as possible.

How should government be financed?

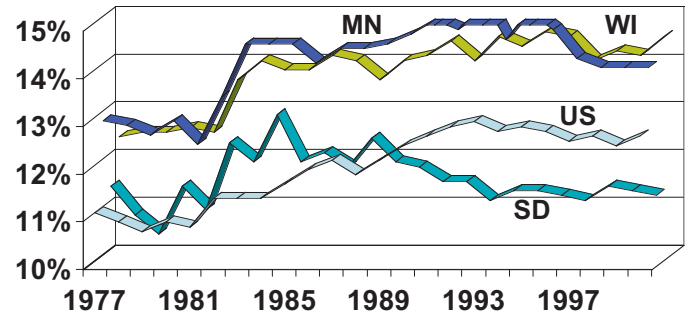
Taxes are the most obvious way to fund government. Borrowing, or future taxation, is another way to finance government. Printing money is a way that the federal government – and only the federal government – can finance activities. Eminent domain is another way to finance government. Eminent domain is the taking of private property for a public good. Even though government takes the property at the market price, since it has to be taken, it is obviously not the price at which the seller was willing to sell.

Is government in Minnesota too small, too big, or just right?

One clear way to determine whether Minnesota's government is the right size is to connect what state and local government does to the state economy. To that end, a good measure is to examine state and local taxation and spending in relation to gross state product (GSP) and to examine GSP on a per capita basis to see how Minnesota ultimately performs.

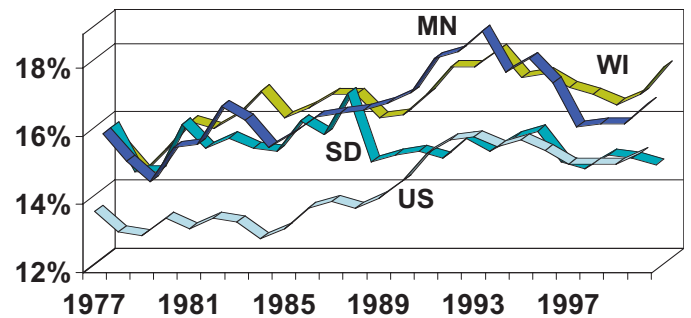
To judge Minnesota's level of taxation, we look at state and local revenues as a percent of GSP from 1977-2000, subtracting federal grants to determine the level of state and local taxation. Minnesota is clearly a high-tax state and has been for years. Over this period, the average of all states is about 12 percent of GSP. Minnesota has averaged about 14 percent of GSP. Wisconsin taxes at about the same level and South Dakota taxes at a much lower level. In the year 2000, Wisconsin ranked 11th, Minnesota ranked 13th and South Dakota ranked 44th in this metric. (See Chart 1.)

CHART 1
State and Local Government Revenues*
to Gross State Product



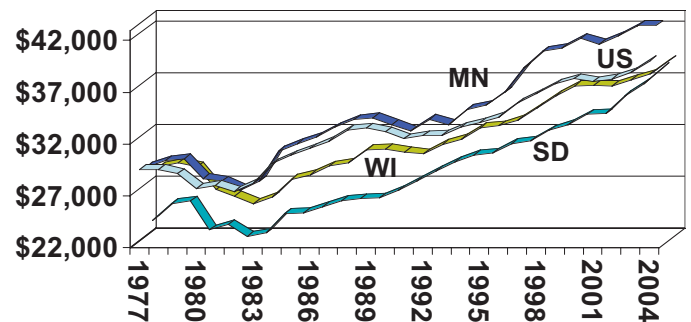
Source: U.S. Census Bureau, BEA
*Excludes federal grants

CHART 2
State and Local Government Expenditures
to Gross State Product



Source: U.S. Census Bureau, BEA

CHART 3
Per Capita Gross State Product
(in 2004 dollars)



Source: U.S. Census Bureau, BEA

To judge Minnesota's level of spending, we look at state and local government spending as a percent of GSP. This number includes federal grants. Based on the level of taxation, it is not surprising that Minnesota and Wisconsin both spent more than the U.S. average from 1977 to 2000 – at a rate of about 16 percent of GSP compared to a national average of 14 percent. (See Chart 2.)

