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ECONOMICS **of the** **PUBLIC** **SECTOR**

Second Edition

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Preface

In one sense, fortune was not kind to the First Edition of this book: no sooner had it appeared than Congress enacted the Tax Reform Act of 1986. In another sense, fortune was kind: the enthusiastic response accorded the First Edition more than compensated for the long hours of writing and rewriting that went into it. For the response, I am grateful. As for the Tax Reform Act, let's just say that—from my perspective as textbook author—I am thankful that, even though it was hailed by politicians as the most sweeping tax reform since the enactment of the income tax, the act did not really represent a radical departure in tax policy. Thus, the concepts and even much of the institutional detail that I described in the First Edition have remained relevant. Still, the Tax Reform Act was of sufficient import to necessitate an immediate and thorough revision of Part Five of the book, which analyzes the U.S. tax structure.

There is a tendency of textbooks to grow in size with each successive edition. I have been wary of falling into this trap—yet it seemed wrong not to include some discussion of two of the central issues facing the United States public sector in the late 1980s: the causes and consequences of the huge federal deficits, and the design of policies to stimulate the economy's growth and productivity. Chapters 2 and 28 provide an introduction to these questions.

Those familiar with the First Edition will note a few other major changes. The discussion of the (Pareto) efficiency of the market economy (Chapter 3) now precedes the introduction to welfare economics (Chapter 4), which focuses on the trade-offs between efficiency and distribution. I have, moreover, added an appendix to Chapter 3 explaining

in more detail the conditions required for the Pareto efficiency, and why competitive economies, in the absence of market failures, are Pareto efficient.

Later, in Part Four, on the theory of taxation, I have divided the discussion of the effects of taxation on economic efficiency into two chapters, one dealing with general principles, and one dealing in particular with the effects on labor supply (Chapter 19). I use that occasion to familiarize students with some of the important empirical work in that area, including the results of income maintenance experiments, econometric studies, and surveys.

As part of the thorough revision of Part Five, I discuss a broad range of issues related to capital taxation (Chapter 22), such as depreciation and capital gains, before I present the specific issues related to the taxation of corporate income (Chapter 23).

Though there have been no changes in expenditure programs quite as dramatic as the Tax Reform Act, the chapters discussing specific expenditure programs have all been updated, not only to reflect the latest data, but also to include issues of current policy concern. Thus, the chapter on health (Chapter 11) includes a discussion of the impact of the new system of reimbursements for Medicare, and the chapter on Welfare Programs (Chapter 14) includes a discussion of recent proposals for reform of the welfare system.

My major aims in writing this book remain the same, however. I wrote it in the belief that an understanding of the issues it addressed was central to any democratic society. Among the most important of these issues are the appropriate balance between the public and private sectors, and how governments can more effectively meet their objectives, whatever those objectives are. Issues in public-sector economics often become highly charged politically, but I tried to present the analysis in an impartial manner, with a clear delineation between the analysis of the consequences of any policy and the value judgments associated with assessing the desirability of the policy. The favorable reception of the First Edition by instructors of a wide variety of political persuasions suggests that I succeeded.

An unexpected bonus was the international enthusiasm for the book. Though I had focused my attention on issues facing the United States, similar issues confront countries around the world, where it has become widely adopted. Most exciting from my perspective is that I seemed to have provided a useful framework within which those in a number of other countries could address the particular policy issues which they faced; adaptations of the book to the economies of Japan, Germany, and Italy are presently under way.

Had this text been written twenty-five years ago, it would have been entitled *Public Finance*, and its focus would have been on sources of revenues. The title *Economics of the Public Sector* and the broader coverage it implies is, however, no accident. In recent years, government spending has reached record levels, and it now accounts for more than a third

of gross national product. The accompanying federal budget deficits have alarmed economists of all political and intellectual persuasions. It is no longer enough to know where the money comes from; one must give equal time to how it is spent.

