

PUBLIC FINANCE

GOVERNMENT REVENUES
AND
EXPENDITURES
IN THE
UNITED STATES
ECONOMY



RANDALL G. HOLCOMBE

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PREFACE

The subject matter of public finance has evolved a great deal in the last half of the twentieth century. Earlier in the century, when government activity fell within limited and well-defined boundaries, public finance was primarily the study of taxation. As government has grown, public finance economists have become increasingly interested in public expenditures, both from the standpoint of analyzing the actual expenditures of governments and from the standpoint of developing a theory of public expenditures. Public expenditure theory provides a rationale for government activity and can help guide policymakers toward the design of more effective public programs. In the decades since World War II, the study of public finance has been extended to examine the public sector decision-making process to understand how resources are allocated within political institutions. Public policy, after all, is not the product of policy experts but rather is the result of democratic decision making. A complete understanding of the public sector must incorporate an understanding of those political institutions that actually produce public policy.

This book attempts to integrate the study of the various aspects of public finance by viewing all the government's activities as a result of the democratic decision-making process. This theme manifests itself throughout the book. For example, the tax system is examined not only in terms of traditional equity and efficiency criteria but also as a product of a democratic decision-making process. The analysis of public expenditures is also developed within the context of the public sector decision-making process that produces expenditure programs. Likewise, government regulations and intergovernmental relations are viewed as products of collective decision making and are analyzed the same way. To provide a foundation for this approach, the book contains three chapters devoted specifically to an economic analysis of political institutions. Thorough coverage of these chapters is not necessary to understand the rest of the book, but, for those who are interested in studying the allocation of resources through political markets in the public sector in the same way that economics analyzes the private sector, these chapters should prove helpful. A distinguishing feature of this book is that it analyzes political institutions in much more detail than do most public finance books and therefore creates a closer tie between economic analysis and public policy.

The unifying theme of this text—that government activity is the result of a democratic decision-making process—is significant for two reasons. First, one's understanding of public finance will be incomplete unless one understands the process by which democratic decision making has created the existing public sector institutions. Second, unlike the invisible hand of the market that is the result of human action but not of human design, the public sector of the economy is the result of conscious human design, so that every voter plays a part in the process. The better the process is understood, the more likely we are to design public sector institutions that behave as we intended. By analyzing public revenues and expenditures in the United States economy

as a product of the democratic decision-making process, the many aspects of public finance can be presented as a unified body of knowledge rather than as a collection of different models of the public sector.

TEACHING FROM THIS BOOK

There is more material in this book than many public finance courses would cover in one term. Although I would not want to discourage anyone from moving at a quick pace to cover the entire book, in my own courses I typically cover certain areas more intensively at the expense of skimming over (or leaving out) some chapters. The chapters follow in a logical order, but, at the same time, there is no reason why they could not be taught in a different order, and there is no reason not to skip some chapters to emphasize others.

An instructor's manual is available for this book that provides a number of possible course outlines that use only a subset of the chapters, and that emphasize different topics. One could emphasize taxation, or public expenditures, or the public sector decision-making process, for example, by selectively using the material in the book. I encourage teachers to look at the instructor's manual if they want more of my ideas on how the book can be used. My suggestions are just that—suggestions.

Some people like to teach a course by closely following the outline of a textbook, while others like to rearrange material to suit their course needs better. I have tried to write the book to facilitate changing the order of the chapters, and to facilitate omitting chapters that are of less interest to some users, as much as is feasible. I view a textbook as raw material to use as an input into designing a course and invite those who use the book to rearrange the material to best suit their desires.

STUDYING FROM THIS BOOK

My overriding goal in writing for students of public finance has been to unify the material into a single body of knowledge rather than present it as a collection of theories. I have tried to do this in several ways. First, I do not overwhelm the reader with complicated technical explanation of concepts when simple explanations can convey a principle just as well. Second, I explicitly note related concepts at the time that a concept is presented, which means sometimes referring ahead to material not yet covered and at other times referring back to material previously covered. Third, the unifying principle of the public sector as a product of a democratic decision-making process underlies all the material.

As an aid to comprehension, all the figures in the book are accompanied by brief explanations. Although the figures are explained fully in the text, the brief explanations serve both to help focus on the key idea and to facilitate review. The conclusions to each chapter provide summaries of important points in the chapter. These conclusions not only review the key material in the chapter but also help reinforce how that material is related to material in other chapters. The questions at the ends of the chapters are also intended to aid in review. Sometimes the questions ask the reader to restate an argument made in the chapter, and other times they ask the reader's opinion on a subject for which there are arguments on both sides. Sometimes a question is used to

try to draw together ideas that at first may not appear to be related. As such, some questions have specific “correct” answers, while others are meant to stimulate thought rather than suggest one answer.

To help identify key ideas, marginal notes have been included beside the text. These notes summarize the main points in the text and point out important ideas. The marginal notes might help on first reading the chapters to identify important points, and also should be helpful for later study. The marginal notes can help students find ideas they remember in the text, and also serve as a list of important points for review. Of necessity, the marginal notes are short and may be hard to understand by themselves, but the ideas they refer to are explained fully in the text. By listing important ideas in the margin rather than at the end of the chapter, students can more easily find the supporting material when they study.

The appendix to chapter 1 reviews indifference curve analysis, which traditionally is taught as a part of microeconomic theory. The appendix provides enough information to get a student started, but someone wanting a more thorough understanding should consult a microeconomic theory textbook. This analysis is used heavily in chapter 2 and is also used in parts 4 and 5. When it is practical to do so, points that are made using indifference curve analysis are also made using other tools of analysis, such as supply and demand curves, both to facilitate understanding and to help out students who may not be familiar with these tools of microeconomics.

ACKNOWLEDGMENTS

I have taught public finance for more than two decades and have learned a great deal from colleagues and from students over the years. I am grateful to all of them and am afraid that any attempt to list them at this point would inevitably leave out more people deserving of my thanks than it would include, so with some misgivings I will forgo trying. I do want to acknowledge those who have given me specific advice on this project, starting with executive editor Rick Leyh and developmental editor Alex von Rosenberg, who both have been very helpful in guiding this book toward completion.

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My largest debt is to my family, who were very supportive during the writing of this book. My children had to make occasional sacrifices when my working into the evenings or on weekends kept me from spending time with them. My wife, Lora, also an economist, has been very helpful throughout this project. I could not have written the book without her support, and I dedicate the book to her in recognition of her contributions as a colleague and as a family member.

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