The public finances

An introductory textbook

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Preface

Two problems—inflation and growth of government—dominated the changes made in the fourth edition of this text which was published in 1975. In this, the fifth edition, published in 1980, discussion of these two topics has been further expanded. Inflation remains an important topic to a student of contemporary public finance because of its persistence. The price level in the United States almost doubled between 1968 and 1978, and by 1979 the economy appeared to be headed for another bout with double-digit inflation. Discussion of inflation as a tax and of its impact on real rates of personal income taxation has been retained from previous editions along with a rather detailed discussion of the possibility of indexing the personal income tax as a means of neutralizing the latter effect. In addition, some evidence suggests that the corporate income tax is also very sensitive to inflation. This effect is examined in some detail here along with an expanded discussion of the general effects of inflation on resource allocation.

The expanded discussion of government growth contained in this new edition deals not with continued growth, but rather with curtailment. The late 1960s were characterized by a veritable explosion in public spending. The shifting in American fiscal institutions which accompanied this expansion was discussed in the third edition of this text, and additional material was added to the fourth edition in an attempt to offer some explanatory basis for understanding government growth. The late 1970s, on the other hand, were marked by an apparent dramatic shift of public attitudes in opposition to continued growth in government. The apparently burgeoning "taxpayers' revolt" was manifest in numerous attempts at both state and federal levels to impose consitutional constraints on government size. Material on government growth has been retained and provides a context for the new material dealing with constitutional limits on taxing and spending which has been included in this new edition.

The social security program now ranks second to national defense in terms of total federal government outlays. Long a program of almost unchallenged political popularity, certain aspects of social security began to become topics of controversy and concern during the 1970s. A separate chapter on social security has been a part of this textbook since the third edition. It has been expanded considerably in this fifth edition to deal with these issues, including the future financing problems confronting social security, the effect of the program on capital formation and economic growth, and equity issues arising from the current structure of spouse benefits.

Other changes have been made in this edition. A new chapter has been added dealing with the effects of capital taxation and deficit finance on economic growth. New theoretical work on the effects of certain taxes has been included and, in the public choice unit, a section has been added dealing with agenda control as a means of manipulating voting outcomes. Significant insitutional changes have also been noted, including such things as changes in capital gains taxation and changes in the rate structure of the corporate income tax. The earned income credit introduced a limited version of a negative income tax in 1975 and became a permanent feature of the personal income tax structure in 1978. Federal estate and gift taxes also underwent significant legislative changes in 1976.

We have attempted, in this fifth edition, to eliminate both institutional and analytical material that is not essential. Our objective has been to keep the size of the textbook within manageable limits, suitable to a one-term introductory course in public finance. Even more than in earlier editions, we have shunned the temptations to convert an introductory textbook into a treatise.

We can claim that the original methodology of this textbook retains its advantages—indeed, that its comparative relevance should have increased substantially over its potential competitors. Earlier editions were often criticized for the positivist stance that was assumed, for an unwillingness to adopt explicitly normative judgments about prevailing or proposed fiscal patterns. A text that makes some

attempt to remain value-free surely carries more relevance to the world in which basic values are being transformed. This suggests that *sticking to the positivist methodology* is the best course to follow here, while trying to reexamine the institutions that emerge and the pressures for changes that are present.

A century ago people studied "political economy." Today they study "economics" and "politics." The additional specialization that this change has produced is, in certain respects, advantageous. But when we come to study the public finances of a nation, the change has been retrogressive in effect. For "public finance" as a field of study is, by definition, the study of the political economy. The student of economics can examine the working of a market system within a *specified set of constraints;* the student of politics can examine the organization and the processes through which social decisions are made. But the two must join in studying the effects of political or collective decisions on the economy. The study of public finance, both at its simplest and at its most complex levels, must involve two stages. Some attention must be given to the aims and the objectives that motivate individuals to behave as they do in the political process. In other words, what does "government" try to accomplish, and how efficient are its efforts in attaining its objectives? Second, how do the institutions organized to carry out collective objectives affect the behavior and the conditions of individuals in the private or market economy? These questions have always been important, but they assume added significance in this age of big government.

