

Harvey S. Rosen

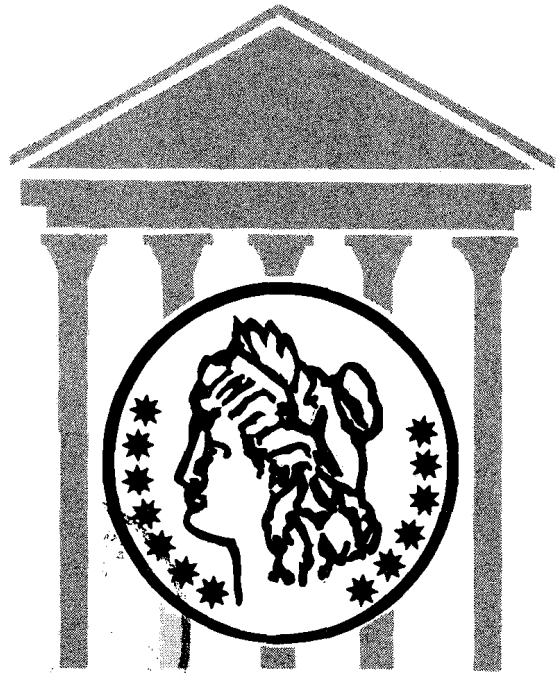
Public Finance



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“It is a foolish thing to make a long prologue.” (II Maccabees 2:32) I shall follow this Biblical advice, and be brief in describing the features of this book. The field of public finance has been changing rapidly in recent years. 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 has attempted 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 has been the widespread application of the tools of econometrics to understanding how tax and expenditure policies affect individual behavior, and how the government itself sets its policies.

The results of modern research have been slow in entering traditional texts. This book brings its readers up to many of the frontiers of current research. The approach to the material, while quite accessible to undergraduates, is basically 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 issues and substantive problems 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.

There is some tendency for economic analysis to lose touch with the reality it is supposed to describe. I have tried to avoid this tendency. The relevant institutional and legal setting is described in ample detail. Moreover, the links between economic analysis and current political issues are constantly emphasized.

Organization

Part One consists of two short chapters which provide a broad perspective on the role of government in the economy. Part Two discusses

the methodological tools used in the study of Public Finance. These include the methods of empirical analysis (Chapter 3) and the fundamentals of theoretical welfare economics (Chapter 4). The remainder of the book follows the conventional tactic of analyzing government expenditure and revenue raising activities separately. Part Three (Chapters 5 through 10) deals with the expenditure side of the budget; various government programs are described and evaluated. Part Four (Chapters 11 through 13) provides a theoretical framework for discussing taxation. The major taxes are analyzed using this framework in Part Five (Chapters 14 through 18). Finally, Part Six considers public finance in a multi-jurisdictional setting; Chapter 19 deals with the special issues that arise under a federal system of government, Chapter 20 concerns international issues.

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

This book is designed for use in undergraduate programs, and graduate programs in public administration. It is assumed that readers are familiar with microeconomic theory at the level of the standard introductory course. Some use is made of indifference curve analysis, a topic that is 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: supply and demand, marginal analysis, and production possibilities curves. This review should be adequate to refresh the memories of readers who have been away from microeconomics for a while.

It is hoped that this book will whet readers' appetites to learn more about public finance. To this end, a large number of articles and books are cited within the chapters and at their ends. A typical citation consists of the author's name with the date of publication following in brackets. The full reference can then be found by consulting the consolidated bibliography that appears at the back of the book. These references vary considerably in technical difficulty; those who wish to pursue specialized topics further have to pick and choose.

Acknowledgments

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.

Several people have read various chapters and provided useful suggestions. Thanks are due to my colleagues at Princeton: Alan Blinder, David Bradford, Don Fullerton, Amy Gutmann, Edwin Mills, and Richard Quandt for their comments. Jonathan Eaton (University of Virginia), David Hartman (National Bureau of Economic Research), Robert Inman (University of Pennsylvania), Sharon Bernstein Megdal (University of Arizona), Wallace Oates (University of Maryland), and Amy Taylor (National Center for Health Services Research) made comments on and contributions to early drafts of the manuscript. Daniel Feenberg (National Bureau of Economic Research), Timothy J. Gronberg (Texas A&M University), Frederick W. Jones (University of Wisconsin-Parkside), Daphne A. Kenyon (Dartmouth College), Mark W. Plant (University of California at Los Angeles), Herbert E. Sim (University of Notre Dame), Harvey Watson (George Washington University), Jeffrey Wolcowitz (Harvard University), and George Zodrow (Rice University) reviewed either part or all of the manuscript. Their thoughtful comments and evaluations helped to bring the final form to this book. I am especially indebted to Richard Tresch (Boston College), who carefully read the entire manuscript, and to Douglas Holtz-Eakin, who did a tremendous job as a research assistant and as a critic. I also appreciate the typing assistance of Terry Butler, Constance Dixon, and Barbara Hickey.

