

J O H N L . M I K E S E L L

# *Fiscal Administration*

*Analysis and*

*Applications*

*for the*

*Public Sector*

11104981  
USED BOOK  
NO REFUND IF REMOVED  
50.25

# ***Fiscal Administration*** *Analysis and Applications* *for the Public Sector*

**FOURTH EDITION**

***John L. Mikesell***  
*Indiana University*



Wadsworth Publishing Company


**I(T)P™** An International Thomson Publishing Company

---

Belmont • Albany • Bonn • Boston • Cincinnati • Detroit • London • Madrid • Melbourne  
Mexico City • New York • Paris • San Francisco • Singapore • Tokyo • Toronto • Washington

**Editorial Assistant:** Jennifer Dunning  
**Production:** Cecile Joyner, The Cooper Company  
**Print Buyer:** Randy Hurst  
**Permissions Editor:** Jeanne Bosschart  
**Interior Designer:** Christy Butterfield  
**Copy Editor:** Betty Duncan  
**Indexer:** Anne Leach  
**Cover Designer:** Cuttriss and Hambleton  
**Compositor:** Scratchgravel Publishing Services  
**Printer:** Vail-Ballou Press

COPYRIGHT © 1995 by Wadsworth Publishing Company  
A Division of International Thomson Publishing Inc.

 The ITP logo is a trademark under license.



*This book is printed on  
acid-free recycled paper.*

Printed in the United States of America.

1 2 3 4 5 6 7 8 9 10—01 00 99 98 97 96 95

For more information, contact Wadsworth Publishing Company.

Wadsworth Publishing Company  
10 Davis Drive  
Belmont, California 94002  
USA

International Thomson Editores  
Campos Eliseos 385, Piso 7  
Col. Polanco  
11560 México D.F. México

International Thomson Publishing Europe  
Berkshire House 168-173  
High Holborn  
London, WC1V 7AA  
England

International Thomson Publishing GmbH  
Königswinterer Strasse 418  
53227 Bonn  
Germany

Thomas Nelson Australia  
102 Dodds Street  
South Melbourne 3205  
Victoria, Australia

International Thomson Publishing Asia  
221 Henderson Road  
#05-10 Henderson Building  
Singapore 0315

Nelson Canada  
1120 Birchmount Road  
Scarborough, Ontario  
Canada M1K 5G4

International Thomson Publishing Japan  
Hirakawacho Kyowa Building, 3F  
2-2-1 Hirakawacho  
Chiyoda-ku, Tokyo 102  
Japan

All rights reserved. No part of this work covered by the copyright hereon may be reproduced or used in any form or by any means—graphic, electronic, or mechanical, including photocopying, recording, taping, or information storage and retrieval systems—without the written permission of the publisher.

#### Library of Congress Cataloging-in-Publication Data

Mikesell, John L.

Fiscal administration : analysis and applications for the public  
sector / John L. Mikesell. — 4th ed.

p. cm.

Includes bibliographical references and index.

ISBN 0-534-24606-0

1. Finance, Public. I. Title.

HJ141.M5 1994

350.72—dc20

94-4547

## About the Author

**J**ohn L. Mikesell is professor of public and environmental affairs at Indiana University. He holds a B.A. from Wabash College and both M.A. and Ph.D. in economics from the University of Illinois. His work on government finance has appeared in such journals as the *National Tax Journal*, *Public Finance Quarterly*, *Public Finance/Finances Publiques*, *Public Budgeting and Finance*, *Public Choice*, *Land Economics*, and *Public Administration Review*. He is coauthor (with John F. Due) of *Sales Taxation, State and Local Structure and Administration* (Johns Hopkins Press). He has worked on fiscal studies for several states, including New York, Minnesota, Indiana, and Hawaii, and has served on the Revenue Forecast Technical Committee of the Indiana Budget Agency for more than a dozen years. He also has been visiting scholar at the Congressional Budget Office. He has served on the executive committees of the National Tax Association and of the Association for Budgeting and Financial Management, including service as chair of the latter.