This book is designed to provide students with an introduction to American fiscal institutions as these exist, and by way of this introduction, to provide them with some elementary steps in any answer to the basic questions just posed. No attempt is made to trace carefully the historical development of these institutions, and exhaustive factual detail is avoided whenever this is possible.

A positive approach is taken in describing and analyzing the fiscal system. *No attempt is made to judge the "goodness" or the "badness"* of the separate aspects of the fiscal system from some presumed criterion of "general interest" or "general welfare." Where possible, the alleged advantages and disadvantages of certain fiscal practices are indicated and arrayed against each other. Traditional "principles" of public finance are discussed, but only along with other principles for fiscal organization based on the acceptance of wholly different objectives.

This introductory textbook does not contain sufficient historical, institutional, or analytical detail to provide the student with the full understanding of the fiscal system that is required for competent evaluation. Such is not its purpose. We hope that the book will serve to introduce students to the wide range of issues that the fiscal system represents, to show them some of the complexities that are necessarily involved, and, most of all, to stimulate them to further study and effort in what must become an increasingly important field of social science, the public finances.

Acknowledgments

We should like to acknowledge the comments made by various users of earlier editions of this text. We have tried to take account of all of these, and, especially, to respond to what seemed to us to be the major reactions.

Anyone who has ever had to prepare a lengthy manuscript knows the value of able secretarial assistance. We have been especially fortunate in this regard and would like to take this opportunity to acknowledge our debt to Gena Mattox at the University of Oklahoma and Betty Tillman Ross at Virginia Polytechnic Institute and State University. Without their hard work, preparation of this fifth edition would not have been possible.

February 1980

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The no-government economy

Democracy's early philosophers suggested that the government is best which governs least, and communism's sacred books promise a withering away of the state. Considered as hypotheses, both norms have been effectively refuted. The position of government, both relatively and absolutely, has continually grown more important in the Western democracies, and the monolithic state of communism has withered little, if at all. "Government" is, therefore, worthy of considerable attention, no matter what our purpose. The old adage about the certainty of "death and taxes" is surely relevant and true.

Political theorists have long adopted the device of explaining the origin of government by assuming conjecturally that it does not exist. This has proved to be a useful expository device, and it will provide a helpful starting point. Despite the fact that this book is to be devoted, almost exclusively, to the government, or the public economy, we shall find it useful to begin by discussing the hypothetical situation or model in which such an economy is absent.

THE ORDERLY ANARCHY

It requires considerable abstraction even to think of a situation in which there is no government at all. One description of such a social order, and probably a highly realistic one, would be summarized by the word "chaos." This will not suit our purposes here, however, and we are interested in the model for its expository usefulness, not for its descriptive accuracy. In order that we may derive the logical origins of the public or collective economy, we need to assume the existence of an orderly and ideally working anarchy. Let us heroically assume that all individuals are ethically reasonable, and that they each respect the equal freedoms of their fellowmen. Assume also that there exists a well-defined structure of property rights. How would the economy of such a society work? You will note that this is similar to the model of government that is implicitly assumed to be in existence when elementary economics is presented to the college sophomore. This chapter may be taken as a very elementary review of the principles of economic organization.