Both my children were born while this book was in progress—Lynne in 1981, and Jonathan in 1983. Although I have not developed a complete theory of the impact of young children upon speed of textbook writing, there appear to be two effects, which (as usual) work in opposite directions: the “sleep-deprivation effect,” which inhibits productivity, and the “future-college-tuition-payment effect,” which serves as a great spur to work. As is often the case (see Chapter 3), it is hard to tell which effect dominates. On the off chance that future econometric research shows that the net effect is to increase productivity, I should give the kids my thanks.

Finally, I am grateful to my family lawyer for technical advice and encouragement.

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Public Finance





Part One



Introduction

People's views on how the government should conduct its financial operations are heavily influenced by their political philosophies. Some people care most about individual freedom, others care more about promoting the well-being of the community as a whole. Philosophical differences can and do lead to disagreements as to the appropriate scope for government economic activity.

However, forming intelligent opinions about governmental activity requires not only a political philosophy but also an understanding of what the government actually does. Where does the legal power to conduct economic policy reside? What does government spend money on, and how does it raise revenue?

Chapter 1 discusses how political views affect attitudes toward public finance, and Chapter 2 outlines the operation of the U.S. system of public finance. Together these two chapters provide a broad perspective which it will be useful to remember as various details are discussed in the rest of the book.

Public Finance and Attitudes toward Government

Sometimes it is said that man cannot be trusted with the government of himself. Can he, then, be trusted with the government of others? Or have we found angels in the forms of kings to govern him? Let history answer this question.

Thomas Jefferson

The year is 1030 B.C. For decades, the Israelite tribes have been living without a central government. The Bible records that the people have asked the prophet Samuel to “make us a king to judge us like all the nations” [I Samuel 8:5]. Samuel tries to discourage the Israelites by describing what life will be like under a monarchy:

This will be the manner of the king that shall reign over you; he will take your sons, and appoint them unto him, for his chariots, and to be his horsemen; and they shall run before his chariots. . . . And he will take your daughters to be perfumers, and to be cooks, and to be bakers. And he will take your fields, and your vineyards, and your oliveyards, even the best of them, and give them to his servants. . . . He will take the tenth of your flocks; and ye shall be his servants. And ye shall cry out in that day because of your king whom ye shall have chosen. [I Samuel 9:11–18]

The Israelites are not deterred by this depressing scenario: “the people refused to hearken unto the voice of Samuel; and they said: ‘Nay; but there shall be a king over us; that we also may be like all the nations; and that our king may judge us, and go out before us, and fight our battles’ ” [I Samuel 8:19–20].

This biblical episode illustrates an age-old ambivalence about government. Government is a necessity—"all the nations" have it, after all—but at the same time it has undesirable aspects. These mixed feelings toward government are inextricably wound up with its taxing and spending activities. The king will provide things that the people want (in this case, an army), but only at a cost. The resources for all government expenditures ultimately must come from the private sector. As Samuel so graphically explains, taxes can become burdensome.

Centuries have passed, mixed feelings about government remain, and much of the controversy still centers around its financial behavior. This book is about the taxing and spending activities of government, a subject usually called **public finance**, but sometimes referred to as **public sector economics** or simply **public economics**.

Our focus is on the microeconomic functions of government, the way government affects the allocation of existing resources and the distribution of income. Nowadays, the macroeconomic functions of government—the use of taxing, spending, and monetary policies to affect the overall level of unemployment and the price level—are usually taught in separate courses.

It is not always exactly clear whether certain subjects "belong" in public finance. Governmental regulatory policies have important effects upon resource allocation. Such policies have goals that sometimes can also be achieved by government spending or taxing measures. For example, if a goal of the government is to limit the size of corporations, one possible policy is to impose large taxes on big corporations. Another policy is to issue regulations making firms that exceed a particular size illegal. However, while corporate taxation is a subject of intense study in public finance, antitrust issues are generally treated only tangentially in public finance texts, and are covered instead in courses on industrial organization. Such a practice seems arbitrary, but it is necessary to limit the scope of the field. This book follows tradition by confining most attention to governmental spending and revenue-raising activities.

ALTERNATIVE VIEWS OF GOVERNMENT

Public finance economists analyze not only the effects of actual government taxing and spending activities, but what these activities ought to be. Views of how government should function in the economic sphere are influenced by general attitudes concerning the relationship between the individual and the state. Political philosophers have distinguished two major approaches.

Organic View

Society is conceived of as a natural organism. Each individual is a part of this organism, and the government can be thought of as its heart. The