

*Second Edition*

# *Public Finance*

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*Harvey S. Rosen*



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*Harvey S. Rosen*

Department of Economics  
Princeton University

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To  
Marsha

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# FOREWORD

The first edition of Harvey Rosen's *Public Finance* has been such a success because it provides a careful balance between theoretical analysis and applications to the current policy debates. I am certain that students have also been grateful for Professor Rosen's very clear and engaging style of writing.

This very readable and useful text is just what one would expect from Professor Rosen. His own research is always motivated by a concern for real issues, and his conclusions are based on careful empirical analysis. That spirit of inquiry makes its way into the pages of this book just as it does into his many professional articles in the leading academic journals.

This second edition reflects the important tax legislation that has been enacted since the first edition was written as well as the recent academic contributions to the field of public finance. The recent Tax Reform Act represents a major application of many of the ideas that public finance economists have discussed over the years. This new edition helps students see the ways in which professional economics thinking has been reflected in this landmark legislation.

I can strongly recommend Harvey Rosen's *Public Finance* for any student who wants to understand modern public finance and its applications to economic policy.

*Martin S. Feldstein*  
National Bureau of Economic Research  
Cambridge, Massachusetts



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# PREFACE

“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 expenditure and tax 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 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; various government programs are described and evaluated. 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 21). Finally, Part Six considers public finance in a multijurisdictional setting; Chapter 22 deals with the special issues that arise under a federal system of government, Chapter 23 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.

### **What's New In the Second Edition?**

“Are you doing anything beside updating the tables?” That's the question many of my colleagues asked when they heard that I was revising *Public Finance*. The answer is, “Quite a bit, actually.” In addition to being reorganized, the material on the expenditure side of the budget (Part Three) has been substantially augmented with new chapters on income maintenance (Chapter 9) and health care policy (Chapter 11). There is also more discussion of such theoretical contributions as preference revelation mechanisms and principal-agent models, and their links to policy issues like “privatization” and defense contracting.

On the revenue raising side (Part Five), a new chapter on debt (Chapter 18) brings together the institutional, theoretical, and empirical work on this important source of government finance. Moreover, the chapters dealing with federal taxation have been thoroughly revised in light of the Tax Reform Act of 1986.

However, the basic thrust of the book is unchanged. As in the first edition, the goal is to interweave institutional, theoretical, and econometric material in such a way that students come away with a clear and coherent view of governmental spending and taxing.

**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 200 academic colleagues who teach public finance responded to a survey that provided useful material on how they focus their courses. Their input afforded an insight on how they teach and on the students who take this course. Comments on the First Edition from:

Roy D. Adams <i>Iowa State University</i>	Roger P. Mendels <i>University of Windsor</i>
Charles L. Ballard <i>Michigan State University</i>	Robert Moore <i>Occidental College</i>
Roy T. Gobin <i>Loyola University of Chicago</i>	Sue Parks <i>University of Wisconsin—Whitewater</i>
Timothy J. Gronberg <i>Texas A&amp;M University</i>	Gian S. Sahota <i>Vanderbilt University</i>
Robert Kelly <i>Fairfield University</i>	John L. Solo <i>University of Iowa</i>
Randall Mariger <i>University of Washington</i>	George Zodrow <i>Rice University</i>

helped to further identify places for refinement and reorganization in this edition.

Several people read various chapters and provided useful suggestions. Thanks are due to:

Douglas Blair <i>Rutgers University</i>	Edwin Mills <i>Northwestern University</i>
Rebecca Blank <i>Princeton University</i>	Wallace Oates <i>University of Maryland</i>
David Bradford <i>Princeton University</i>	Anthony Pellechio <i>World Bank</i>
Eleanor Brown <i>Pomona College</i>	James Poterba <i>Massachusetts Institute of Technology</i>
Robert Inman <i>University of Pennsylvania</i>	Uwe Reinhardt <i>Princeton University</i>
Helen Ladd <i>Duke University</i>	Efraim Sadka <i>Tel-Aviv University</i>

The thoughtful comments and evaluations from:

James Alm <i>University of Colorado</i>	Douglas Holtz-Eakin <i>Columbia University</i>
Neil Bruce <i>Queens University</i>	Edward Kienzle <i>Boston College</i>
O. Homer Erikson <i>Miami University</i>	B. Michael Pritchett <i>Brigham Young University</i>
J. Fred Giertz <i>University of Illinois</i>	Robert Rider <i>University of Southern California</i>
Jonathan H. Hamilton <i>University of Florida</i>	Michael G. Sher <i>University of Minnesota</i>
Rich Hanson <i>University of California—Irvine</i>	Richard Steinberg <i>Virginia Polytechnic Institute</i>
Roger S. Hewett <i>Drake University</i>	Thomas F. Stinson <i>University of Minnesota</i>

who reviewed either all or part of the manuscript helped to bring the final form to this edition. I am indebted to John Capeci, who did a fine job as a research assistant, and to Lillian Pekar, who typed the manuscript.

As a father with an intense concern about the education of his children, I have tried to get them interested in public finance. However, both Lynne (6 years) and Jonathan (3 years) opined that the first edition of my book was “yucky.” When I asked the reason for this unfavorable review, they explained that they preferred books with color in the pictures. I am grateful to Lynne and Jonathan for the suggestion, and to the people at Richard D. Irwin, Inc., for implementing it.

Finally, I thank my family lawyer for technical advice and encouragement.

*Harvey S. Rosen*

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