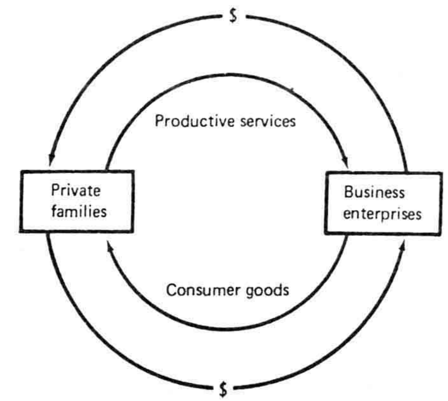
THE ECONOMIC ORGANIZATION

Individuals in such a hypothetical society would find it advantageous to conduct their economic affairs through markets, and such institutions would emerge to facilitate the many exchanges that persons might want to make, one with another. Resources, human and nonhuman, would become specialized to particular employments, and business enterprises, business firms, would arise to organize production aimed at meeting consumer needs. This simple and familiar model of the no-government economy is shown in the "wheel of income" diagram, Figure 1-1.

The economic units are of two kinds: individuals or families on the one hand, and business units, or firms, on the other. Trade takes place among these units in two broadly defined markets. These are the markets for consumer or final goods and services and the market for productive services. The bottom half of Figure 1–1 indicates the consumer goods market; the top half shows the productive services market. In the consumer goods market, private individuals or families receive consumer goods and services from business firms. In the other market, the suppliers and demanders are reversed. Private people supply productive services (labor, land, capital) to firms. In a broad sense, therefore, looking at the whole wheel, private people "trade" productive services for final products. Firms buy productive services and transform them into final products.

Direct barter would be grossly inefficient, however, and some particular commodity would be agreed upon as an appropriate mone-

FIGURE 1-1
The wheel of income



tary commodity. Once selected, this "money" commodity would be used in the direct discharge of all obligations. The "money" would allow the structure of interlocking markets to be completed. Individuals would sell productive services to business firms for money, and, in turn, they would take this money and purchase from business firms final goods and services. The circular flow would be closed, and the economic activity of the community would be a continuous process.

Business firms exist with a view toward making profits. For this reason the firms will be guided in their decisions concerning the organization of production by the desires of consumers. The tastes and wants of individuals as consumers are the basic determinants of what the economy shall produce and how its resources shall be allocated among the many possible employments. The operation of the economy in this way is said to follow the principle of *consumer sovereignty*.

PRINCIPLE OF CONSUMER SOVEREIGNTY

As are all such principles, that of consumer sovereignty is an oversimplification in application to the way in which the no-government economy would really operate. Any complete description would require a careful enumeration of several qualifying factors, such as inconstancy in consumer wants, persuasion by business firms, and the existence of uncertainty. This sort of discussion is not, however, needed at this point. The principle is useful as a starting point of discussion because it does provide an indication of the fundamental organizing influence in the no-government economy. Despite imperfections, the resources of the economy would, by and large, be directed toward the production of goods and services which individuals, expressing their desires as consumers, indicate a willingness and an ability to purchase.

The consumers' ability to purchase goods and services, and in this way their ability to direct the organization of economic production, is limited by the number of monetary units which they can command. And this, their "income," is in turn determined by their ability to sell their productive services to firms or to other individuals. Individuals who are unable to earn income in the marketplace for productive services, and who have no accumulated wealth, cannot influence the organization of production at all. The economy organized purely on the basis of consumer sovereignty has, for these reasons, been called the "one dollar-one vote" system in contrast to the system of political democracy which presumably makes decisions at least ideally, on the basis of "one man-one vote." The pure market economy, which is a shorthand name for an economy organized solely on the basis of consumer sovereignty, does not, therefore, respond to other than the pecuniary needs of individuals. This economy does not necessarily utilize its resources where they are most "needed" on some undefined nonmarket criterion of "need."

THE VOLUNTARY ECONOMY

What can be said in favor of and against an economy organized in this way? In the first place, individuals are free within the limits of their economic power. No individual coerces any other individual; a market transaction represents a wholly voluntary exchange from which both parties expect to receive benefits. The market economy is an organized method of securing voluntary cooperation among individuals. It is essentially a system of spontaneous order which arises out of individual participation of numerous buyers and sellers. Resources are allocated to the many possible employments and apportioned within the separate individual employments; goods and services are produced and distributed without a direct central plan ever having been discussed, approved, formulated, or even contemplated. The first main advantage of this sort of economy is, therefore, that it is "free" or "voluntary." Individuals need not conform; each person may "do his own thing" in a market economy. There is no prohibition against "opting out" if the one who does so is prepared to accept the consequences.