# Preface

**P**ublic finance and budgeting is characterized by change. That is true whether one is interested in attitudes about the proper role of government; whether one considers government spending, government revenue, or the gap between the two; whether the focus is federal, state, or local government in the United States or the finances of some other nation; whether one is concerned with theory or practice; whether the observer is a neophyte or a seasoned hand. No part of the field is constant for long, but the age-old questions of how much to allocate for what and where to obtain the resources necessary to cover the allocation always remain, even as the answers to them change. Indeed, if one sticks to the field long enough, old answers pop up as new people enter the field, re-discover the old answers, and proclaim them new!

As did the earlier editions, this volume sticks to two distinguishing principles. First, a public affairs student must have an idea of where the money comes from, not just sort of, but really. As an earlier preface observed, “If armies move on their stomachs, then certainly governments crawl on their purses!” That is no less true for the 1990s than it was for the 1980s; those lacking an understanding of revenue options, systems, and policies will miss out on much of the fun. The second principle is that learning public financial administration and budgeting requires running the numbers. Most questions and exercises at the end of the chapters are not speculative in nature but require the student to develop an intimate relationship with pencil and paper, calculator, or computer. That emphasis is absolutely intentional.

Several specific revisions need to be noted. First, there is a new chapter that looks specifically at federal and state–local budget processes. Material about the specific processes, institutions, and the like that were scattered about in other chapters, in previous editions, on budget cycles and methods have been gathered and expanded here. Special attention is given the differences between federal and state–local processes, constraints, and institutions. Second, all materials have been updated to include the most recent fiscal data now available and to include federal changes through the Revenue Reconciliation Act of 1993. Third, many international comparisons have been added, to provide more contrasts between the public sector of the United States and that of our major trading partners. Fourth, material has been added on several topics of current concern, including new performance budgeting, public pension–fund management, mandates, internal control, value-added taxes, privatization, and state-supported gaming. Finally, several new cases and exercises have been added, and the bibliography of sources for additional reading has been updated and expanded.

I would like to thank the reviewers of this edition for their helpful comments: W. Bartley Hildreth, Louisiana State University; Hugh Hinton, University of Toledo; Fred A. Kramer, University of Massachusetts, Amherst; and James K. Shaw, University of San Francisco.

As with other editions, my students and colleagues at Indiana University continue to enjoy pointing out errors and misinterpretations in the book, as well as in other areas of my professional life. Their attention to detail and efforts to keep me current with the field are deeply appreciated. I also thank the Congressional Budget Office. While serving as visiting scholar there, I learned much about the federal budget and how that process works, an education that permitted several improvements to the book. Finally, I could not have written this book without the capable and efficient secretarial support I have had. For this, I thank Becky Howard, Becky Neal, and Maggie Pearson who pitched in to help and, most especially, Kathy Haney, who made sure that everything got done right. Couldn't have done it without you!

*John L. Mikesell*

# Contents

<b>CHAPTER 1</b>	<b><i>Fundamental Principles of Public Finance</i></b>	<b>1</b>
	<i>The Basis of Government Action: Nonappropriability</i>	2
	<i>Privatization</i>	6
	<b>Public Choice and Public Finance</b>	10
	<i>Building Social Decisions from Individual Preferences</i>	10
	<i>The Paradox of Voting</i>	14
	<i>Complications from Representation</i>	15
	<b>The Constraints of Federalism</b>	17
	<b>Conclusion</b>	19
	<b>Questions and Exercises</b>	20
	<b>Case for Discussion</b>	21
	<i>Case 1-1: Market Interplay, Municipal Utilities, and a Common-Pool Resource</i>	21
 <b>PART ONE</b>	 <b><i>BUDGETING, BUDGET STRUCTURES, AND BUDGET REFORM</i></b>	 <b>23</b>
<b>CHAPTER 2</b>	<b><i>The Logic of the Budget Process</i></b>	<b>25</b>
	<b>Budget Logic and Form</b>	25
	<i>The Size and Growth of Government Expenditure</i>	27
	<i>Some Terminology of the Budgeting and Spending Process</i>	33
	<i>Orientations of a Budget</i>	37
	<i>Budget Decision and the Provision Flow</i>	38
	<b>The Budget Cycle</b>	42
	<i>Executive Preparation</i>	43
	<i>Legislative Consideration</i>	44
	<i>Execution</i>	45
	<i>Audit and Evaluation</i>	45
	<b>Budgets and Political Strategies</b>	47
	<i>Roles</i>	48
	<i>Strategies</i>	49
	<b>Conclusion</b>	54
	<b>Questions and Exercises</b>	54
	<b>Cases for Discussion</b>	56
	<i>Case 2-1: What Cost Matters for Making Decisions?</i>	56