Meanwhile, the economic theory of the public sector has burgeoned. Some of this recent literature is devoted to analyzing government expenditures. From cost-benefit analysis to public choice theory, economists now have much to say about how government spends its funds. Much of the recent literature in public economics reflects the development of new and more sophisticated models, such as the theory of optimal taxation. I have chosen to present the modern view of public-sector economics in a simple and intuitive way, to relate the most important contributions of this fast-growing literature to undergraduates taking a first course in public finance.

Public-sector issues include some of the most exciting in all of economics. Health, defense, education, social security, welfare programs, and tax reform all receive steady attention in the news media. Economic analysis brings special insights to the debates. Should education be publicly provided? What is the long-term outlook for our social security program? How do current proposals for tax reform match our knowledge of incidence, efficiency, and equity? These kinds of questions breathe life into the course, which is why I give them careful attention.

Examining specific tax and expenditure programs offers an additional benefit: it underscores the importance of design features. One of the lessons we have learned in the past decade is that good intentions are not enough. Urban renewal programs, intended to revitalize our cities, had the unintended consequence of reducing the supply of housing to the poor. One of the major objectives of the tax reform of 1986 was to simplify the tax code, but it seems, instead, to have made it even more complex. I use examples like these, of unintended consequences, not only to enliven the course but also to instill in students the important habit of testing theory against the complex environment in which public-sector decisions are enacted and implemented.

The organization of this book is based on the principle of flexibility. The sequence I follow is, first, to introduce in Part One the fundamental questions, institutional details, and a review of the microeconomic theory underlying the role of the public sector. Part Two develops the theory of public expenditures, including public goods, public choice, and bureaucracy, while Part Three applies the theory to the five largest areas of public expenditure in the United States: health, defense, education, social security, and welfare programs. Parts Four and Five repeat this pattern, presenting the theory of taxation and its analysis, respectively. Part Six takes up two further topics: issues concerning state and local taxation and expenditure and fiscal federalism; and issues concerning stabilization and growth, with particular emphasis on the relation between microeconomic analysis and macroeconomic performance.

A perfectly workable alternative to this sequence would be to cover

taxation before expenditures. Parts Four and Five have been carefully developed so that the teacher wishing to go straight to taxation after Part One can do so without loss of continuity. Further tips on how courses can be organized, as well as lecture notes, test questions, and coverage of advanced topics that some teachers may wish to include in their lectures, are contained in the *Instructor's Manual*, for which Eleanor Brown of Pomona College has done the lion's share of the work for this edition. Another ancillary, the new *Study Guide and Readings*, by Edward C. Kienzle of Stonehill College, helps students to review the material in this book at the same time that it puts accessible portions of the literature in their hands.

The list of those to whom I am indebted is a long one. I owe a special acknowledgment to Karla Hoff, who was more than just a graduate research assistant. She not only updated the figures, she uncovered unpublished data and checked the accuracy of the entire text. More than that, she served as my harshest critic. In writing any textbook at this level, one often has to make simplifications to make the ideas accessible. The problem is how to make those simplifications, while at the same time doing full justice to the complexity of the subject. Karla insisted that there be no compromises on either account: that each passage be clearly accessible to a student with no background in economics, but at the same time that it not oversimplify the subject.

My teachers at Amherst College, James Nelson and Arnold Coltery, not only stimulated my interest in economics, and in the particular subject of this course, but laid the foundations for my later studies. They also showed me, by example, what good teaching meant; I hope that some of what I learned from them is reflected in this book. At M.I.T. Dan Holland (currently editor of the *National Tax Journal*) and E. Cary Brown introduced me to the formal study of public economics. Again, I hope some of the blend of policy, theory, and institutional detail that marked their work is reflected here. The insights of my colleagues and collaborators at the institutions at which I have worked (M.I.T., Yale University, Stanford University, Princeton University, Oxford University, Cambridge University, and the National Bureau of Economic Research) and the government agencies (Treasury, Labor, Interior, Energy, Agency for International Development, State of Louisiana, State of Texas) and international organizations (World Bank, Interamerican Development Bank, Organization of Economic Cooperation and Development) for which I have consulted have also proved invaluable. I should mention Henry Aaron (Brookings Institution), Alan J. Auerbach (University of Pennsylvania), Greg Ballantine (former Assistant Secretary of the Treasury for Tax Policy), William J. Baumol (Princeton University), Charles T. Clotfelter (Duke University), Partha Dasgupta (Cambridge University), Peter A. Diamond (M.I.T.), Avinash Dixit (Princeton University), Martin Feldstein (Harvard University), Harvey Galper (Brookings Institution), Robert E. Hall (Stanford University), John Hamilton (University of Florida), Arnold C. Harberger (University