The second main advantage is that the market economy incorporates a high degree of "efficiency." This means quite simply that the individually inspired motivations of consumers, workers, property owners, and business enterprises combine to secure an overall economic organization which is not grossly extravagant in its usage of scarce resources available for disposition. Decisions are decentralized private decisions, and therefore, mistakes are individualized private mistakes.

SOCIAL JUSTICE, MONOPOLY, INSTABILITY, GROWTH, AND THE QUALITY OF LIFE

What are the disadvantages of this pure market organization, even in this hypothetically reasonable world? First of all, individuals would surely differ in their capacities to earn income and hence to share in the social product of the economy. Capacities to earn income depend on the initial distribution of property rights and on the distribution of skills. There is no assurance that the working of the market process could offset or correct for these initial differences in capacities sufficiently to generate a regime meeting standards for "social justice." Ethical norms may conflict sharply with observed economic results, and many persons may be unwilling to accept these results. We shall not try to define "social justice," but Chapter 8 will be devoted to an examination of some of the problems that arise in distributional policy, an area that now commands widespread attention among economists. Here we need only note that if the market economy does not distribute its product in such a manner as to be acceptable to a majority of individuals, some attempts will be made to implement changes. Such attempts imply political action. But a word of caution even at this early stage. Acceptability to academic intellectuals is not equivalent to acceptability to a dominant political coalition in a democracy.

A second major difficulty with the pure market economy arises when it is acknowledged that individuals and groups may prevent the orderly functioning of the economic process by securing excessive power over particular submarkets. Monopoly power may emerge in the no-government economy, and insofar as this is the case, the operation of the principle of consumer sovereignty is distorted. Monopoly presents the consumer with false alternatives from which to choose, and it may prevent the entry of prospective suppliers into various occupational and productive categories. Market values may come to reflect artificial values, not based on resource costs, as these are derived from consumer choices. Overall efficiency in the economy is reduced.

A third major problem with this highly simplified no-government economy is introduced when we recognize that the tastes of individuals are highly changeable and that this shifting of tastes applies to the monetary commodity as well as to everything else. A sudden shift in favor of holding larger amounts of money inactive will reduce the total money demand for goods and services. This reduction in aggregate demand may cause prices to fall, but prices are likely to be relatively rigid. If this is the case, unemployment may arise and remain for more or less prolonged periods of time. Or, conversely, a sudden shift toward holding smaller amounts of money inactive may set off inflation in the level of prices. Attempts to stabilize the level of aggregate monetary demand become a function of government.

Tied to both of the above problems is a further problem, that of generating long-term economic growth. Insofar as monopoly prevents full efficiency in resource use, and insofar as fluctuations in demand generate unemployment and inflation, the growth potential of the economy may not be realized, suggesting an appropriate area of governmental action.

Finally, and almost by definition, the no-government economy may not be successful in resolving problems raised by complex economic interdependencies. When the economic behavior of a person affects the utility or costs of many other persons, marketlike exchanges may not arise spontaneously. This is the domain of "public" or "collective" goods and services, and under sufficiently broad and inclusive definitions we can categorize all "market failures" in these terms, including those mentioned above. Modern concern about the "quality of life," and specifically about the effects of individual and business behavior on the physical environment may be discussed in these terms, along with the more familiar public goods issues. Chapter 4 will treat this set of problems in some detail.

