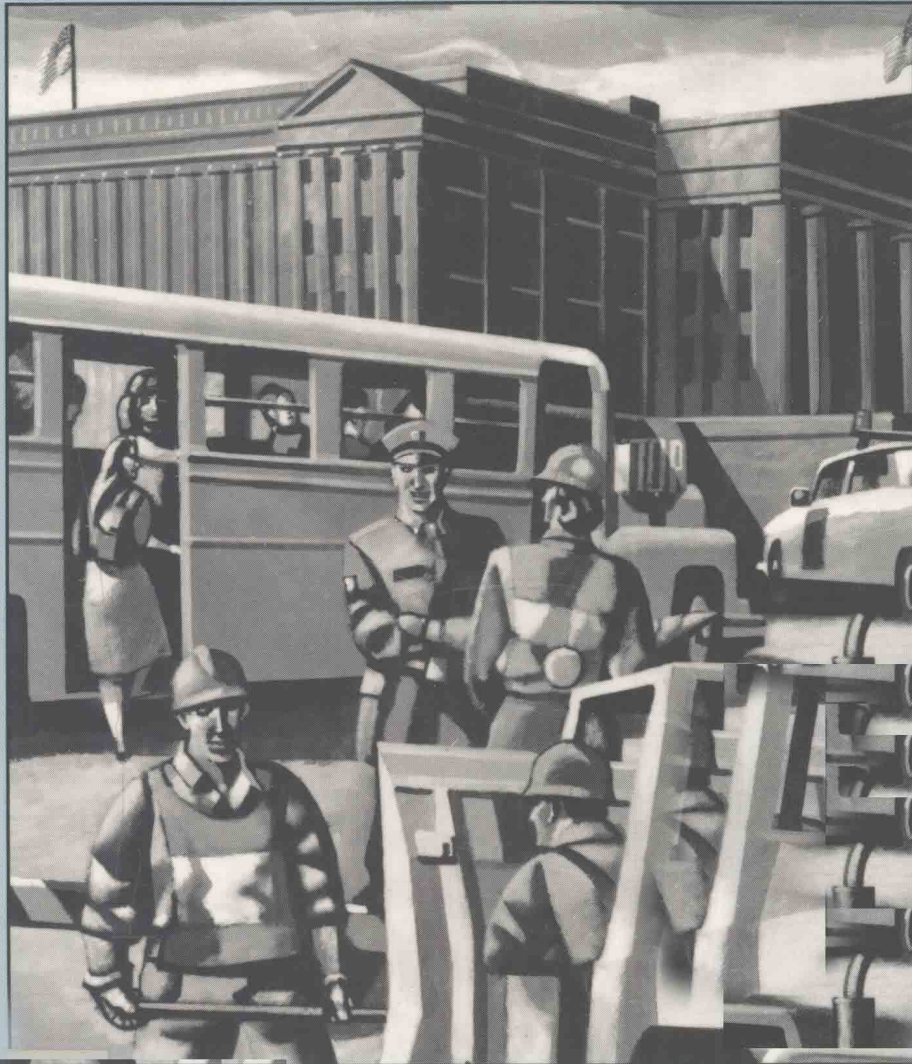


T H I R D

Readings, Issues, and Problems in
Public Finance

E D I T I O N



Eleanor Brown
Robert L. Moore

READINGS, ISSUES, AND PROBLEMS IN PUBLIC FINANCE

Third Edition

Eleanor Brown
Pomona College

Robert L. Moore
Occidental College

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READINGS, ISSUES, AND PROBLEMS IN PUBLIC FINANCE

Preface

Public finance is a broad discipline whose policy relevance and theoretical structure will overflow the bounds of any textbook. The goal of this supplementary collection of readings, applications, questions, and problems is to give undergraduates and policy students a taste of and, we hope, a taste for the many interesting issues that extend beyond the basic textbooks in public finance. It is not intended to be an encyclopedia of issues in public finance, nor is it a compendium of the discipline's greatest hits. Rather, we have tried to provide material that will enable students to apply the key principles of public finance as they grapple with some of the major policy concerns of the day. In choosing among topics and articles, we have tried to include ones that are (1) interesting to students, (2) important in their implications for policy, and (3) illustrative of analytical economic reasoning.