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As in the First Edition, I am deeply indebted to Drake McFeely, my editor at Norton, for his thoughtful and insightful editorial comments that greatly improved the book and for the care and attention he paid in shepherding the book through the various stages of production. The final thanks are due to his colleague, Sandra Lifland, who also helped shape the Second Edition.

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J.E.S.

Contents

Preface xxi

Part One Introduction

1 The Public Sector in a Mixed Economy	1
The Mixed Economy	2
An Impetus for Government Action: Market Failures	3
Government Failures	5
Earlier Views Concerning the Role of Government	7
What or Who Is the Government?	8
The Public Sector and the Fundamental Economic Questions	10
Studying the Economics of the Public Sector	12
Normative versus Positive Economics	13
Disagreements among Economists	16
<i>Failure to Trace the Full Consequences of a Government Policy</i>	17,
<i>Differences in Views about How the Economy Behaves</i>	17, Disagreement
<i>over Values</i>	20
Summary	20
Key Concepts	21
Questions and Problems	21
2 The Public Sector in the United States	23
The Kinds of Government Activity	24
Providing a Legal System	25
Government and Production	25
<i>Producing Goods and Services</i>	25, <i>Subsidizing Production</i>
<i>Business</i>	31, <i>Government Activities in Financial Markets</i>
	32

Government Purchases of Goods and Services	34
Government Redistribution of Income	36
<i>Public Assistance Programs 37, Social Insurance Programs 37, Hidden Redistribution Programs 38</i>	
Total Government Expenditures: A Bird's Eye View	39
<i>Federal versus State and Local Responsibilities 39</i>	
Perspectives on the Size of the Public Sector in the United States	41
<i>The Growth in Expenditures and Their Changing Composition 41, Comparison of Expenditures across Countries 44</i>	
Government Revenues	45
<i>Taxes and the Constitution 46, Federal Taxation Today 47, State and Local Revenues 49, Comparison of Taxation across Countries 50</i>	
The Federal Government's Budget Process	50
<i>Deficit Financing 51, The Gramm-Rudman Act 54, Impounding Funds 55, The Function of Budgets 55, Playing Tricks with the Data on Government Activities 58</i>	
Summary	59
Key Concepts	59
Questions and Problems	60
 3 The Economic Rationale for Government	 61
The Efficiency of Competitive Markets: The Invisible Hand	61
<i>The Two Fundamental Theorems of Welfare Economics 63, The Pareto Efficiency of the Competitive Economy 65, Competition and Innovation 71</i>	
Market Failures as a Rationale for Government Activity	71
<i>1. Failure of Competition 71, 2. Public Goods 74, 3. Externalities 75, 4. Incomplete Markets 76, 5. Information Failures 78, 6. Unemployment, Inflation, and Disequilibrium 79, Relationships among Market Failures 80</i>	
Redistribution and Merit Goods: Two Further Rationales for Government Activity	80
Two Perspectives on the Role of the Government	81
<i>A Normative Analysis 82, A Positive Analysis 83</i>	
Summary	84
Key Concepts	84
Questions and Problems	84
Appendix: Pareto Efficiency and Competitive Equilibrium— A Diagrammatic Analysis	85
<i>Exchange Efficiency 85, Production Efficiency 87, Product-Mix Efficiency 88</i>	
 4 Welfare Economics: Efficiency versus Equity	 90
Efficiency and Distribution Trade-Offs	90
Pareto Efficiency	93

