

# Public Finance

Seventh Edition



Harvey S. Rosen

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## PUBLIC FINANCE

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# Preface

“It is a foolish thing to make a long prologue” (II Maccabees 2:32). I shall once again follow this Biblical advice and be brief in describing the features of this seventh edition. The field of public finance is quite different than it was a generation ago. On the theoretical side, one of the main achievements has been to integrate the analysis of government spending and taxing more closely with basic economic theory. A prime example is the literature on optimal taxation, which attempts to *derive* prescriptions for government fiscal behavior using standard economic tools, rather than to announce a set of ad hoc “principles” for tax design. On the empirical side, the most exciting development is the widespread application of the tools of econometrics to understanding how expenditure and tax policies affect individual behavior and how the government itself sets policies.

The results of modern research have been slow to enter traditional texts. This book takes its readers to many of the frontiers of current research. The approach to the material, while accessible to undergraduates, is the same as the approach shared by most economists who are now active in the field.

The development of public finance has not proceeded free of controversy. In this book, disputes concerning both methodological and substantive issues are discussed at length. One reviewer of an early draft of the manuscript warned against displaying too much of the profession’s dirty laundry in public. My feeling, however, is that “full disclosure” should apply not only in the market for securities, but in the market for ideas as well.

Economic analysis sometimes loses touch with the reality it is supposed to describe. I have tried to avoid this tendency. The relevant institutional and legal settings are described in ample detail. Moreover, the text constantly emphasizes the links between economic analysis and current political issues.

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## Organization

Part One now consists of three chapters that set the stage for the rest of the book. Chapter 1 consolidates two short chapters from the previous edition, and provides a broad perspective on the role of government in the economy. The next two chapters discuss the methodological tools used in the study of public finance. These include the methods of empirical analysis (Chapter 2) and the fundamentals of theoretical welfare economics (Chapter 3). The remainder of the book follows the conventional tactic of analyzing government expenditure and revenue-raising activities separately.

Part Two (Chapters 4 through 11) deals with the expenditure side of the budget. It describes and evaluates various government programs. Part Three (Chapters 12 through 14) presents a theoretical framework for discussing taxation. The major revenue-raising instruments are analyzed using this framework in Part Four (Chapters 15 through 19). Finally, Part Five deals with the special issues that arise under a federal system of government.

Some instructors may choose to do the tax side (Parts Three and Four) before the expenditure side (Part Two); the book is designed so this can be done easily. In the same way, the chapters within Parts Two, Three, and Four can generally be taken up in any order desired without serious loss of continuity.

This book is designed for use in undergraduate curricula as well as graduate programs in public administration. Readers should be familiar with microeconomic theory at the level of the standard introductory course. Because some use is made of indifference curve analysis, a topic not covered in all introductory courses, indifference curves are carefully explained in the appendix to the book. In addition, this appendix provides a brief review of other topics in basic microeconomics, including the supply and demand model, marginal analysis, and consumer and producer surplus. This review should be adequate to refresh the memories of readers who have been away from microeconomics for a while. A glossary of key terms appears after the appendix.

The British statesman Edmund Burke noted that “To read without reflecting, is like eating without digesting.” To facilitate this digestive process, each chapter ends with a set of discussion questions. Their purpose is to encourage students to apply and extend the principles that they have learned. Several reviewers of the previous edition suggested that I both increase the number of discussion questions and include more computational exercises. It’s a good idea, and instructors who like to assign problems will find a lot more selection than before.

I hope that *Public Finance* will whet readers’ appetites to learn more about this field. To that end, a large number of articles and books are cited within the chapters. A typical citation consists of the author’s name followed by the date of publication in brackets. Readers can find the full reference in the consolidated bibliography at the back of the book. The references vary considerably in technical difficulty; those who wish to pursue specialized topics further have to pick and choose. In addition, the end of each chapter has a short list of suggested readings. They are suitable for inclusion in undergraduate syllabi.

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## What’s New in the Seventh Edition?

“Are you doing anything beside updating the tables?” That’s the question many of my colleagues asked when they heard I was revising *Public Finance*. The answer is, “Quite a bit, actually.” There are literally dozens of new examples of how the study of public finance can shed light on contemporary policy discussions. For example, the chapter on public goods uses

the post-September 11 debate on airport security to frame the discussion of public versus private provision of public goods. Similarly, vaccinations against smallpox are used as an example of positive externalities in Chapter 5.

On the expenditure side, Chapter 8, “Expenditure Programs for the Poor”, has been thoroughly revised to include new research on 1996 welfare reform. This research looks systematically at how the benefit reduction rates, time limits, and work requirements of the new system have affected labor supply and other economic decisions of welfare recipients. The section on Medicaid has been substantially augmented, and now discusses the impact of the recent Medicaid expansions on insurance coverage (the “crowding out” controversy) as well as the notch that the program induces in the leisure-income budget constraint.

Chapter 9 on Social Security has new explanations of the annuities market, the trust fund and its relationship to the federal budget, and the retirement effects of the system. It also discusses the recommendations of President Bush’s Commission on Social Security Reform. Chapter 10 on Medicare analyzes one of the most prominent policy questions in this area, prescription drug coverage. In addition, there is a discussion of the intriguing conjectured relationship between health insurance coverage and the pace of technological change in medicine. Chapter 6, “Political Economy”, now has a major new section on the rent-seeking model.

On the revenue side, Chapter 13, “Taxes and Efficiency”, contains a new example that links excess burden to earlier material on externalities. This is the so-called “double-dividend hypothesis,” which claims that efficiency would be enhanced by reducing marginal income tax rates and making up the shortfall in revenues with pollution taxes. The discussion of the personal income tax (Chapter 15) now includes a major section on the Alternative Minimum Tax (AMT). The material explains why the AMT is becoming so important as a policy issue and possible ways to deal with it. On the business tax side (Chapter 17), there is a discussion of the hypothesis that a link exists between the corporation tax and the Enron and other corporate accounting scandals. This chapter also covers the Bush administration’s proposal for a dividend exclusion in the personal income tax. The discussion of the estate tax in Chapter 19 includes new research on its impact on saving. The chapter also discusses the peculiar status of the current law, according to which the estate tax is scheduled to be eliminated in 2010 and then brought back to life in 2011.

Despite these changes, the basic thrust of the book is unchanged. As in the previous editions, the goal is to interweave institutional, theoretical, and econometric material to provide students with a clear and coherent view of government spending and taxing.

Harvey S. Rosen

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It is a pleasure to acknowledge all the people who have helped in the preparation of this book. As a graduate student, I was fortunate to be taught by two of the world's outstanding figures in public finance, Martin Feldstein and Richard Musgrave. Feldstein and Musgrave differed considerably in their approaches to the subject, but they shared a fundamental outlook—public finance is not a mere academic exercise; its goal is to help us understand and perhaps improve real-world situations. The intellectual influence of both these men is evident throughout the text.

Nearly 400 academic colleagues who teach public finance responded to a survey that provided useful material on how they focus their courses. The input afforded insights about their needs and those of the students who take their courses.

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H. S. R.

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