In some sense, this book might best be thought of as a “reading/workbook.” Each chapter starts with a selection of readings, organized around specific issues. The introduction to each article points out the key issues. The questions that follow try to elucidate the value of the text. These questions are arranged in ascending breadth of focus. The first question focuses narrowly on the text. For the student who is stumped at this point, the signal is, “Do some rereading.” Further questions ask for more thoughtful reflections on the material presented. Many of these questions provide an excellent basis for classroom discussion.

After these readings, each chapter moves on to shorter discussions, with questions, of further issues not covered in the principal readings. Many of these involve recent news events and help to further bridge the gap between textbook analysis and the real world. If these entries convey the subliminal message, “Newspapers deserve reading and critical reflection,” so much the better.

Approximately half of the eight chapters conclude with “solved problems.” These are a new feature of this edition. Solutions are also now provided for a few of the more difficult questions that accompany the readings. This provides further feedback to students on whether they have mastered the key concepts in that unit. The solved problems are independent of the rest of the material in the chapter. Obviously, these problems are most useful when students write out complete answers before consulting the solutions. In our own classrooms, we encourage students to become active, rather than passive, learners. We hope this book and these new features will aid in engaging students in active learning.

The contents of this book are arranged in a sequence that is typical of many public finance courses, but the chapters stand independently and can be used in any order. We have followed closely the pattern in which topics are introduced in Harvey Rosen’s text, *Public Finance*. Well over half the readings and issues are new to this edition, including, among many others, the government’s role in financing higher education, public choice in public education, the earned income tax credit as a welfare policy, a cost-benefit analysis of the Clean Air Act, the treatment of capital gains in the personal income tax, and the economics of state lotteries. Many items retained from the previous edition have been revised to reflect policy changes in such areas as social security, federal taxation, and health care policy.

Many people helped bring this book to fruition. Our first round of thanks goes to those people who wrote pieces specifically for this project; we are deeply grateful to Jim Wyckoff, Steve Marks, Rebecca Blank, Edward Golding, Nadja Zalokar, Jim Luckett, and Jay Prag. We are also grateful to those who provided specific problems and issues, including Mike Tamada (Occidental College), and David Harrington, Kathy Krynski, and Bruce Gensemer (Kenyon College). We also owe a great debt to Pat McCabe and all the other talented people at Irwin who helped with this book.

Finally, we both would like to thank our colleagues and students at Occidental and Pomona College for their interest in, and discussions about, various aspects of this project.

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PART I

Market Failure

Issue: *If efficiency dictates that resources are allocated to private goods through competitive markets and to public goods by a collective mechanism such as government, what do we do with "mixed" goods that are neither purely private nor purely public?*

"Can Software Be Made Safe from Piracy?" Ralph Vartabedian

"To What Extent Is Education a Public Good" James Wyckoff

Issue: *Market failure and federal aid to college students.*

"More Families Need More Aid for College" Jesse Jackson

"Dukakis Asks College Loans to Be Repaid on Job" Robin Toner

"What's Wrong with Our Schools?" (excerpt from *Free to Choose*)
Milton and Rose Friedman

Further Issues and Questions in Market Failure

Issue: *How to break up traffic jams.*

Issue: *Climbers reach Washington's Peshastin Pinnacles via the Coase theorem.*

Issue: *Regulating drivers in smoggy Denver.*

Solved Problems in Market Failure

If efficiency dictates that resources are allocated to private goods through competitive markets and to public goods by a collective mechanism such as government, what do we do with "mixed" goods that are neither purely private nor purely public?