Income Distribution 94

The Utility Function and Marginal Utility 95, *Pareto Efficiency and the
Utility Possibilities Schedule* 97, *Pareto Efficiency and the Compensation
Principle* 100, *The Social Indifference Curve and Income Distribution* 102

Social Choices 104

Social Choices in Practice 105, *Utilitarianism versus Rawlsianism* 106,
A Comparison of Utilitarian and Rawlsian Social Welfare Functions 108,
Rawls and Egalitarianism 110

Assessing Policy Alternatives 110

Deriving Social Welfare Functions 110, *Measuring Inefficiency* 112,
Making Policy Decisions 115

Summary 115

Key Concepts 116

Questions and Problems 116

Part Two Public Expenditure Theory

5 Public Goods and Publicly Provided Private Goods 119

Definition of Public Goods 119

Goods for Which Rationing Is Unfeasible 120, *Goods for Which Rationing
Is Undesirable* 122

Impure Public Goods 123

Inefficiencies from the Private Provision of Public Goods 124, *Goods for
Which Exclusion Is Feasible but Costly* 126

Publicly Provided Private Goods 127

Rationing Devices for Publicly Provided Goods: Uniform Provision 128,
Queuing as a Rationing Device 130

The Changing Balance between Public and Private Provision 131

Efficiency Conditions for Public Goods 131

Demand Curves for Public Goods 132, *Pareto Efficiency and Income
Distribution* 137, *Limitations on Income Redistribution and the Efficient
Supply of Public Goods* 138, *Distortionary Taxation and the Efficient
Supply of Public Goods* 139

Efficient Government as a Public Good 141

Summary 141

Key Concepts 142

Questions and Problems 142

Appendix: An Alternative Exposition of Public-Goods Efficiency—
The Leftover Curve 143

6 Public Choice 145

Private Mechanisms for Allocating Resources 146

Public Mechanisms for Allocating Resources	147
<i>The Problem of Preference Revelation 147, The Problem of Aggregating Preferences: Reconciling Differing Views 147</i>	
Majority Voting	148
<i>How the Typical Taxpayer Casts His Vote 149, The Median Voter 154, The Inefficiency of the Majority Voting Equilibrium 156, The Voting Paradox 157, Single-Peaked Preferences and the Existence of a Majority Voting Equilibrium 158, Arrow's Impossibility Theorem 160, Further Results on Voting 161, The Two-Party System and the Median Voter 162</i>	
Politics and Economics	163
<i>Why Do Individuals Vote? 163, Elections and Special-Interest Groups 164, The Power of Special-Interest Groups 165, The Altruistic Politician? 166, The Persistence of Inefficient Equilibrium 167</i>	
Alternative Schemes for Determining the Level of Public Goods	168
<i>Lindahl Equilibrium 168, New Revelation Mechanisms 169</i>	
Values and Competence	170
Summary	171
Key Concepts	171
Questions and Problems	171
Appendix: New Revelation Mechanisms	173
7 Public Production and Bureaucracy	177
Public Enterprises and Production in the United States	178
<i>Public Production of Private Goods 179, Public Production of Public Goods and Publicly Provided Private Goods 181, Changing Patterns in Government Production 182</i>	
The Rationale for Government Production of Private Goods:	
Market Failures	184
<i>Natural Monopoly 185, Public Production and Other Market Failures 189</i>	
Other Ways for Government to Reconcile Private and Social Interests: Regulation and Taxation	190
Alternative Arrangements for the Production of Publicly Provided Goods	192
<i>Contracting for the Production of Public Services 192, Voucher Schemes 194</i>	
Are Public Enterprises Less Efficient?	194
<i>Comparison of Efficiency in the Public and Private Sectors 195</i>	
Sources of Inefficiency in the Public Sector	198
<i>Organizational Incentives 199, Individual Incentives 201</i>	
The Bureaucracy	202
<i>Differences between Administrative Activities and Other Production Activities 202, What Do Bureaucrats Maximize? 204, Bureaucratic Procedures and Risk Aversion 208, Reform of the Bureaucracy 209</i>	
Summary	210

