

# PUBLIC FINANCE IN THEORY AND PRACTICE

SECOND EDITION



HOLLEY H. ULBRICH

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# Preface to the second edition

Much has changed in the world of public sector economics since the first edition of this book came out eight years ago. Tax protests and battles over Social Security and health care have escalated, while massive budget deficits have become one of the most critical public issues of our time. The core theoretical foundations of public sector economics, however—the theory of public expenditure and the principles of taxation—remain both intact and relevant, and they receive due treatment in this book.

Users of the first edition will notice many changes in both organization and content in response to reviewer comments and my own experience in teaching from this book. Issues of income distribution now form a part of the five foundation chapters, along with two chapters on the size and structure of governments and an expanded treatment of public choice. It is impossible to address either expenditures or taxation without first considering the pervasive issues of income distribution on public sector decision-making processes.

A deeper treatment of the theory of public expenditures resulted in splitting the single chapter on public goods and externalities into two chapters, followed immediately by three chapters on applied issues in public expenditure—budgeting, borrowing, and cost-benefit analysis. The structure of the revenue and taxation chapters is largely unchanged, but the content has been updated and expanded. The chapters on competition and government and on infrastructure have been deleted, with some of the material moved to other chapters and some available on the web site. The final three chapters on issues in public expenditure revisit the issues in providing public education, Social Security, and health care in the light of the experience of the past decade.

In both the first and second editions, we emphasize that government includes all levels of government—federal, state, and local. The United States is one of a handful of countries with a federal form of government (Canada, Germany, Switzerland, and Australia are among the others). Most nations have a unitary structure with only central and local governments. But at the same time, the European Union has expanded not only its membership but also the responsibilities that are carried out by the EU rather than its individual member countries, presenting a new challenge to our understanding of federalism as a fiscal issue. Within nations, the respective roles of different levels of government have changed greatly in just the past two decades. Much more of the “action” in terms of service delivery and revenue-raising is now concentrated at the state and local level. So this challenge of fiscal federalism appears throughout the book.

In a global economy, it is no longer adequate to study public finance from the perspective of one particular country. Considering the institutions and practices of many nations is an important reminder that the way in which the economics of public finance works out in practice in one particular country is the result of an encounter of a general theory with a specific

history and set of institutions. Differences between countries reflect the same theory at work in different cultures with different histories, resources, and values. Different nations might reasonably make different choices that are more suited to their size, income levels, history, and preferences. These other experiences will serve as a reminder that economic theory and policy analysis rarely produce a single solution to a particular question or problem, but rather a number of possible solutions with different attributes. That emphasis not only remains but is strengthened in this second edition especially with the addition of end-of-chapter questions that invite the student to “think globally.”

Behavioral economics has been around for a long time but has received much more attention in the past ten years, and it receives more attention in this book. The only Nobel Prize in economics to go to a psychologist was given to Daniel Kahneman in 2002 for his work in understanding how people make decisions. Behavioral economics helps us to understand why policy decisions often do not have the impact that theoretical models would predict. Behavioral economics does not replace the standard theory, but rather enriches it.

There are two basic premises of behavioral economics: the motivational and the cognitive. Humans are motivationally more complex than is adequately described by the self-interest model. They are also social and relational beings who are influenced by social norms and by concern for others, especially those closest to them. At the same time, humans are generally not as good or as fast at acquiring, processing and applying information to their choices as the rational choice model implies, an idea pioneered by Herbert Simon with his description of bounded rationality. Behavioral economics is introduced in the first chapter and applications, including end of chapter questions, are found throughout the book.

Economists rely heavily on descriptive statistics to flesh out the theory. So do politicians and economic journalists. Numbers give concrete reality to ideas. It is important for students to learn to tease the story out of the statistics, to be able to describe situations in concrete terms, to spot trends and look for patterns. For that reason, along with all the descriptive statistics in the chapters, there is an end-of-chapter question in each chapter that invites students to explore the world of descriptive statistics as it applies to the material in that chapter.

Finally, economics is a policy science. Its original name was political economy, and the political referred not to politics but to policy. So each chapter also offers the student a policy application question to address.

# Acknowledgments

I want to acknowledge the contributions of my colleagues at the Strom Thurmond Institute, Ellen Saltzman and Lori Dickes; five anonymous reviewers who offered many helpful suggestions; my students in public administration and policy studies who were helpful guinea pigs and critics of both the first edition and this revision; Robert Langham at Routledge, who encouraged me to undertake a second edition; graduate student Patrick Tandoh-Offin and undergraduate economics student and computer artist Corey Allen, who prepared the illustrations; and Joyce Bridges and Kathy Skinner who helped to prepare the final manuscript. I also acknowledge the support of my patient and encouraging husband, Carlton Ulbrich, during this long process of revision.

I hope that this textbook will provide the student a solid foundation in the theory and practice of public finance or public sector economics that will enable him or her to be a more informed citizen, and perhaps encourage a career in public policy that is based on a solid understanding of the economic foundations.