A BASIS FOR FURTHER DISCUSSION

The hypothetical and unrealistic model of the no-government economy was introduced in this initial chapter only to provide a basis for subsequent discussion. A rudimentary understanding of the way that the market economy functions is essential for an understanding of the effects generated by the introduction of a public or governmental sector. This does not imply that, necessarily and always, governmental economic activity constitutes an "interference" with the working of the actual market or private economy. Government activity can make the market work better or worse, or it may be neutral in its impact. And, of course, the results here depend strictly on the criteria for "better" and "worse" that are selected.

2

The all-government economy

In the previous chapter we made the heroic assumption that government did not exist in order to discuss a pure market economy and to show how an economic origin of government can be traced to difficulties in this economy. In this chapter we shall go to the other extreme of the private-public spectrum. We shall assume that *all* economic activity is governmental. This assumption may seem even more heroic than its opposite, but it will be helpful in providing the framework for an analysis of the mixed economy that exists.

THE COLLECTIVITY OF CHOICE

The distinguishing feature of governmental or public organization that we want to emphasize here is the collectivity of choice. In a market economy, individuals (families) make *private* decisions; the individual alone chooses to buy potatoes rather than turnips and also chooses how many pounds of potatoes to buy. Such market decisions may affect the choice alternatives that other buyers and sellers confront, but this is done indirectly. By sharp contrast, in a governmental or collective economic setting, it becomes impossible for the individual (the family) to choose *privately*. The choice must be collective, in that the same result may be applicable to all participants, and this result must be directly selected. If garbage collection

is governmentally organized, the individual family cannot decide independently or privately that its own refuse shall be collected twice weekly without regard to the rate of collection to be provided other families in the community. When choosing among differing rates of collection, the individual or family is choosing a result that will, once chosen, be made applicable to *all* other individuals or families in the community. Under certain conditions, publicly provided goods and services may be made differentially available to different groups in the community; some "privileged" families may have twice-weekly garbage pickups while others have fortnightly service. These conditions would, however, be exceptional. As a general principal, the "one man-one vote" basis of the democratic decision process along with generally accepted respect for standards of equality ensures that publicly provided services shall be made *equally available* to all members of the community.

As the discussion in Chapter 4 will emphasize, the technological characteristics of certain goods and services make them amenable to collectivization. With such goods and services, the most efficient means of provision may require that all members of the group be allowed equal access. The modern theory of public goods represents an extension of the orthodox efficiency norms to such goods and services, often called collective consumption or public goods. We shall defer specific discussion of such goods and services until Chapter 4. In this chapter, by contrast, discussion is concentrated on the central features that emerge from governmental or collective provision, or supply of goods and services, regardless of the technological characteristics. Let us assume, for this chapter's discussion, that some goods and services provided collectively are divisible among persons in final consumption, while some are indivisible in a technological sense.

We propose to examine in somewhat further detail the economy in which all goods and services are provided collectively, through some political decision process in contrast with a market process. Further, let us assume that the political decision structure is effectively democratic. (The precise implications of this assumption will be discussed in some detail in Part III.) As we have noted above, the primary difference between the result emerging in this all-government economy and that which emerges in the no-government market economy will be that, in the latter, individuals can adjust *privately* with each person making his or her own consumption decisions whereas, in the former, individuals must adjust to commonly available, and collectively determined, rates of consumption for all goods and services. Private expressions of preference exhibited through differential purchase patterns could not be observed. The all-government economy would, therefore, be described by a uniformity of consumption patterns among all members of the political community.

THE POTENTIAL FOR TRADE IN PRESENCE OF A NUMERAIRE

If individuals' preferences for final goods and services differ, one from the other, and if all individuals are provided with uniform quantities for consumption, uniform quantities for all goods, some of which are technologically divisible, gains from trade must exist. Those persons who like oranges more than apples can secure mutual advantages in trades with those who have the opposing preferences. This suggests that the all-government economy, the all-collectivized world, will tend to depart from its pattern of conformity in consumption *if trade can take place.* The necessary condition for trade to take place is the existence of some one commodity that can be utilized as a numeraire or money unit. So long as one such commodity exists, the emergent trading process will tend to reproduce the results of the market economy, regardless of the initial collectivization of supply. This allows us to state an important principle. So long as the goods involved are technologically such that divisibility in consumption among separate persons is efficient, attempts to enforce conformity in consumption of such goods through collective provision must fail provided only that a single divisible or numeraire commodity exists. Socialist governments have learned this principle by experience. Attempts to provide all families with "free" milk, "free" housing, "free" bread result in retrading of allotted quantities of these goods for other goods and services that are, to some persons, privately, more desirable.