Key Concepts	211
Questions and Problems	211

8 Externalities	213
Externalities: Some Distinctions	214
The Consequences of Externalities	215
Private Solutions to Externalities	216
<i>The Coase Theorem</i> 217, <i>Social Sanctions</i> 218, <i>Failures of Private Solutions</i> 219	
Public Remedies for Externalities	220
<i>Fines</i> 221, <i>Regulation</i> 226, <i>Comparison between Regulations and Fines</i> 227, <i>Choice among Fines, Subsidies, and Regulations</i> 229, <i>Problems with Compensation</i> 232, <i>Legal Remedies for Externalities</i> 233	
Summary	235
Key Concepts	235
Questions and Problems	235

Part Three Expenditure Programs

9 The Analysis of Expenditure Policy	237
Need for Program	238
Market Failures	238
Alternative Forms of Government Intervention	239
<i>Higher Education: An Example</i> 240, <i>The Importance of Particular Design Features</i> 241	
Efficiency Consequences	242
<i>Private-Sector Responses to Government Programs</i> 242, <i>Income and Substitution Effects and Induced Inefficiency</i> 243	
Distributional Consequences	246
<i>Evaluating the Distributional Consequences</i> 248, <i>Fairness and Distribution</i> 249	
Equity-Efficiency Trade-Offs	250
Program Evaluation	251
Political Process	252
Summary	254
Key Concepts	254
Questions and Problems	254
10 Cost-Benefit Analysis	256
Private Cost-Benefit Analysis	257
<i>Present Discounted Value</i> 257	

Social Cost-Benefit Analysis	259
<i>Valuing Nonmarketed Commodities</i>	259
Cost Effectiveness	264
Shadow Prices and Market Prices	266
Discount Rate for Social Cost-Benefit Analysis	266
The Evaluation of Risk	270
Distributional Considerations	271
<i>Distributional Weights</i>	272, <i>The Effect of Public Programs on Measures of Inequality</i>
274	
Summary	277
Key Concepts	278
Questions and Problems	278
 11 Health Care	 280
An Outline of U.S. Government Medical Programs	282
<i>Direct Assistance</i>	284, <i>Tax Expenditures</i>
284	
Rationale for Government's Role in Health-Care Financing, Provision, and Regulation	287
<i>Inequality and Government Financing of Medical Services</i>	287, <i>Market Failures</i>
288, <i>Why Medical Markets Do Not Satisfy the Standard Conditions for Well-Behaved Competitive Markets</i>	289
Health Insurance	296
<i>The Importance of Health Insurance</i>	296, <i>The Consequences of Health Insurance</i>
297, <i>Moral Hazard</i>	299
Reforms in the Provision and Financing of Health Care	300
<i>Reducing the Extent of Insurance Coverage</i>	300, <i>Reforming the Manner in Which Hospitals Are Reimbursed</i>
301, <i>Regulation of Physicians</i>	302, <i>Changing the Organization of the Medical Industry</i>
302, <i>Extending Benefits to the Uninsured</i>	304, <i>Covering Catastrophic Medical Expenses</i>
305	
Summary	306
Key Concepts	307
Questions and Problems	307
 12 Defense	 308
The Organization of Defense	311
<i>Civilian Control</i>	312, <i>Defense Procurement</i>
313, <i>The Draft versus the Volunteer Army</i>	315
Cost-Effectiveness Analysis	316
<i>Multiple Objectives</i>	317, <i>Alternative Scenarios</i>
318, <i>Trade-Offs in Allocating Defense Dollars</i>	318, <i>Some Problems in Allocating Defense Expenditures</i>
319	
How Much Is Enough?	320
<i>The Value of Marginal Analysis</i>	321, <i>Deterrence and the Arms Race</i>
322	

