

PUBLIC FINANCE

FOURTH EDITION

A Contemporary Application of Theory to Policy



David N. Hyman

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David N. Hyman
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Preface

The fourth edition of *Public Finance: A Contemporary Application of Theory to Policy* is a major revision designed to update the text and focus on emerging fiscal issues of the next century. The textbook continues its comprehensive treatment of economic theory and applications in the field of public finance. Institutional material is integrated with the theory and applied to current issues, emphasizing microeconomic analysis of government functions, expenditures, and finance.

International issues are achieving greater significance in public finance. It is desirable for undergraduates in the 1990s to have a global comparative perspective on domestic economic issues. To provide resources on global issues, each chapter of this textbook now has a separate *International View* section that provides students with information or analysis on fiscal issues in other nations, or explains how increased integration of the U.S. economy into a vast global economy affects economic policy. Each chapter also contains a *Public Policy Perspective* that applies the text analysis to a current issue and provides facts on the U.S. public sector. I have added one completely new chapter to this edition on *Government and Health Care*, to focus on an issue of growing importance to the U.S. economy as more and more of our resources are absorbed in the provision of medical services.

This text is easily adapted to a variety of approaches to teaching public finance and incorporates detailed analyses of both expenditure and revenue aspects of public finance. I also provide an abundance of real-world examples and data to provoke students' interest, presenting an unbiased exposition of the field of public finance by discussing opposing views of important issues.

CHANGES IN THIS EDITION

In addition to the new *International View* and *Public Policy Perspective* features in each chapter, there are many other changes in this new edition. To improve the pedagogy of the text, each chapter now begins with a statement of learning objectives. Periodic *Checkpoints* in each chapter provide short questions to help students gauge their understanding of the material. To

better motivate students, the introductions for all chapters have been rewritten and now include more examples. The new introductions in each chapter provide a better setting for the analyses to follow.

I have also reorganized the text and compressed some of the analyses to make room for new material. The first part of the text maintains its focus on developing and using the efficiency criterion to understand the role of government in the economy. However, in this edition I have integrated more examples with theory, including an earlier analysis of the effects of taxes and subsidies on resource use. Chapters 5 and 6 of the third edition have been combined into a single new Chapter 5 that integrates the theory of public choice with an analysis of the political process.

In Part Two, I have moved the chapter on cost-benefit analysis forward to form Chapter 6 where I have placed added emphasis on the analysis of government investment. The analyses of government subsidies, income support programs, and Social Security pensions have been updated. A new Chapter 9 discusses economic issues relating to health care, health insurance, and the role of government in financing and providing medical services. This new chapter synthesizes a set of related issues to help students understand both the causes of soaring health care costs in the United States and mechanisms to control the growth of health care expenditures, including government participation in the market for health care services. The chapter also discusses national health insurance as it is used in Canada and Great Britain.

In Part Three, I have added more examples to the introductory analysis of government finance and more discussion, at a level which the average undergraduate can understand, of such issues as optimal taxation. Chapter 12, *Budget Deficits and the Government Debt*, has been reorganized to better focus on the issue of national saving and the long-run impact of the federal deficit on economic growth and future living standards.

Part Four, which discusses the theory and structure of taxation, begins with a separate chapter on the theory of income taxation and has been updated to include the results of recent empirical research. The analysis of payroll taxes, which appeared together with the analysis of the corporation income tax in the third edition, is now integrated with the analysis of personal income tax. Naturally, the chapter concerning taxation of personal income in the United States has been revised to include recent changes in the tax law effective in 1991 and includes a discussion of recent research on the economic effects of the Tax Reform Act of 1986. The analysis of the corporate income tax in Chapter 15 has been revised to place greater emphasis on general issues regarding the taxation of business organizations; international issues in corporate income taxation; and proposals for the reform of the corporate income tax, including the corporate cash-flow tax. The discussion of consumption and wealth taxation in Chapters 16 and 17 has been updated and includes many new relevant examples.

In Part Five, Chapters 19 and 20 of the third edition have been combined into a single chapter to provide a concise discussion of fiscal federalism, decentralized government, and state and local fiscal issues for the 1990s.

SPECIAL FEATURES OF THIS BOOK

In addition to the boxed-off features that provide discussion of international issues and public policy, each chapter also has new pedagogical features, including learning objectives and concept checks.

To facilitate learning, basic concepts are set in bold type when first introduced, and every chapter concludes with a summary, a list of important concepts, and a short “forward look” that explains the relationship between that chapter and those to follow. Also, each chapter contains ten questions for review. These questions are not problem sets; rather, they are designed to assist students in reviewing the material covered in the chapter by posing questions related to the major points or ideas developed in the text. Four problems are also included after the review questions. Each chapter has an annotated bibliography that offers suggestions for further reading and in-depth study. The bibliography should prove particularly useful in courses where term papers are assigned. Liberal use is made of footnotes throughout the book to provide additional source material and to explain and document material. A glossary at the end of the book lists all important concepts in alphabetical order for easy reference.