*Case 2-2: Developing and Using Budget Strategy: The Earth Resources  
Technology Satellite (ERTS)* 58

*Case 2-3: Strategies in Defense of the Defense Budget* 61

**CHAPTER 3**      ***Budget Structures and Institutions:  
Federal and State–Local***      **65**

**The Federal Budget** 65

*Spending by the Federal Government* 65

*The Federal Budget Process* 67

*Mandatory Spending* 81

*Federal Deficits* 86

*Federal Fiscal Policy* 93

**State and Local Budgets** 96

*Spending by State and Local Governments* 96

*State and Local Government Budget Processes* 97

*State and Local Deficits* 103

**Conclusion** 105

**Questions and Exercises** 105

**Appendix 3-1: Job Creation and State–Local Fiscal Policy** 106

**CHAPTER 4**      ***Budget Methods and Practices***      **113**

**Preparation of Agency Budgets** 113

*Elements of Cost Estimations* 114

*Budget Justification* 118

**Review of Budgets** 119

*Phantom Balance and Deficit Reduction* 123

**Managing Budget Execution** 128

**Audit and Evaluation** 132

**Some Special Problems of Public Employee Compensation** 135

*Wages and Salaries* 136

*Retirement Programs* 139

**Conclusion** 142

**Questions and Exercises** 143

**Cases for Discussion** 147

*Case 4-1: Green Felt-Tip Pens, a Tape Recorder, and Embezzlement:  
Where Did the Budget Process Fail?* 147