The first article, reporting on the rising amount of theft of "intellectual property" such as cable TV signals and computer software, illustrates both how common and how problematic public goods are. You will be asked whether these goods qualify as public goods, what market failure plagues their private production, and what efficiency issues are at stake.

The second article concerns education, one of

the many mixed goods that have public good characteristics alongside private ones. Mixed goods are frequently objects of government provision. Consider, for example, police protection: Lowering the level of crime reduces the private costs borne by victims, and everyone becomes less apprehensive as the level of public safety improves.

When a publicly provided mixed good is largely private, there arises the question of whether to charge consumers for its consumption. The government may run the post office because universal service provides option value and national pride to all of us, but we still pay for the private benefit of using the mail. The government's approach to a mixed good might reasonably depend on the relative importance of its public and private characteristics. The second article presents a methodology for quantifying the public good dimension of a good that is, at least at the margin, primarily private.

CAN SOFTWARE BE MADE SAFE FROM PIRACY?*

Ralph Vartabedian †

Each evening in homes across Southern California, mom, dad and the kids warm up their

* *Los Angeles Times*, November 28, 1982. Copyright 1982, Los Angeles Times. Reprinted by permission.

† Times Staff Writer.

favorite couch and switch on an illegal television receiver to steal the broadcast signals of California Subscription Television Service.

This seemingly innocuous act of tuning in the television station without paying a fee has become a popular form of electronic-era bravado among many otherwise law-abiding

households, even though it violates no fewer than a half dozen federal and state statutes, according to the pay-TV firm. The company estimates that 50,000 homes steal its signal in this fashion.

Such theft of electronic data is growing in popularity on a broad scale, part of what some industry officials see as a high-technology crime wave that is permeating some of the healthiest and fastest-growing segments of the U.S. economy.

BREAKDOWN IN PROTECTION

The greatly heralded age of information and technology is finally arriving in offices and homes across the nation. But as illustrated by the growing popularity—and widespread public acceptance—of stealing pay-TV signals, there has been a breakdown along the way in the locks and doors that historically have protected all kinds of so-called “intellectual property.”

At issue is how to preserve creators' rights to valuable new information and ideas in a society that has thrived for centuries on a free intellectual marketplace.

“As we enter the information age with all the aspects of automating the treatment of information, we have essentially produced information as an intangible asset subject to crime,” say Donn Parker, one of the nation's top computer-crime experts and a consultant at SRI International, a research firm in Menlo Park, Calif.

Meanwhile, there is mounting litigation between corporations based on a hodgepodge of unclear case law that governs the rapidly changing area of intellectual property rights.

The problems are multiplying partly because ever greater amounts of society's wealth no longer are physical assets that can be locked up. New ideas, manufacturing processes, data

bases and basic technology represent some of the most important forms of wealth today.

“Intellectual assets are unlike financial assets or physical assets,” says Henry Hanson, director of intellectual property at Minneapolis-based Honeywell Inc. “It is a little bit like catching smoke in your hand sometimes. They are dynamic. They are intangible.”

What qualifies today as intellectual property is indeed far-flung: Everything from the innards of Pac-Man to the huge data banks of personal information kept on virtually every American by government agencies, credit bureaus and others. Intellectual property also describes such things as the satellite transmissions of sporting events and the industrial technology used to manufacture computer chips.

One measure of how the growth of intellectual property has exploded is the volume of copyrighted material nationwide. In just the past decade, the annual volume of new copyright filings has jumped 40%, according to the Library of Congress.

Governments as well as the owners of this new property are struggling to find ways to integrate it properly into established legal and commercial structures.

Tax experts, for example, are examining how some taxes might be applied to intellectual property in the same manner that they apply to physical property, according to Gary Jugum, assistant chief counsel for the California Board of Equalization.

For instance, California sales tax applies to software sold on a computer disk. But if the software is sold and transferred electronically, there is no tax—an obvious contradiction in tax theory since the product is the same.