I have attempted to make this book as self-contained as possible. The book can be used by students who have only minimal backgrounds in economics. Appendices to several chapters facilitate this process. For those weak in basic microeconomic theory, Chapter 1 includes an appendix that provides students with a handy source of reference for basic microeconomic tools. It is comprised of concise and simple explanations of such concepts as indifference curves, income and substitution effects, consumer surplus, producer surplus, cost, and production theory. This appendix is not designed to provide class material, but it will aid students in understanding the analysis used throughout the book. In classroom testing of this textbook, my own students found the appendix to Chapter 1 a welcome addition to an intermediate-level economics course text.

More in-depth analysis of efficiency is provided in an appendix to Chapter 2, which uses Edgeworth-Bowley box diagrams to derive efficiency loci.

The appendix to Chapter 11 derives formulas for the excess burden of taxation and discusses the relevance of compensated demand and supply curves to tax analysis. The appendices to Chapters 2 and 11 are designed to cover more technical material and may easily be skipped without loss of continuity.

POSSIBLE COURSE OUTLINES

This text contains more material than could possibly be covered in a one-semester (or one-quarter) course in public finance. Individual instructors who teach one-semester courses will find enough material in this book to tailor such courses to their own particular needs and interests. Those who teach

a two-semester sequence in the microeconomic aspects of public finance could cover Parts One and Two, the expenditure aspects of public finance, in the first semester and Parts Three, Four, and Five, government finance and fiscal federalism, in the second semester. Instructors who wish to teach the macroeconomic aspects of public finance could easily supplement the material in the text with excerpts from one of the many good macroeconomic texts on the market.

I suggest four possible course outlines for a one-semester course, each outline having a particular emphasis. Instructors may adjust these outlines in accordance with their own preferences.

OUTLINE 1: BASIC PRINCIPLES OF PUBLIC FINANCE

For intermediate economics courses, with students who have had at least one course in basic microeconomic theory.

1. Chapters 1–5: The economic basis for government activity. Efficiency, market failure, externalities, public goods, public choice, and political equilibrium.
2. Chapters 10–12: Principles of government finance.
3. Chapters 14–17: Application of tax theory to tax policy.
4. Selections chosen from Chapters 6, 7, 8, 9, and 18: Topics in public policy or state and local finance, chosen as time permits and in accordance with the interests of the instructor.

OUTLINE 2: THE FUNCTIONS OF GOVERNMENT AND GOVERNMENT EXPENDITURE

For courses that specialize in public policy and government expenditure, with students who have had at least one course in economics.

1. Parts One and Two: The economic basis of government activity and application of that theory to selected policy issues.
2. Part Five: State and local government finance.

OUTLINE 3: TAX THEORY AND POLICY

For courses that emphasize taxation, with students who have had at least one course in economics.

1. Chapters 1–2: The functions of government and the concept of efficiency.
2. Chapters 10–17: Government finance, tax theory, and tax policy.

OUTLINE 4: PUBLIC POLICY

For courses in public affairs or public policy, with students who have had little or no background in economics.

1. Chapters 1–2: Efficiency, markets, and the economic basis for government activity.

2. Selections from Chapters 3–5: Chosen as appropriate to subject emphasis and backgrounds of students. The topics could include externalities, public goods, and political equilibrium.
3. Selections from Chapters 6–9: Issues in public policy. The instructor may wish to omit some of the more difficult sections in these chapters.
4. Chapter 10: Introduction to government finance.
5. Selections from Chapters 11–17: Topics in tax policy, chosen according to the extent to which the instructor wishes to cover the subject.
6. Selections from Chapter 18: Topics in fiscal federalism, chosen according to the objectives of the course. More difficult sections could be omitted.

ANCILLARY MATERIALS

INSTRUCTOR'S MANUAL/TEST BANK

I have prepared a concise *Instructor's Manual/Test Bank* to accompany this text. The manual has been completely revised for the fourth edition. It should be useful to instructors who wish to arrange their lecture notes so that they correspond to this text. The instructor's manual section summarizes the instructional objectives of each chapter and offers suggestions for supplementing text materials and developing lectures. The test bank section includes true/false, multiple choice, and essay questions for each chapter. Answers to end-of-chapter problems appear in the Instructor's Manual.

STUDY GUIDE

A *Study Guide*, written by Michael Peddle, College of the Holy Cross, includes problems, chapter summaries, and sample test questions designed to help your students master topics you cover in class and to prepare for examinations.

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David N. Hyman
Raleigh, North Carolina



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