*Case 4-2: Broad-Rule Cuts of Unnecessary Travel* 150

*Case 4-3: Balancing the Chicago Public School Budget* 153

## **Appendix 4-1: Budget Preparation, or How to Be a Budget Analyst** 154

## **CHAPTER 5      *Budget Classifications and Reform*      165**

**Flaws in Traditional Budgets as a Tool for Decision Making** 166

**Alternate Budget Classifications and Structures** 169

*Performance Budgets* 170

*Program Budgets* 173

**A Budget System Alternative: Zero-Based Budgets** 182

**The New Performance (Outcome) Budgeting** 186

**Conclusion** 189

**Questions and Exercises** 190

**Cases for Discussion** 193

*Case 5-1: Following Departmental Lines (and Scores?)* 193

*Case 5-2: A View of Zero-Based Budgeting* 194

**Appendix 5-1: The Federal Functional Classification** 198

**Appendix 5-2: The Federal Budget Process in the National Performance Review** 209

## **CHAPTER 6      *Capital Budgeting, Public Infrastructure, and Project Evaluation*      219**

**Why Have Separate Capital Budgets?** 220

*A Capital-Budget Process* 223

*Accounting for Time: Discounting and Compounding* 230

*Problems in Capital Budgeting* 237

**Cost–Benefit Analysis** 238

*Elements in Cost–Benefit Analysis* 239

*Some Special Problems of Cost–Benefit Analysis* 250

*A Final Note on Cost–Benefit Analysis* 253

**Conclusion** 254

**Questions and Exercises** 254

**Cases for Discussion** 260

*Case 6-1: What Does Cost Mean?* 260

*Case 6-2: The GAO on the Need for a Federal Capital Budget* 261

<b>PART TWO</b>	<b>REVENUE SOURCES, STRUCTURE, AND ADMINISTRATION</b>	<b>269</b>
<b>CHAPTER 7</b>	<b>Taxation: Evaluation Criteria</b>	<b>271</b>
	Fiscal Criteria 278	
	Equity 279	
	Business and Individual Shares 288	
	Adequacy or Revenue Production 289	
	Collectability 293	
	Economic Effects 294	
	Taxes and Externalities 295	
	Conclusion 297	
	Questions and Exercises 297	
<b>CHAPTER 8</b>	<b>Major Tax Structures: Income Taxes</b>	<b>299</b>
	Some Background 300	
	Individual Income Taxation 302	
	Problems of Income Tax Structure: Defining Income 302	
	Adjusted Gross Income 304	
	Personal Deductions 307	
	Taxable Income 309	
	Tax Rates 309	
	Credits 312	
	Effective Rates 312	
	Indexation 313	
	Tax Computation 315	
	Corporate Income Taxation 316	
	Payroll Taxation 318	
	Conclusion 319	
	Questions and Exercises 319	
	Case for Discussion 321	
	Case 8-1: What Rate? 321	
<b>CHAPTER 9</b>	<b>Major Tax Structures: Taxes on Goods or Services</b>	<b>324</b>
	Alternate Forms of Goods and Service Taxation 325	
	Selective Excise Taxation 329	

<i>Luxury Excises</i>	330
<i>Sumptuary Excises</i>	331
<i>Benefit-Base Excises</i>	332
<i>Regulatory and Environmental Excises</i>	333
<i>Other Excises</i>	333
<b>General Taxes on Goods and Services: Retail Sales and Value-Added Taxes</b>	<b>334</b>
<i>Retail Sales Taxes</i>	334
<i>Value-Added Taxes</i>	341
<b>Conclusion</b>	<b>345</b>
<b>Questions and Exercises</b>	<b>346</b>
<b>Cases for Discussion</b>	<b>347</b>
<i>Case 9-1: Sales Tax and Used Cars</i>	347
<i>Case 9-2: Girl Scout Cookies and the Snack Tax</i>	351
<i>Case 9-3: Complying with the Canadian VAT</i>	353

<b>CHAPTER 10</b>	<b><i>Major Tax Structures: Property Taxes</i></b>	<b>356</b>
	<b>Structural Issues About Property Taxes</b>	<b>357</b>
	<i>Rates, Levies, and Assessed Value</i>	359
	<i>Assessment</i>	360
	<b>Property Tax Relief</b>	<b>366</b>
	<i>Exemptions and Abatements</i>	366
	<i>Circuit Breakers</i>	369
	<i>Deferrals</i>	371
	<i>Classification</i>	372
	<i>Tax Increment Financing</i>	372
	<b>Problems of the Property Tax</b>	<b>374</b>
	<i>Fractional Assessment and Assessment Uniformity</i>	374
	<i>Limits and Control</i>	380
	<b>Conclusion</b>	<b>383</b>
	<b>Questions and Exercises</b>	<b>383</b>
	<b>Cases for Discussion</b>	<b>387</b>
	<i>Case 10-1: Use-Value Assessment for Farmland: Some Operational Questions</i>	387
	<i>Case 10-2: Finding Revenue in Reassessment</i>	389
	<i>Case 10-3: Property Taxes and a World-Class House</i>	391

<b>CHAPTER 11</b>	<b>Tax Administration</b>	<b>392</b>
	Administration	392
	Total Collection Cost	397
	The Administrative Structure	400
	Centralization	400
	Integration of Activities	401
	Revenue Estimation	403
	Revenue (or Receipts) Forecast	404
	Revenue Impact (Fiscal Notes)	408
	Tax-Expenditure Budgets	409
	Conclusion	411
	Questions and Exercises	411
	Appendix 11-1: The State of Minnesota Tax-Expenditure Budget: Criteria and Measurement	412
<b>CHAPTER 12</b>	<b><i>Revenue from Public Prices: Charges for Public Services and Public Monopoly Products</i></b>	<b>417</b>
	User Fees	420
	User Charges	422
	Advantages of User Charges	424
	Limitations of User Charges	425
	Charge Guidelines	427
	Public Monopoly Revenue: Utilities, Liquor Stores, and Gambling Enterprises	430
	Government Utilities	431
	Liquor Stores	432
	Gambling Enterprises	432
	Lotteries	433
	Conclusion	436
	Questions and Exercises	436
<b>CHAPTER 13</b>	<b><i>Intergovernmental Fiscal Relations: Diversity and Coordination</i></b>	<b>441</b>
	Spillovers	442
	What About Economies from Bigness?	443
	Fiscal Disparity	444