Holley Ulbrich  
Clemson, South Carolina

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## Part 1

# Government and the market

Like other branches of economics, public finance or public sector economics combines a body of theory with a set of institutions to describe, analyze, and interpret the workings of government in a predominantly private economy. The theory is more or less universal, but it works out differently in different institutional contexts. Policies that work well for a small, homogeneous, highly centralized nation or in highly competitive markets may have very different effects in a nation that is larger, heterogeneous, and decentralized, or in an economy with a substantial concentration of private economic power. While much of this book is written from an American perspective, that viewpoint is heavily qualified by frequent comparisons with experience in other countries, particularly but not exclusively other English-speaking industrial and post-industrial countries.

From before recorded history, human societies have felt the need to have governments. Very small societies may get by with relatively little government, but once societies become large, complex, and technologically sophisticated, they need a referee, a rule setter, an authority for resolving disputes. Many of those rules and disputes are economic in nature.

Some governments, like the American government in the words of the Declaration of Independence, “derive their just powers from the consent of the governed.” Others exist by force of arms, or tradition, or external imposition, or other sources of power. Governments come into being to balance the desire of the individual for autonomy and freedom with the need for citizens to find ways to work together to address common concerns, manage shared resources, protect themselves from each other and external enemies, and resolve the boundary problems that separate one household from another.

In many countries, the powers and limitations of government are laid out in formal documents. Among the major English-speaking countries, those documents are a more or less continuous series, beginning with Magna Carta in 1215; the US Articles of Confederation in 1781, superseded by the US Constitution of 1787; the British North America Act of 1867 that is the core of the Canadian Constitution; the 1900 Constitution of the Commonwealth of Australia; and the 1949 Constitution of India, just to list a few.

However limited the original mandate—and in the United States, the original mandate, the Articles of Confederation, was very limited indeed—sooner or later, the role of government begins to expand. Much thought and discussion goes into determining what government should be permitted to do when the central vision is a private society that is largely governed by individual choice, with government intervening only when necessary. However, the opportunity to use the government to get others to pay for your pet project or to restrict your pet annoyance tends to expand both the budgetary and regulatory reach of government.

The paragraph above describes a distinctly American (and to a lesser degree, British) view of government. Most Americans assume that this individualistic interpretation of the role of



## 2 Government and the market

government—as an intruder into primarily market and private decisions—to be “the way it is,” rather than one interpretation among many possible ones. Many nations have no such hierarchy of activity, with the market as primary and the government as secondary. Instead, there may be a fluctuating blend of public and private activity, with the assignment of tasks to one or the other determined on an *ad hoc* basis. Western and Latin American countries have shifted back and forth between a larger public role and a larger private role in an effort to balance competing demands of equity and efficiency, individual security and work incentives, public infrastructure, and private capital.

Still other countries have undergone a public/private sorting-out process in reverse. In the former Soviet Union and Eastern Europe, the challenge has been to transition from a system in which the community took precedence over the individual to one that provides a much larger sphere for private, individual decisions. It has been a slow and confusing road, from a system in which the government managed almost all economic activity to an alternative model in which individuals, markets, and private voluntary associations play important roles in organizing economic activity. One of the biggest needs was the creation of the social infrastructure that supports the market, such as financial institutions, regulatory agencies, property rights, and contract law.

Reflecting on the transition experience of Eastern and Central European countries in the past two decades suggests that there is no single “right” balance between individual and community, public and private, government and the market. Different societies can and do settle at different points along the continuum from minimum government, maximum market/private sector to the opposite extreme. The point of settlement is always a moving target.

Mindful of diversity, we nevertheless attempt to distill the common ground of public sector economics across many different cultural and institutional contexts. The five chapters in Part 1 address some fundamental issues about government that provide the background for a closer examination of the revenue and expenditure dimensions of public sector activity. Chapter 1 reviews basic understandings about the division of responsibility between governments and markets. Chapter 2 provides a quantitative measure of the size and scope of government—how much revenue flows into public coffers and from what sources, and which services those revenues are used to provide.

Chapter 3 addresses the structure of governments, which is particularly important in federal systems with three levels of government, such as the United States, Canada, and Australia. In a federal system, authority and responsibility are sometimes shared and sometimes divided across levels of government. While most countries have local governments with varying degrees of autonomy, there is a more limited number of countries with three levels of government with their own defined spheres of activity. In such countries, the structure must address such questions as: Do the benefits from government programs stay local (or within the state or province), or do they spill over to other areas? Which taxes are suited to local use? What responsibilities are national in scope? Understanding the interplay between theory and context, including the formal and informal division of responsibility between state, local and federal, between government, market and the nonprofit sector is an essential part of one’s education as a policy economist.

The decision-making process in the public sector is of necessity different from that of the private sector. While decisions in the private sector are made by voting with dollars, public sector decision-making is more complex, involving both economic and political considerations such as agenda-setting, monitoring and incentives, and incomplete information. The branch of political economy that addresses that decision-making process from an economic perspective is known as public choice, the subject of Chapter 4.