

# Public Finance

FIFTH EDITION



Harvey S. Rosen

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**Harvey S. Rosen**

*Department of Economics  
Princeton University*

 **Irwin  
McGraw-Hill**

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# Irwin/McGraw-Hill

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PUBLIC FINANCE, fifth edition

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This book is printed on acid-free paper.

3 4 5 6 7 8 9 0 DOC DOC 3 2 1 0

ISBN 0-256-17329-X

Editorial director: Michael Junior

Publisher: Gary Burke

Executive editor: Paul Shensa

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Designer: Lorna Lo

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Supplement coordinator: Louis Swaim

Interior and cover design: Vargas/Williams Design

Compositor: Shepherd Inc.

Typeface: 10/12 Times Roman

Printer: R.R. Donnelley

Cover and interior details image: Alsloot, Denis van. *Triumph of the Archduchess Isabella in the Brussels Ommeganck of Sunday, 31st May 1615*, 1615, oil on canvas, 117 × 381 cm. Victoria & Albert Museum, London/Art Resource, NY.

## About the cover

In earlier eras, governments spent a substantial amount of money on pageantry. A spectacular example is illustrated in the painting by Denis van Alsloot, *The Ommeganck Procession* (1615), which records the Triumph of the Regent Isabella in Brussels. Today, civic processions are much less important in government budgets, although they have not disappeared altogether (think of Inauguration Day celebrations). Should parades be publicly provided? If so, how many, and who should pay for them? This is a minor but typical example of the kind of question that comes up in the field of public finance, which concerns the spending and taxing activities of government.

## Library of Congress Cataloging-in-Publication Data

Rosen, Harvey S.

Public finance / Harvey S. Rosen. — 5th ed.

p. cm.

Includes index.

ISBN 0-256-17329-X

1. Finance, Public—United States. I. Title.

HJ257.2.R67 1998

336.73—dc21

98-13616

CIP

<http://www.mhhe.com>

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***To my sibs***

# About the Author

## HARVEY S. ROSEN

Harvey S. Rosen is the John L. Weinberg Professor of Economics and Business Policy at Princeton University. Professor Rosen, a Fellow of the Econometric Society and a Research Associate of the National Bureau of Economic Research, is well known for his contributions to the fields of Public Finance, Labor Economics, and Applied Microeconomics. From 1989 to 1991, he served as Deputy Assistant Secretary (Tax Analysis) at the U.S. Treasury. His articles have appeared in such journals as *Econometrica*, *American Economic Review*, and *Journal of Political Economy*. He is currently on the editorial boards of the *Journal of Economic Literature*, *International Tax and Public Finance*, and *Regional Science and Urban Economics*.



# 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 fifth 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 links between economic analysis and current political issues are constantly emphasized.

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## Organization

Part One consists of two short chapters that 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 12) deals with the expenditure side of the budget. It describes and evaluates various

government programs. Part Four (Chapters 13 through 15) provides a theoretical framework for discussing taxation. The major revenue-raising instruments are analyzed using this framework in Part Five (Chapters 16 through 20). Finally, Part Six deals with the special issues that arise under a federal system of government.

Some instructors may choose to do the tax side (Parts Four and Five) before the expenditure side (Part Three); the book is designed so this can be done easily. 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 curricula as well as graduate programs in public administration. Readers are assumed to 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 and marginal analysis. 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.

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. A typical citation consists of the author’s name followed by the date of publication 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. In addition, at the end of the book is a list of suggested readings organized on a chapter-by-chapter basis. They are intended to be suitable for inclusion in undergraduate syllabi.

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## What’s New in the Fifth 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. On the expenditure side, the most important changes are in Chapter 9, “Expenditure Programs for the Poor.” Changes in income maintenance policy enacted in 1996 scrapped Aid to Families with Dependent Children (AFDC), and replaced it with a new system in which

the states play a larger role and there is more emphasis on “workfare.” The new law and the controversies surrounding it are at the heart of the revised chapter. Chapter 10, “Social Security,” also has substantial new sections. For years, a political cliché has been that Social Security is the third-rail of politics—touch it and you die. But now, various reforms such as privatization are very much on the public policy agenda, and the chapter discusses their economic implications.

On the revenue side, the chapters dealing with taxation have been thoroughly revised in light of the changes enacted in 1997. In addition, Chapter 20, “Taxes on Consumption and Wealth,” now contains an extended discussion of the Hall-Rabushka flat tax. This proposal received a lot of attention during the last presidential election when it was the centerpiece of Steve Forbes’ campaign to obtain the Republican nomination, and it is likely to surface in the next election as well.

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



# 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.

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.