**Coordination and Assistance 445***Tax Systems 445**Grants 449**Mandates 460***Conclusion 463****Questions and Exercises 463****Case for Discussion 463***Case 13-1: It Worked Once, but Would It Work Again? 463***PART THREE DEBT ADMINISTRATION AND  
FUND MANAGEMENT****465****CHAPTER 14 Debt Administration****467****Federal Debt 468****State and Local Government (Municipal) Debt 470****Municipal Bonds and the Tax Reform Act of 1986 473****Appropriate Debt Policy 476****The Mechanics of Bond Values 477****Debt Structure and Design 478****Ratings 481****Bond Guarantees 487****Underwriting, Interest Rates, and Ownership 489****Lease–Purchase Finance and Certificates of Participation 492****Conclusion 495****Questions and Exercises 496****Appendix 14-1: Standard & Poor's Rating Criteria  
for General-Obligation Debt 499****CHAPTER 15 Managing Funds: Working Capital and  
Pension Balances****510****Cash Management and Working Capital 510***Managing Working Capital 511**Elements of Cash Management 512**Investable-Funds Management 518***Managing Public Pension Funds 526**

Conclusion	530
Questions and Exercises	531
Cases for Discussion	534
Case 5-1: Establishing Cash-Management Programs	534
Case 5-2: Managing Cash for the Sheriff's Interest?	537
<b>Selected Bibliography</b>	<b>543</b>
<b>Glossary</b>	<b>554</b>
<b>Index</b>	<b>577</b>

## LIST OF FIGURES

1-1	The Elements of Nonappropriability	4
1-2	Choices and Voting	14
2-1	Service Delivery and Revenue Systems as Separate Planning Processes	27
2-2	Financial Information for Management	35
2-3	Relationship of Budget Authority to Outlays, 1995	36
2-4	Flow of Public-Service Provision	39
2-5	1994 Budget Proposal, Fire Department, City of Bloomington, Indiana	40
2-6	Phases of a Budget Cycle	43
3-1	Discretionary Federal Outlays as a Percentage of Total Outlays, Fiscal 1962–1993	83
4-1	An Example of a Budget-Status Report	131
5-1	Salt Lake City Performance Budget Illustration	172
5-2	The Governor's Budget Request, Commonwealth of Pennsylvania Public Television Network, 1993–1994	182
5-3	Salary Classification in Traditional, Performance, and Program Budgets	183
5-4	The Flow of Zero-Based Budgets	184
6-1	Capital-Improvement Programming and Budgeting	224
6-2	Capital-Budget Guidelines and Definition: Pennsylvania	228
6-3	Display from the State of Wyoming Budget, 1993–1994 Biennium	231
6-4	Compounding	233

6-5	Individual Demand for a Park	243
7-1	Impact, Shifting, and Incidence	286
7-2	Relationships Between Tax Rate and Tax Revenue: The Tax-Revenue Curve	290
8-1	Elements of the Federal Individual Income Tax Structure	303
8-2	The Rate Schedule After the Revenue Reconciliation Act of 1993	312
8-3	A Portion of the Federal Tax Table	313
8-4	An Example of Income Tax Computation	315
9-1	The Flow of Production and Distribution	329
9-2	The Minnesota Sales and Use Tax Return	335
9-3	Brackets for Collection of 5 Percent (Nominal) Sales Taxes in Maryland and Massachusetts	336
9-4	Suspending Sales Tax by Certificate	338
10-1	Parcel Record Card for Residential Real Property	366
10-2	Single-Family Residence Sales in Norton, Virginia, 1987	378
10-3	Single-Family Residence Sales in Buena Vista, Virginia, 1987	378
11-1	Illustration of Tax Return Processing Flow	394
11-2	General Forms of Organization	402
14-1	Deciphering Municipal-Bond Quotes	479
14-2	Yields of U.S. Treasury Securities by Term to Maturity, December 31, 1993	481
14-3	Average Yields of Long-Term Treasury, Corporate, and Municipal Bonds	482
14-4	A Certificate-of-Participation Arrangement	496
15-1	Cash Balance Through a Year for a Fund	512
15-2	Control for Cash Management: Receipts and Disbursement	514
15-3	Collection and Deposit Float	515
15-4	A Postal Lockbox Collection System	516
15-5	Application of a Concentration Account	517