These issues are so new that authority for dealing with them is widely dispersed throughout agencies of government, law enforcement and the courts. Corporations are just beginning to take a unified approach to intellectual property management.

SHORT-TERM SOLUTION

On a practical level the problems sometimes seem insurmountable. California Subscription Television, for example, figures it would have to spend \$2 million on new scrambling devices to shut off the estimated 50,000 pirates of its signal. But the firm has been reluctant to spend that kind of money because it believes it will only give manufacturers of illegal devices one more product to market.

"These people are really business parasites," says Mark Edelman, until recently a vice president at the firm. "We go through the burden of setting up the business and paying all the copyright fees. All they do is develop a device to steal all that."

Determining exactly how widespread such violations are is difficult because so far nobody has kept statistics on reported offenses.

Nevertheless, a high-tech underground seems to be flourishing. Take, for example, the proliferation across Southern California of electronic bulletin boards set up by personal-computer users for the illegal trading of computer programs. To get access to the bulletin boards requires a home computer and a telephone. The caller hooks his computer into another computer that advertises various pirated software packages for sale. An entire transaction can be handled over the telephone between two strangers.

"You don't even have to look someone in the eye when you pirate a computer program," observes Parker, of SRI. "In the computer software field, I have had computer company executives tell me that for every copy of their programs that they sell, two of them are pirated. I don't know if that is typical, but that's why we are beginning to study it," Parker adds.

VIOLATIONS ARE RAMPANT

Such computer software piracy has been outlawed since the early 1970s, when copy-

right privileges were extended to software. Nevertheless, violations are rampant, and many experts are clearly concerned about the potential consequences.

"Copyright is very directly related to a free society," says Mel Ninner, a copyright specialist at the UCLA law school. "If we are going to have an open society and artistic, literary and scholarly creativity that is not (government) controlled, then we have got to rely on the creators earning their living from the marketplace."

"It takes a long time for the legal system to react, and, in the meantime, you have an enormous industry that is expanding rapidly and moving into new areas," says James Pooley, a Silicon Valley attorney specializing in trade secret law.

California, Massachusetts, Minnesota and Florida are at the forefront in examining these new issues, but getting new laws passed even in those states has proven a major hurdle.

All too frequently, existing laws must be bent to fit high-technology crimes, some experts say. For example, when two Philadelphia programmers were arrested for stealing \$144,000 worth of computer time several years ago, they were formally charged with mail fraud because there were no appropriate statutes, Parker says.

At the same time, corporations are ending up in court more often because civil laws are unclear about intellectual property rights.

By any measure, electronics and computer manufacturers have the biggest problem protecting their technology and developing safeguards.

So far, no computer system has ever been built with electronic security measures that cannot be penetrated by unauthorized users. So-called military "tiger teams" have demonstrated that even the Pentagon's own Worldwide Military Command and Control System computer is not tamper-proof, according to Pentagon sources.

It is difficult to prevent disaffected or avaricious employees from peddling a company's critical secret knowledge to buyers on the outside, industry officials say.

"We could totally bar the doors and pull the shades on all of the windows, strip search employees as they go out and X-ray them to make sure they didn't swallow something," says Honeywell's Hanson. "You could just carry it to an extreme that would just be totally unacceptable."

QUESTIONS

1. How would you categorize cable TV broadcasts and computer software programs in terms of "rivalness" and "excludability"? Does your answer change if such goods could be more effectively protected?
2. With no government intervention in markets for these goods (and others involving intellectual property), what, if any, market failure would you anticipate? Consider first whether the efficient amount of these goods would be produced and, second, whether the efficient amount of consumption of these goods would occur for any given amount of production.
3. Given the breakdown in protection of intellectual property noted in the article, indicate how, if at all, preserving creators' rights might enhance efficiency.
4. An economics major claims that once a program is produced, stealing pay-TV signals can actually promote static efficiency since the marginal cost associated with each additional viewer of a broadcast is zero while the marginal benefit is positive. Do you agree?