

Public Finance

Sixth Edition



Harvey S. Rosen

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Harvey S. Rosen

*Department of Economics
Princeton University*



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An early representation of taxation in action is the beautiful anonymous painting, *Festival in the Piazza della Signoria, Florence*. It depicts the annual offering of compulsory tribute to the Duke. The proceeds were used to finance various public projects, among other things. For modern governments, the process may not be as elegant, but the basic elements are the same—people pay taxes that are used to support public sector activities. The taxing and spending activities of government are the subject of the field of public finance.

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Public Finance

*To my friends**

*"Behold what is good and pleasant: for friends to sit together." (*Psalms* 133:1)

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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 *National Tax Journal*, *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 sixth 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 text constantly emphasizes the links between economic analysis and current political issues.

Organization

I have changed the book’s organization to get things off to a faster start. Part One now consists of three chapters. Chapter 1 consolidates two short chapters from the previous edition, and provides a broad perspective on the role of government in the economy. The next two chapters discuss the methodological tools used in the study of public finance. These include the methods of empirical analysis (Chapter 2) and the fundamentals of theoretical welfare economics (Chapter 3). The remainder of the book follows the conventional tactic of analyzing government expenditure and revenue-

raising activities separately. Part Two (Chapters 4 through 11) deals with the expenditure side of the budget. It describes and evaluates various government programs. Part Three (Chapters 12 through 14) presents a theoretical framework for discussing taxation. The major revenue-raising instruments are analyzed using this framework in Part Four (Chapters 15 through 19). Finally, Part Five deals with the special issues that arise under a federal system of government.

Some instructors may choose to do the tax side (Parts Three and Four) before the expenditure side (Part Two); the book is designed so this can be done easily. In the same way, the chapters within Parts Two, Three, and Four 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 should 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.

I hope that *Public Finance* will whet readers’ appetites to learn more about this field. To that 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. Readers can find the full reference in the consolidated bibliography at the back of the book. The 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 each chapter is a list of suggested readings. They are suitable for inclusion in undergraduate syllabi.

What’s New in the Sixth 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. I have substantially reworked the coverage of welfare economics in Chapter 3. The assumptions behind the First Fundamental Theorem have been moved forward in the chapter, allowing students to see at an earlier point that market failure may be a real concern. In addition, the

Second Fundamental Theorem and its implications for thinking about public policy issues are now introduced. On the expenditure side, the most important changes are in Chapter 8, “Expenditure Programs for the Poor.” The 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.” Preliminary research on the impact of the new law is now becoming available, and it is discussed in this chapter. In Chapter 10, new material on reform options for Medicare has been added, including Medical Savings Accounts.

Education is becoming an ever more prominent item on the national policy agenda. New material in several chapters is meant to keep students abreast of the issues. Chapter 4 discusses the impact of early intervention programs. Chapter 11 on “Cost-Benefit Analysis” now contains an extended example discussing an important issue in public education policy, the evaluation of reductions in class size. Chapter 20 has new material on whether the US system of financing education fits into the normative model of federalism.

The institutional content of Chapter 10, “Political Economy,” has been updated with a discussion of the Budget Enforcement Act and whether or not it is effective at disciplining federal spending. Recent research on the impact of budgetary rules at the state level is discussed, including its relevance (or lack thereof) for designing budgetary procedures at the federal level.

On the revenue side, the discussion of the excess burden of differential taxation of inputs in Chapter 13 has been entirely reworked with a model that is simpler yet still makes all the key points. Chapter 15, “The Personal Income Tax,” contains a new section on the relationship between deductions and complexity, and Chapter 18, “Debt Finance,” is now more oriented toward the analysis of budget surpluses and their effects.

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

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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 Gary Hoover (University of Alabama), Paul Menchik (Michigan State University), Ben Scafidi (Georgia State University), and Aaron Yelowitz (University of California at Los Angeles), who reviewed the entire manuscript. I received detailed comments on entire chapters from Andrew Samwick (Dartmouth College) and Amy K. Taylor (US Center for Health Services Research). Thanks are due to Jonathan Meer and Craig Perry for assistance in preparing the manuscript.

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When I wrote the first edition of *Public Finance*, my children Lynne and Jonathan were babies. Now they are old enough to have friends who are using the book. To those friends I make a simple plea: Do not visit the sins of the father upon his children! Finally, I thank my family lawyer for technical advice and encouragement.

Brief Table of Contents

P A R T Getting Started

1

- 1 Introduction 3
- 2 Tools of Positive Analysis 19
- 3 Tools of Normative Analysis 31

P A R T Analysis of Public Expenditure

2

- 4 Public Goods 55
- 5 Externalities 79
- 6 Political Economy 106
- 7 Income Redistribution: Conceptual Issues 136
- 8 Expenditure Programs for the Poor 156
- 9 Social Insurance I: Social Security and Unemployment Insurance 178
- 10 Social Insurance II: Health Care 200

11	Cost-Benefit Analysis	220
-----------	------------------------------	------------

P A R T **A Framework for Tax Analysis**

3

12	Taxation and Income Distribution	253
13	Taxation and Efficiency	282
14	Efficient and Equitable Taxation	306

P A R T **The United States Revenue System**

4

15	The Personal Income Tax	335
16	Personal Taxation and Behavior	373
17	The Corporation Tax	398
18	Deficit Finance	423
19	Taxes on Consumption and Wealth	440

P A R T **Multigovernment Public Finance**

5

20	Public Finance in a Federal System	471
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Appendix Some Basic Microeconomics 507

Glossary 529

References 539

Author Index 555

Subject Index 561

Table of Contents

P A R T Getting Started

1

- 1 Introduction 3
 - Public Finance and Ideology 4
 - Organic View of Government 4
 - Mechanistic View of Government 5
 - Viewpoint of This Book 6
 - Government at a Glance 7
 - The Legal Framework 7
 - The Size of Government 9
 - Expenditures 12
 - Revenues 14
 - Our Agenda 16
 - Summary 16
 - Discussion Questions 16
 - Selected References 17
 - Appendix: Doing Research in Public Finance 17

- 2 Tools of Positive Analysis 19
 - The Role of Theory 20
 - Methods of Empirical Analysis 23
 - Interviews 23
 - Experiments 23
 - Econometric Studies 25
 - Concluding Remarks 28
 - Summary 29
 - Discussion Questions 30
 - Selected References 30

3	Tools of Normative Analysis	31
	Welfare Economics	31
	Pure Exchange Economy	32
	Production Economy	37
	The First Fundamental Theorem of Welfare Economics	38
	Fairness and the Second Fundamental Theorem of Welfare Economics	40
	Market Failure	44
	Market Power	44
	Nonexistence of Markets	44
	Overview	45
	Buying into Welfare Economics	46
	Summary	47
	Discussion Questions	48
	Selected References	49
	Appendix: Consumer and Producer Surplus	49

P A R T Analysis of Public Expenditure

2

4	Public Goods	55
	Public Goods Defined	55
	Efficient Provision of Public Goods	58
	Deriving the Efficiency Contribution	60
	The Free Rider Problem	64
	The Privatization Debate	65
	Public versus Private Provision	65
	Public versus Private Production	65
	Education	69
	What Do Expenditures for Public Education Accomplish?	71
	New Directions for Public Education	73
	Public Goods and Public Choice	74
	Summary	75
	Discussion Questions	75
	Selected References	76
	Appendix: Preference Revelation Mechanisms	76