The pressures toward the elimination of the gains from trade involved in uniform or in arbitrarily selected consumption patterns, and the emergence of trade unless prohibited, suggest the major difficulty that would emerge in an all-government economy. Such an organization of the economic structure fails to accommodate the differential preferences of individuals. As suggested in Chapter 1, the major advantage of a market economy is that individuals are free to express their own preferences; the converse of this is the major disadvantage of the government or controlled economy; individual preferences cannot readily be satisfied, regardless of the way in which collective decisions are made. This conclusion remains valid in a pure democracy as well as in other political structures.

COLLECTIVE ORGANIZATION AND ECONOMIC EFFICIENCY

A second advantage that has been claimed for the market organization of economic activity is its efficiency in the utilization of resources. Despite many imperfections, a market economy tends to channel resources into those uses that are most valued in pecuniary terms, as indicated by the "votes" of consumers. An overall directing influence comparable to "consumers' sovereignty" does not exist in collective organization. Even in the ideal or "pure" democracy, where all individuals have equal political power vested in their vote, varying intensities of preference cannot be normally expressed. The failure of collective organization to allow for adequate expressions of individual preferences, therefore, produces the corollary failure of such an organization to meet standard efficiency norms. If we define economic efficiency in terms of the degree to which individual preferences are satisfied, that is, if values relevant to the measurement of efficiency are derived from individuals' utility functions, collective organization and/or control of an economy must be given low marks on this count. If, of course, we choose to define efficiency on the basis of some other set of values which is not based on individuals' utilities as expressed in their behavior we can get almost any result we seek.

COLLECTIVE ORGANIZATION AND DISTRIBUTION

The all-government economy ranks poorly in terms of individual freedom and economic efficiency. It ranks highly in terms of equality in distribution of goods and services, at least insofar as the political reality matches the ideal model of equal power democracy. As we noted in Chapter 1, one of the difficulties in the pure market economy is its tendency to satisfy pecuniary demands, demands that are related strictly to the dollar votes of individuals. Insofar as different individuals enter the market with widely different monetary endowments, the results must embody widely different levels of consumption. Inequality in consumption, not only of particular goods and services, but of all goods and services, tends to be characteristic of the pure market economy. The central socialist critique of the market economy is based on a recognition of this characteristic feature. The more extreme advocates of extensive socialist or collectivist organization of the economy are willing to sacrifice the advantages of individual freedom and economic efficiency in order to secure what they consider a more important objective, equality among persons in consumption standards.

The inequality in distribution produced in the pure market economy, along with the suppression of individual expressions of preference and the inefficiency of resource use in the pure collectivist economy, has led many economists and social philosophers to support a "compromise" attempt to secure the best of both worlds. Market economists, who are at the same time egalitarians, and socialist economists, who at the same time value individual freedom and economic efficiency (and there is little fundamental difference between these two groups despite differing labels) have often proposed that, as regards the divisible goods sector of an economy, collective action be limited to the redistribution of income and wealth among persons and that, once the desired redistribution of income and wealth takes place, individuals be allowed to express their preferences through the workings of a market economic order. In one sense, the mixed economy of the United States finds its intellectual origins in this combination.

