



Public Finance

A Contemporary Application of Theory to Policy

David N. Hyman

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DAVID N. HYMAN

North Carolina State University

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PREFACE

The fifth edition of *Public Finance: A Contemporary Application of Theory to Policy* has been revised to help focus on emerging fiscal issues of the next century. The textbook continues its comprehensive treatment of economic theory and applications in the field of public finance. Institutional material is integrated with the theory and applied to current issues, emphasizing microeconomic analysis of government functions, expenditures, and finance.

International issues are achieving greater significance in public finance. To provide resources on global issues, each chapter of this textbook has a separate *International View* feature that provides information or analysis on fiscal issues in other nations or explains how increased integration of the U.S. economy into a vast global economy affects economic policy. Each chapter also contains a *Public Policy Perspective* that applies the text analysis to a current issue and provides facts on the U.S. public sector.

This book is adapted easily to a variety of approaches to teaching public finance and incorporates detailed analyses of both expenditure and revenue aspects of public finance. I also provide an abundance of real-world examples and data to provoke students' interest, presenting an unbiased exposition of the field of public finance by discussing opposing views of important issues.

CHANGES IN THIS EDITION

The fifth edition has been extensively updated and revised. Gross domestic product, as opposed to gross national product, is now used to compute ratios showing the share of government in the economy. Many of the *International Views* and *Public Policy Perspectives* have been updated, and several are new, added to highlight current issues.

Changes in public policy regarding government assistance to the poor, Social Security, health benefits, and taxation also are reflected in the revised text. Social Security is now the single most important federal government program, having surpassed

national defense in 1993 for the first time. The revision of the book reflects the continued growth of Social Security and other entitlement programs in the United States by providing up-to-date analysis of these programs. The analysis of income support programs now includes a section on the newly expanded Earned Income Tax Credit (EITC) as a means of subsidizing the working poor.

The analysis of Social Security pensions highlights problems associated with aging populations. Chapter 8 has been thoroughly updated to reflect changes in the Social Security and tax law. It includes analysis of the privatization of Social Security systems to deal with problems induced by aging of the population under pay-as-you-go systems. Coverage of intergenerational and distributive effects of Social Security are better highlighted in this new edition. The discussion of the Medicare program has been condensed and much of the more detailed analysis of problems of the Medicare system is now in Chapter 9, integrated with analysis of health care policy.

The chapter on government and health care (Chapter 9) has been revised and reorganized to provide more analysis of the peculiarities of the market for health care services in the United States. Basic supply and demand analysis is used to look at health care policy issues from an economic perspective. Although recent proposals for reform are considered, the goal of the chapter is to discuss issues in health care policy emphasizing the role of government in the financing and provision of health care. The analysis of trends in health care spending in the United States has been updated, and recent projections of future health care spending are presented. A new section on the impact of **asymmetric information** in the market for health care has been added, along with analysis of the effects of such information imperfections on the functioning of the market. The analysis of health insurance has been revised to include more analysis of risk. Supply-and-demand analysis is used to examine factors leading to inefficiency and high cost in health care markets. A new *Public Policy Perspective* examines why growing health care costs are an economic problem for the United States. New sections in this chapter analyze **Medicare** and **Medicaid**, along with recent trends in spending and policy for these existing government health insurance programs. A new section on health care reform has been added to the chapter to discuss issues and policies relating to the role of government in markets for health care and health insurance. Included in this section is analysis of universal coverage and gaps in U.S. health insurance coverage in the 1990s, along with analysis of universal entitlement systems, managed competition, and national health insurance.

The continued openness of the U.S. economy is reflected throughout the book via revision of many of the *International View* features to discuss recent international agreements under GATT and NAFTA. On the tax side, there is more analysis of taxation in foreign nations with particular emphasis on the use of the value-added tax in Europe, Canada, and other nations.

All the tax chapters have been updated to reflect changes in tax law since 1993 and recent empirical research on the economic effects of taxes. Chapter 12 has been revised to reflect changes in deficit reduction laws in the United States and recent trends in both the deficit and economic analysis of its effects. A new section on the effect of deficit finance on political equilibrium has been added. The analysis of the effects of the federal deficit on credit markets and national saving has been updated,

and a new section of the incidence of deficit finance has been added. The analysis of the national debt has been updated with the latest available data.

Chapter 14 has been extensively revised to reflect changes in the tax law in 1993. Analysis of taxable income, tax preferences, and tax rate structure has been updated to reflect rules prevailing in 1994. A new *Public Policy Perspective* uses estimates of effective average and marginal tax rates in 1994 to examine the progressivity of the federal income tax. The analysis of excess burden of tax preferences has been revised. Chapter 15 has been revised to reflect changes in the corporate income tax structure and rules enacted in 1993 and effective 1994.

SPECIAL FEATURES OF THIS BOOK

In addition to the boxed features that provide discussion of international issues and public policy, each chapter also has pedagogical features, including learning objectives and concept checks.

To facilitate learning, basic concepts are set in bold type when first introduced, and every chapter concludes with a summary, a list of important concepts, and a short “forward look” that explains the relationship between that chapter and those to follow. Also, each chapter contains ten questions for review. These questions are not problem sets; rather, they are designed to assist students in reviewing the material covered in the chapter by posing questions related to the major points or ideas developed in the text. Four problems are also included after the review questions. Each chapter has an annotated bibliography that offers suggestions for further reading and in-depth study. The bibliography should prove particularly useful in courses with assigned term papers. Liberal use is made of footnotes throughout the book to provide additional source material and to explain and document material. A glossary at the end of the book lists all important concepts in alphabetical order for easy reference.

