

These are solutions to the second home assignment for the course of Public Finance. Once we grade your solution, you will see your points in the section Study group roster in the SIS. You could have obtained up to 10 points. In case you have questions about your grade or these solutions, do not hesitate to contact Miroslav Palansky at miroslav.palansky@fsv.cuni.cz.

Problem 1

Briefly answer the following questions:

- a) Which selection criterion is most commonly used in Czechia to select public procurement suppliers? Take a specific example of a good or service that the Czech government regularly buys and explain what might be a disadvantage of this selection criterion when buying this particular service or good.
- b) What do we call taxes and subsidies that are intended to internalize the externalities of the taxed and subsidized activities? How do they work?
- c) Using a diagram, explain why deadweight loss arises in the health care market when there is insurance that covers a substantial part of direct health care costs (80%, for example).
- d) Explain the current pension system in your country of origin.
- e) What is employment protection legislation (EPL)? What are the benefits and drawbacks of having extensive EPL (i.e. very protective of employees)?

Solution

- a) Price criterion. Example: a road. If we select the supplier only based on price, it might happen that the quality of the road will not be good and we will have to repair it soon.
- b) Pigouvian taxes. They are imposed on agents that generate externalities in such a way and extent that ensures that the socially optimal amount of a good/service is produced/consumed.
- c) In Figure 1, the socially optimal quantity of medical services provided is Q_0 , which is the point at which marginal social benefits equal marginal social costs. Because insurance creates a wedge between the marginal private cost and marginal social cost, medical services will be overconsumed (at quantity Q_1), creating a deadweight loss of size I.

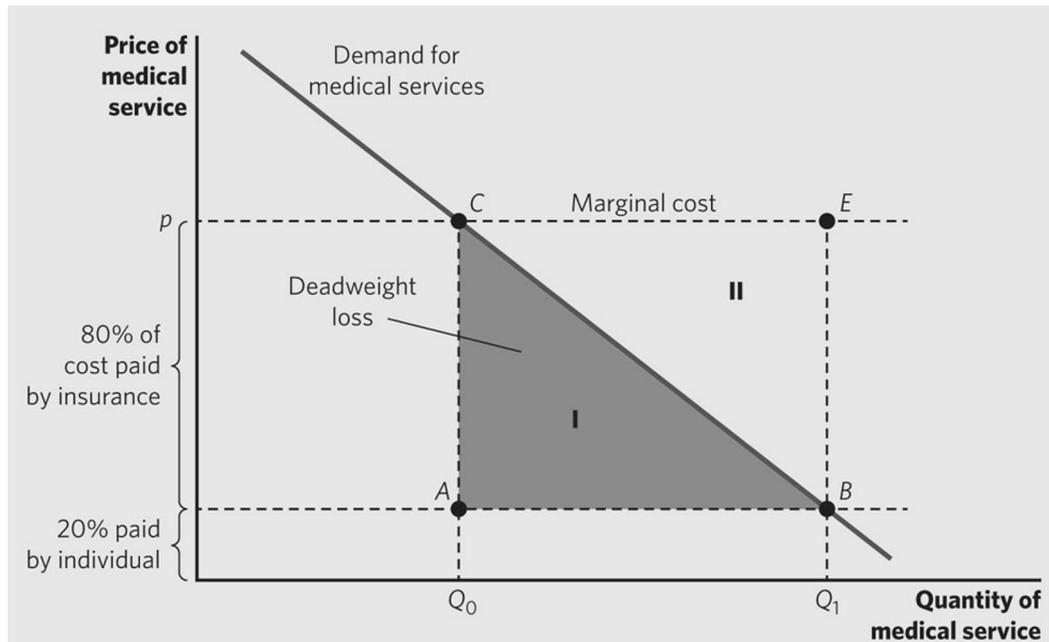


Figure 1: DWL in the health care market. Source: Figure 13.4. from Stiglitz, J. E., & Rosengard, J. K. (2015). *Economics of the Public Sector: Fourth International Student Edition*. WW Norton & Company.

- d) Czechia: three pillars. First, state pensions financed from social security taxes with continuous flows. Second, a now-cancelled pension fund system (2% from the first pillar + 3% from private funds). Third, private pension funds subsidized by the state through direct subsidies and tax deductions.
- e) EPL is a set of laws that protects workers from being dismissed easily from their jobs. Benefits include the promotion of stability and equality among people; the main drawback is that EPL makes markets ineffective and rigid.