The implied isolation or separation of the distributional function of government from the actual provision of goods and services has, however, rarely been observed in political reality. Governments provide goods and services; insofar as they do so, equality tends to characterize the distributional pattern among persons, not equality in overall incomes or purchasing power but equality in the particular consumption availability of the specific goods and services that are collectively supplied. It is perhaps misleading to discuss income-wealth redistribution as an independent and separate function of government. Income-wealth redistribution is accomplished through governmental political action, but, as a general rule, the redistribution per se is not the primary objective. Instead, the objective is the provision of specific goods and services to all qualified recipients on a nondiscriminatory basis. And this is the characteristic feature of collectivist organization that is emphasized in this chapter.

THE WORLD OF EQUALS

It is a useful exercise to construct a model in which the no-government economy (in which economic resources are allocated by a perfectly functioning market) and the all-government economy (in which economic resources are allocated exclusively by the political decision structure, assumed here to be democratically organized), generate roughly equivalent results. This would be the case if all persons should be identical, both with respect to initial endowments or capacities (human and nonhuman) and to preferences or utility functions. Since their initial endowments are identical, final consumption patterns could not diverge due to income-wealth differentials. There should arise little or no objection to market allocation of resources on the grounds of distributional results. On the other hand, because preferences are identical, there would be little or no objection if the whole economy were to be collectively organized either. Since all preferences are the same by definition, almost any political decision rule would produce results that would satisfy all preferences. In such an extreme model, there would be little or no difference in the workings of an economy organized on purely market lines and one organized on purely collectivist lines.

EQUAL ENDOWMENTS AND DIFFERENTIAL PREFERENCES

Individuals are not, of course, identical, one with another, either in initial endowments or capacities or in their preferences. It will be useful, however, to relax these two assumptions separately. In so doing, the implied assumptions about human nature in both capitalist and in socialist organization are revealed. For now, let us assume only that individuals differ in their preferences; that utility functions differ, while they remain identical in their initial resource endowments (human and nonhuman). In this case, the relative advantages of market over collectivist economic organization become apparent. Since, by definition, individuals do not differ in their basic or inherent capacities, there can be little or no legitimate objection to the market-determined allocation of resources on distributional grounds. By contrast, because they do differ in preference patterns, the collectivist organization of the economy would generate strong objections. Conformity would be introduced, along with the corollary inefficiency, without compensating distributional advantages.

DIFFERENTIAL ENDOWMENTS AND EQUAL PREFERENCES

Let us now reverse the model and assume that all persons possess identical utility functions but that they differ in basic or inherent resource endowments or capacities (both human and nonhuman). This model provides the strongest support for the collectivist organization of the economy. Because individuals are, by assumption, equal in preferences, any differentials in consumption patterns that result from the market allocation of resources can be traced directly to initial differences in endowments or capacities. All inequality in the final consumption of goods and services is due to distributional differences among persons. The imposition of uniform consumption patterns under collectivist organization of the economy in this model only seems to thwart the expression of individual preferences. The latter differ one from another only because of initial inequalities in endowments or capacities. Market allocation, by contrast, would, in this model, allow for the satisfaction of the apparent but not real differentials in preferences while doing nothing toward achieving distributional objectives.

DIFFERENTIAL ENDOWMENTS AND DIFFERENTIAL PREFERENCES

We know, of course, that individuals differ in both their basic endowments and their preferences. Essentially, the long and continuing debate between the advocate of the market economy and the collectivist reduces to their contrasting assumptions about human nature. Advocates of the market order assume with Adam Smith, that the differences between the philosopher and the street porter are not large, that observed inequalities in consumption patterns largely reflect differences in taste. At the least, they assume that, with appropriate arrangements collectively made to ensure that each person has an opportunity to utilize his or her inherent capacities to the fullest extent desired, distributional results will not be wholly objectionable. Advocates of collectivist order assume, with Plato, that there are fundamental and basic differences in the capacities of human beings to produce economic values. Even with the widest practicable opening of the opportunities for individuals to utilize these capacities to the fullest, the collectivist predicts that distributional inequalities will persist and on such a scale as to be unacceptable. Such differences in preferences as are acknowledged to exist are assumed to be less relevant for social policy than the differences in capacities that generate the distributional inequalities.