Summary	323
Key Concepts	324
Questions and Problems	324

13 Social Insurance 325

The Structure of the Social Security System	326
Social Security, Private Insurance, and Market Failures	330
<i>High Transaction Costs 331, Lack of Indexing: The Inability of Private Markets to Insure Social Risks 331, Adverse Selection, Differential Risks, and the Cost of Insurance 332, Moral Hazard and Social Security 333, Retirement Insurance as a Merit Good 334</i>	
Problems Facing the Social Security System	334
<i>The Causes of the 1983 Crisis in Social Security 335, The 1983 Response to the Crisis in Social Security 337, Current Equity Issues in the Design of Social Security 339, Current Efficiency Issues 341</i>	
Alternative Perspectives	344
Summary	344
Key Concepts	345
Questions and Problems	345

14 Welfare Programs and the Redistribution of Income 346

Welfare Programs and Social Insurance	348
Cash versus In-Kind Redistribution	349
<i>Inefficiencies from In-Kind Redistribution 349, Inefficiencies from Subsidized Food Stamps 352, Incentive Effects of Eligibility Standards 354, Should the Government Interfere with Individuals' Free Choices? 355, Housing 355</i>	
Categorical versus Broad-based Aid	356
<i>Efficiency and Equity Issues 357, The Negative Income Tax 358</i>	
How Effective Has Our Present Welfare System Been in Reducing Poverty?	360
<i>The Paradox of Unchanged Inequality 361, Poverty among Children 363, Recent Reform Initiatives 363</i>	
Summary	364
Key Concepts	365
Questions and Problems	365

15 Education 367

The Structure of Education in the United States	368
<i>Federal Tax Subsidies to Private and Public Schools 370</i>	
Why Is Education Publicly Provided and Publicly Financed?	371
<i>Is There a Market Failure? 372, Distribution 372, Imperfect Capital Markets 373</i>	

Current Issues	373
<i>How Should Public Educational Funds Be Allocated?</i>	374, <i>Reforming the Financing of Education</i>
<i>Public Support for Private Schools</i>	379, <i>Aid to Higher Education</i>
380	
Summary	382
Key Concepts	383
Questions and Problems	383

Part Four Taxation: Theory

16 Taxation: An Introduction	385
Background	386
<i>Changing Patterns of Taxation in the United States</i>	387, <i>Designing an Income Tax System</i>
388	
The Five Desirable Characteristics of Any Tax System	390
<i>Economic Efficiency</i>	390, <i>Administrative Costs</i>
393, <i>Flexibility</i>	395, <i>Political Responsibility</i>
396, <i>Fairness</i>	399
Summary	408
Key Concepts	409
Questions and Problems	409
17 Who Really Pays the Tax: Tax Incidence	411
Incidence of Taxes in the United States	413
Tax Incidence in Competitive Markets	415
<i>The Effect of Elasticity</i>	418, <i>Does It Matter Whether the Tax Is Levied on Consumers or Producers?</i>
419, <i>Analysis of the Effect of the Tax at the Level of the Firm</i>	420, <i>Tax Incidence and the Demand and Supply for Labor</i>
421, <i>Taxation of Inelastic Factors and Commodities</i>	421
Tax Incidence in Monopolistic versus Competitive Environments	423
<i>Relationship between the Change in the Price and the Tax</i>	425, <i>Ad Valorem versus Specific Taxes</i>
425	
Tax Incidence in Oligopolies	426
Equivalent Taxes	427
<i>Income Tax and Value-Added Tax</i>	427, <i>Equivalence of Consumption and Wage Taxes</i>
427, <i>Equivalence of Lifetime Consumption and Lifetime Income Taxes</i>	429
Factors Affecting Tax Incidence Analysis	429
<i>Tax Incidence under Partial and General Equilibrium</i>	430, <i>Short-run versus Long-run Effects</i>
430, <i>Open versus Closed Economy</i>	431, <i>Associated Policy Changes</i>
431	
Summary	432
Key Concepts	433
Questions and Problems	433