I have been the beneficiary of numerous suggestions for improvements over the previous edition. I am particularly grateful to William T. Bogart (Case Western Reserve University), Sewin Chan (Rutgers University), Peter Garlick (SUNY—New Paltz), Jill Boylston Herndon (Hamline University), William Hoyt (University of Kentucky), Stephen Lile (Western Kentucky University), Thad Mirer (SUNY—Albany), and Matthew N. Murray (University of Tennessee), who reviewed the entire manuscript. I received detailed comments on entire chapters from Rosanne Altshuler (Rutgers University), Rebecca Blank (Northwestern), Don Fullerton (University of Texas), William Gale (Brookings), William Gentry (Columbia), L. Jay Helms (University of California—Davis), Janet Holtzblatt (US Treasury), and Amy K. Taylor (US Center for Health Services Research).

A number of scholars identified places for refinement and reorganization in this edition, or helped me out with particular issues. They include:

Gerald Auten  
*US Treasury*

Thomas Barthold  
*Joint Committee on Taxation*

John A. Christianson  
*University of San Diego*

Bev Dahlby  
*University of Alberta*

John Fitzgerald  
*Bowdoin College*

Fred E. Foldvary  
*Virginia Tech*

James Hines  
*University of Michigan*

Douglas Holtz-Eakin  
*Syracuse University*

Paul Hughes-Cromwick  
*Henry Ford Health System*

Alessandro Lizzeri  
*Princeton University*

Robin Lumsdaine  
*Brown University*

Molly K. Macauley  
*Resources for the Future*

Olivia Mitchell  
*University of Pennsylvania*

John Murray  
*Bank of Canada*

Mark Rider  
*US Treasury*

Kenneth Small  
*University of California, Irvine*

Marianne Vigneault  
*Bishop's University*

Kristen Willard  
*Columbia*

Recognition of and an expression of appreciation to the people who reviewed and made useful suggestions for earlier editions of this text are also appropriate.

Roy D. Adams  
*Iowa State University*

James Alm  
*University of Colorado*

Gary M. Anderson  
*California State University, Northridge*

Charles L. Ballard  
*Michigan State University*

Douglas Blair  
*Rutgers University*

David Bradford  
*Princeton University*

Neil Bruce  
*Queens University*

Lawrence P. Brunner  
*Central Michigan University*

Donald E. Campbell  
*College of William and Mary*

Edward Coulson  
*Pennsylvania State University*

Kevin T. Duffy-Deno  
*Southeastern Massachusetts University*

O. Homer Erekson  
*Miami University, Ohio*

J. Fred Giertz  
*University of Illinois*

Amihai Glazer  
*University of California, Irvine*

Roy T. Gobin  
*Loyola University of Chicago*

Timothy J. Gronberg  
*Texas A & M University*

Jonathan H. Hamilton  
*University of Florida*

Rich Hanson  
*University of California, Irvine*

Roger S. Hewett  
*Drake University*

Robert Inman  
*University of Pennsylvania*

Robert Kelly  
*Fairfield University*

Edward Kienzle  
*Boston College*

Bruce R. Kingman  
*SUNY, Albany*

Helen Ladd  
*Duke University*

Charles G. Leathers  
*University of Alabama*

Gary D. Lemon  
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*Rochester Institute of Technology*

Randall Mariger  
*University of Washington*

Roger P. Mendels  
*University of Windsor*

Fanus van der Merwe  
*Potchefstroom University for Christian  
Higher Education, South Africa*

Robert Moore  
*Occidental College*

Susan Parks  
*University of Wisconsin—Whitewater*

Anthony Pellechio  
*World Bank*

Alfredo M. Pereira  
*University of California, San Diego*

James Poterba  
*Massachusetts Institute of Technology*

B. Michael Pritchett  
*Brigham Young University*

Uwe Reinhardt  
*Princeton University*

Robert Rider  
*University of Southern California*

Steven R. Sachs  
*University of Connecticut*

Efraim Sadka  
*Tel-Aviv University*

Gian S. Sahota  
*Vanderbilt University*

Albert J. Shamash  
*Trenton State College*

John L. Solow  
*University of Iowa*

Richard Steinberg  
*Virginia Polytechnic Institute and State University*

Thomas F. Stinson  
*University of Minnesota*

Paul Styger  
*Potchefstroom University for Christian Higher Education, South Africa*

Lennard van Vuren  
*Potchefstroom University for Christian Higher Education, South Africa*

Michael Wasylenko  
*Syracuse University*

George Zodrow  
*Rice University*

Readers of the preface to the first edition may recall a brief discussion of the impact of baby-induced sleep deprivation upon productivity as a textbook author. I am now learning that teenagers also cause their parents to lose sleep, albeit for different reasons. Still, Lynne and Jonathan make home life fun and interesting, and were very patient when I disappeared occasionally to work on this project. I appreciate their forbearance. (And I owe the new opening quotation in the Appendix to Jonathan, or, more specifically, to the Madonna CD that he was blaring through the house one day.) Finally, I thank my family lawyer for technical advice and encouragement.

H. S. R.

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