THE UNITED STATES IN 1980

The mixed market-collectivized economies of the United States and other Western countries reflect a continuing and shifting compromise between these two essentially opposing views of human nature and their divergent implications for socioeconomic and political arrangements. Especially in the United States in the late 1970s, this compromise seemed to be becoming an increasingly uneasy one. There was, on the one hand, evidence of rather widespread dissatisfaction with the performance of the public sector reflecting, perhaps, not so much a shift in fundamental assumptions about human nature as a changed perception of the ability of government to accomplish avowed objectives. This increasingly negative view of the performance of collective institutions was reflected most vividly in widespread interest in attempts to impose constitutional limits on public taxing and spending.

It was unclear whether this loss of faith in government institutions was being translated into renewed faith in the ability of markets to organize the economy effectively. There was some evidence that this was happening as, for example, in the political support for deregulation of industries such as transportation. At the same time, however, there appeared to be considerable reluctance to lessen government intervention in other industries, most notably energy and health services.

3

Government as an economic unit

The mixed economy that we observe includes both market and collective provisions of goods and services, both a private and a public sector. Having introduced the model of the hypothetical market economy in Chapter 1, we shall now discard this for other than reference purposes. This textbook is concerned with the *economics of the public sector,* with *the public economy,* with respect both to the principles of its operation and to the institutional realities that we confront.

THE SUBJECT OF PUBLIC FINANCE

The government, considered as a unit, may be defined as the subject of the study of public finance. More specifically, public finance studies the economic activity of government as a unit. In this respect, as well as in many others, we consider "government" to be an independent entity, a unit, analogous to a person.

In order to illustrate this analogy, let us look at the economic activity of an individual that we might choose to study. There are several stages in our inquiry. First of all, we should want to find out how our person, say, E. J. Jones, earns an income and how much it is. For example, Jones may be paid by the hour, or on salary, or may not work at all but instead, receive an income by clipping coupons for bond interest or by qualifying for some governmental welfare pro-

gram. Second, how is the income spent? Jones may be a gourmet and delight in fancy foods, or a gold enthusiast, or a connoisseur of pop art, or maybe a genuine miser who spends almost nothing and saves most of these earnings. All of such information might be gathered in the first stage of inquiry into Jones' economic activity.

But we should want to know more than this. We should try to learn something about how Jones makes *decisions* or *choices* among the possible alternatives. Why work at one job instead of another? What criteria determine purchases? These and many more questions arise at a second stage of the investigation. Because we can never expect to read Jones' mind accurately, the answers to some of these questions may never be revealed, but we should try, by studying our subject's behavior as well as by asking direct questions to learn as much as we can. Beyond this we should try to construct models of behavior that will yield certain predictions which might be tested against our observations.

This analogy with the study of Jones' economic activity can be both helpful and misleading when we come to consider the activity of the government. The first stage is very similar. We need to gather the "facts" about the public finances, about the public economy. We shall need to know just how the government secures its revenues (its income) and how these revenues are spent. This involves us with both sides of the government's budget account.

When we come to the second stage, however, some important differences appear. Just as with Jones, we want to know something about the way that the relevant decisions or choice are made. We want to know why the government chooses to collect the major share of its revenues through the personal income tax rather than through, say, a turnover tax. And we want to know why the government spends $80 billion on defense rather than on rebuilding the cities. And why is the total level of spending what it is? To get the answers, or even approximate ones, to such questions as these, we need to examine the way in which governmental decisions are made. But here our analogy with the study of E. J. Jones breaks down. With Jones, we try to understand, as best we can, how a single mind can reach decisions. But we know that governmental decisions are finally reached as a result of the interaction of many individuals participating in some sort of political process. Therefore, any approach to answering the questions here must involve some consideration of the political or collective choice process.