18 Taxation and Economic Efficiency: Consumption 437

- Effect of Taxes Borne by Consumers 438
 - Present and Future Consumption 441, The Consumer Surplus Approach to Deadweight Loss 445, Measuring the Deadweight Loss 446*
- Effect of Taxes Borne by Producers 449
- Effects of Taxes Borne Partly by Consumers, Partly by Producers 452
- Summary 453
- Key Concepts 453
- Questions and Problems 453
- Appendix: Measuring Deadweight Loss 454

19 Taxation and Economic Efficiency: Labor Supply 456

- Effects of Taxation on the Quantity of Labor Supplied 456
 - Relationship between Labor and Consumption 458, Income and Substitution Effects of Taxation 459, Distortionary Effects of Wage Taxation 462, Distortion with Inelastic Labor Supply 464, Taxes and Female Labor Force Participation 466, Retirement Decision 468*
- Measuring the Effects of Taxation on Labor Supplied 468
 - Surveys 468, Statistical Techniques Using Market Data 469, Experiments 471*
- Other Dimensions to Labor Supply 473
 - Effort 474, Job Choice 474, Education 475, Labor Supply and Other Household Decisions 475, Form of Compensation 476*
- Summary 476
- Key Concepts 476
- Questions and Problems 476

20 Optimal Taxation 478

- The Fallacy of Counting Distortions 478
- The Second-Best Fallacy 479
- Optimal Redistributive Income Taxation 479
 - Why Impose Distortionary Taxes? 480, The Trade-off between Inequality and Inefficiency 480, Why Does More Progressivity Imply More Deadweight Loss? 481, A Diagrammatic Analysis of the Deadweight Loss of Progressive Taxation 483, Relationship between Deadweight Loss and Redistribution 485, The Utility Possibilities Curve and Distortionary Taxation 486, Rawlsian Taxation 488, Relationship between Progressivity and Government Expenditures 489, A Numerical Calculation of the Optimal Flat-Rate Tax 489*
- The Optimal Structure of Income Taxes 489
 - Labor Supply Elasticities and Tax Rates 490, General Equilibrium Effects 493*

Redistribution through Commodity Taxes	493
<i>The Inefficiency of Commodity Taxation 493, Further Arguments against Differential Commodity Taxation 494, Ramsey Taxes 494, Interest Income Taxation and Commodity Taxation 498</i>	
Optimal Taxation and Production Efficiency	498
The Dependence of Optimal Tax Structure on the Set of Available Taxes	501
Summary	502
Key Concepts	503
Questions and Problems	503
Appendix: Deriving Ramsey Taxes on Commodities	503

Part Five Taxation in the United States

21 The Personal Income Tax	507
An Outline of the U.S. Income Tax 507	
Principles behind the U.S. Income Tax 510	
<i>The Income-based Principle and the Haig-Simons Definition 510, The Progressivity Principle 512, The Family-based Principle 513, The Annual Measure of Income Principle 514</i>	
Practical Problems in Implementing an Income Tax System 515	
<i>Determining Income 515, Timing 519, Personal Deductions 520, Unit of Taxation 527</i>	
Average and Marginal Tax Rates: A Closer Look 530	
Summary 530	
Key Concepts 532	
Questions and Problems 532	
22 The Taxation of Capital	534
Definition of Income from Capital 535	
<i>Depreciation 535, Capital Gains 539, Pensions and Retirement Income 541, Inflation 543</i>	
Special Treatment of Capital Income 545	
<i>Housing 545, Interest on State and Municipal Bonds 546, Other Special Provisions 546</i>	
Some Explanations of Complexity of Capital Taxation 547	
<i>Administrative Costs 547, Horizontal Equity and Efficiency 547, Incentive Effects 548</i>	
Effects of Uniform Taxes 548	
<i>Effect of Capital Income Taxation on Savings and Investment 548, Effect of Capital Income Taxes on Risk Taking 553</i>	
Consequences of Non-Uniform Taxes 555	
<i>Housing: An Example of Non-Uniform Treatment 556</i>	