South Dakota, however, has also averaged higher spending than the national average at about 14.5 percent of GSP. How is this possible when South Dakota taxes at a much lower level than the national average? The U.S. government has redistributed income from the wealthier states to the less wealthy states and South Dakota receives a lot more in federal grants.

The net effect of the federal government involvement in income redistribution between Minnesota and South Dakota is that in Minnesota we pay more in state and local taxes and we clearly get more public goods and services than South Dakota. In 2000, Minnesota ranked 19th in state and local spending as a percent of GSP. Wisconsin ranked 15th and South Dakota ranked 34th.

Is government in Minnesota providing the “right” amount of public good and services? While this is a difficult question to answer definitively, the state appears to be performing well. A good indicator of economic well-being is per capita GSP. In 2004, Minnesota ranked 8th in the nation in GSP per capita. Both Wisconsin and South Dakota had per capita GSP below the national average in 2004. (See Chart 3.) It looks like the size of government is about right in Minnesota. Although the state is in the top third in taxes, it is clearly one of the wealthier and more productive states in the country.

Future challenges

In 2004, at the state level, about three-fourths of Minnesota spending was for the main reasons that state government should exist: education, health care, and transportation. Providing for these public goods raises the biggest challenges we face in the future.

Education

Education is the key if we want to continue to have one of the nation’s top economies. In 1920, Minnesota’s economy was well below the national average. It was not until 1957 that we started to outperform the national economy. Over the last 15 years, we have outperformed the national economy more significantly. (See Chart 3.) What has been the impetus for the change?

Sometime after WWII, the state began pouring money into education. This is the cause of our high-performing economy today. To be sure, education is not the only factor in economic prosperity — but it is a large one. Economic bidding wars among cities and states, such as offering subsidies and tax incentives to lure businesses, are the wrong way to promote economic growth. Bidding wars do not create jobs, they just move them around. If a state or local government wants to create high-quality jobs it must create high-quality workers through education.

Transportation

Transportation is an important issue, but not as critical to Minnesota’s economy as education. There are many successful local economies suffering from too much congestion that continue to grow. Mass transit and congestion pricing may help alleviate this problem and should be explored. Although important, transportation is not the engine that is going to drive an economy (puns unintended).

Health care

Health care is a tough market for economists because of the prevalence of asymmetric information. It is a difficult market to figure out the proper role of government. How can decent health care be made available for every citizen at an affordable cost? This is obviously a tough issue, but like transportation, health care is not as critical to Minnesota’s economy as education.

The framework for citizens

When you think about the state of Minnesota and what government ought to be doing, think about these questions: What is the public good? Is the market producing the right amount of the good? Is there a market failure? Are there externalities, monopolies, asymmetric information contributing to the failure? If there is a market failure, will government intervention help? Market failure alone does not justify government intervention. Government also has to show that when it intervenes, it will improve the outcome.

Mind-Opener Schedule

Wednesday, August 3

The Future

Tom Gillaspy
State Demographer

Tom Stinson
State Economist

If demography is destiny, what do the tea leaves predict for Minnesota? What are the fiscal and demographic trends we face?

Thursday, August 18

The Feds

Tim Penny
Co-Director, Humphrey Institute Policy Forum

Dave Durenberger
Chair, National Institute of Health Policy

How will spending on Medicare and Medicaid affect Minnesota's budget for the next generation?

Wednesday, August 31

The 800-Pound Gorilla in Minnesota: Health Care

Dan McElroy
Chief of Staff to Governor Tim Pawlenty

Jan Malcolm
Chief Executive Officer, Courage Center

Lynn Blewett
Director, Public Health Administration Program
University of Minnesota

How can the state address the demographic time bomb of providing our aging population high-quality health care at a price we all can afford?

Wednesday, September 14

The 800-Pound Gorilla in Our Backyards

Karen Anderson
Mayor of the City of Minnetonka

Matt Smith
Director of Financial Services, City of Saint Paul

How do we meet post-9/11 homeland security demands facing local governments? How can we provide greater public safety with limited resources?

Late September (date to be announced)

Wrap-up Mind-Blower (evening)

Join the Citizens League and reform-minded policy makers to review what we learned in the previous sessions and discuss ideas for how we can most effectively serve the public good.

Citizens League

555 North Wabasha St., Suite 240
St. Paul, MN 55102
ph#: 651/293-0575
fax#: 651/293-0576

www.citizensleague.net

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