I have attempted to make this book as self-contained as possible. The book can be used by students who have only minimal backgrounds in economics. Appendices to several chapters facilitate this process. For those weak in basic microeconomic theory, Chapter 1 includes an appendix that provides students with a handy source of reference for basic microeconomic tools, including concise and simple explanations of such concepts as indifference curves, income and substitution effects, consumer surplus, producer surplus, cost, and production theory. This appendix is not designed to provide class material, but it will aid students in understanding the analysis used throughout the book. In classroom testing of this textbook, my own students found the appendix to Chapter 1 a welcome addition to an intermediate-level economics course textbook.

More in-depth analysis of efficiency is provided in an appendix to Chapter 2, which uses Edgeworth-Bowley box diagrams to derive efficiency loci.

The appendix to Chapter 11 derives formulas for the excess burden of taxation and discusses the relevance of compensated demand and supply curves to tax analysis. The appendices to Chapters 2 and 11 are designed to cover more technical material and may easily be skipped without loss of continuity.

POSSIBLE COURSE OUTLINES

This book contains more material than could possibly be covered in a one-semester (or one-quarter) course in public finance. Individual instructors who teach one-semester courses will find enough material in this book to tailor such courses to their own particular needs and interests. Those who teach a two-semester sequence in the microeconomic aspects of public finance could cover Parts One and Two (the expenditure aspects of public finance) in the first semester and Parts Three, Four, and Five (government finance and fiscal federalism) in the second semester. Instructors who wish to teach the macroeconomic aspects of public finance easily could supplement the material in the text with excerpts from one of the many good macroeconomic books on the market.

I suggest four possible course outlines for a one-semester course, each outline having a particular emphasis. Instructors may adjust these outlines in accordance with their own preferences.

Outline 1: Basic Principles of Public Finance

For intermediate economics courses, with students who have had at least one course in basic microeconomic theory.

1. Chapters 1–5: The economic basis for government activity. Efficiency, market failure, externalities, public goods, public choice, and political equilibrium.
2. Chapters 10–12: Principles of government finance.
3. Chapters 14–17: Application of tax theory to tax policy.
4. Selections chosen from Chapters 6, 7, 8, 9, and 18: Topics in public policy or state and local finance, chosen as time permits and in accordance with the interests of the instructor.

Outline 2: The Functions of Government and Government Expenditure

For courses that specialize in public policy and government expenditure, with students who have had at least one course in economics.

1. Parts One and Two: The economic basis of government activity and application of that theory to selected policy issues.
2. Part Five: State and local government finance.

Outline 3: Tax Theory and Policy

For courses that emphasize taxation, with students who have had at least one course in economics.

1. Chapters 1–2: The functions of government and the concept of efficiency.
2. Chapters 10–17: Government finance, tax theory, and tax policy.

Outline 4: Public Policy

For courses in public affairs or public policy, with students who have had little or no background in economics.

1. Chapters 1–2: Efficiency, markets, and the economic basis for government activity.
2. Selections from Chapters 3–5: Chosen as appropriate to subject emphasis and backgrounds of students. The topics could include externalities, public goods, and political equilibrium.
3. Selections from Chapters 6–9: Issues in public policy. The instructor might wish to omit some of the more difficult sections in these chapters.
4. Chapter 10: Introduction to government finance.
5. Selections from Chapters 11–17: Topics in tax policy, chosen according to the extent to which the instructor wishes to cover the subject.
6. Selections from Chapter 18: Topics in fiscal federalism, chosen according to the objectives of the course. More difficult sections could be omitted.

ANCILLARY MATERIALS

Instructor's Manual/Test Bank

I have prepared a concise *Instructor's Manual/Test Bank* that has been completely revised for this fifth edition. It should be useful to instructors who wish to arrange their lecture notes so that they correspond to the text. The Instructor's Manual summarizes the instructional objectives of each chapter and offers suggestions for supplementing text materials and developing lectures. The Test Bank includes true/false, multiple-choice, and essay questions for each chapter. Answers to end-of-chapter problems appear in the Instructor's Manual.

Study Guide

A *Study Guide*, written by Michael Peddle, Northern Illinois University, includes a list of chapter objectives, problems, chapter summaries, and chapter review questions designed to help your students master topics you cover in class and to prepare for examinations. The "Issue in Brief" section in every chapter presents an application of material in the chapter and includes discussion questions.

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ABOUT THE AUTHOR

David N. Hyman, Professor of Economics at North Carolina State University, has taught both undergraduate and graduate courses in public finance there since 1969. Professor Hyman received his Ph.D. in Economics from Princeton University. He has held Woodrow Wilson, Earhart, and Ford Foundation fellowships and was a Fulbright senior research scholar in Italy in 1980. Professor Hyman is a member of the Academy of Outstanding Teachers at North Carolina State University and in 1982 received the Alumni Association Outstanding Teacher Award. He is the author of several widely used textbooks in economics and has published scholarly articles in the *National Tax Journal*, *Public Choice*, the *Journal of Economic Education*, and other respected academic journals. He is a referee for the *Public Finance Quarterly* and other scholarly publications.

Professor Hyman served the President's Council of Economic Advisers as a consultant under the Reagan administration and as a senior staff economist under the Bush administration. He has also been a guest scholar at the Brookings Institution and has worked as a government budget analyst and as an economist for the Board of Governors of the Federal Reserve System and the U.S. Comptroller of the Currency.

Professor Hyman is also a photographer whose palladium and platinum prints are in the permanent collection of the Corcoran Gallery of Art in Washington, D.C. His photographs have been exhibited by galleries and museums and have been published in art books and on the covers of several novels.

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