## LIST OF TABLES

1-1	Individual Benefits from the Project: Example 1	11
1-2	Individual Benefits from the Project: Example 2	12
1-3	Individual Benefits from the Project: Example 3	13

1-4	Voting Results	15
2-1	Government Expenditures and Price Deflators in the National Income and Product Accounts	29
2-2	The Public Sector in Selected Industrialized Countries, 1990: Purchases and Outlays as a Percentage of Gross Domestic Product	33
3-1	Federal Outlays by Function: Fiscal Years 1970, 1980, 1990, 1993	66
3-2	Highlights of Major Acts Establishing the Federal Budget Process	69
3-3	The Executive Federal Budget Process	71
3-4	House Authorization Committees and Appropriation Subcommittees	73
3-5	The Congressional Budget Timetable	76
3-6	Summary of Proposed and Enacted Rescissions, Fiscal Years 1974–1993	82
3-7	Post–Second World War Federal Budget Deficit History	88
3-8	State and Local Government Expenditure in the United States, Fiscal Year 1990–1991	98
3-9	State Budget Periodicity in 1987	102
3-10	State and Local Government Surplus or Deficit as a Percentage of GDP	104
4-1	Checklist for Budget Justification	120
4-2	Some Errors or Abuses Sought By Auditors	133
4-3	Relative Expenditure on Wages and Salaries, Fiscal Year 1990–1991	135
4-4	Aggregates of State and Local Government Employee Retirement System Finances, Fiscal Year 1990–1991	143
5-1	Alternative Budget Formats and Associated Features	170
5-2	Program-Budget Structure, Commonwealth of Pennsylvania	176
5-3	Program-Budget Structure Used by Park Ridge, Illinois	178
5-4	Program-Budget Structure in the U.S. Department of Defense	180
6-1	Selected Questions for a Capital-Budget Request	230
6-2	Payback Analysis	249
6-3	Projects with Ranking Criteria Conflict	250
7-1	Government Revenue by Source and Level, Fiscal Year 1990–1991	272



7-2	Major Tax Sources Levied by States and Localities, January 1994	274
7-3	Tax Revenue as a Percentage of GDP and Percentage Distribution from Major Tax Sources, OECD Countries, 1990	276
7-4	Public Opinion: "Which Do You Think Is the Worst Tax— That Is, the Least Fair?"	277
7-5	Regressivity, Proportionality, and Progressivity in Tax Systems	283
7-6	Federal Effective Tax Rates by Quintiles for All Families, 1990	285
7-7	An Example of Sales Tax Effective Rates	287
7-8	Compilation of Selected Tax-Income Elasticities as Found in Various Tax Studies	293
8-1	History of Federal Individual Income Tax Exemptions and Lowest and Highest Bracket Rates	310
8-2	Effective-Rate Impact of a Flat-Rate Income Tax (10%) and a Large Personal Exemption (\$1,500 per Person) on Selected Families of Three	315
9-1	Federal Taxes on Goods and Services	326
9-2	National Summary of State and Local Taxes on Goods and Services	328
9-3	Normal VAT Rates in European Community and Selected Other Countries, 1993	345
10-1	Property Tax in U.S. Government Finances, 1990–1991	358
10-2	Property Classification by Statutory Rates and Assessment Ratios	373
10-3	Tax Increment Financing	374
10-4	Coefficient of Dispersion Calculation	377
10-5	Distribution of Selected Local Areas by Coefficients of Intra-Area Dispersion: 1966, 1971, 1976, and 1981	379
10-6	Property Tax–Control Structures and Their Effects	381
10-7	Rate Computations for a Levy Control	382
11-1	Audit Coverage by the IRS	396
11-2	Administrative-Cost Estimates for Major Taxes	399
11-3	Sources of Tax Revenue in New Jersey	400
11-4	Steps in Revenue Estimation	407
12-1	Government Sales Revenue: User Charges and Public Monopolies	419