

# Brief Table of Contents

## P A R T Introduction

### 1

- 1 Public Finance and Attitudes toward Government 3
- 2 Government at a Glance 10

## P A R T Tools of Public Finance

### 2

- 3 Tools of Positive Analysis 25
- 4 Tools of Normative Analysis 37

## P A R T Analysis of Public Expenditure

### 3

- 5 Public Goods 61
- 6 Externalities 85
- 7 Political Economy 112
- 8 Income Redistribution: Conceptual Issues 142
- 9 Expenditure Programs for the Poor 162

10	Social Insurance I: Social Security and Unemployment Insurance	183
11	Social Insurance II: Health Care	205
12	Cost-Benefit Analysis	223

P A R T    A Framework for Tax Analysis

# 4

13	Taxation and Income Distribution	255
14	Taxation and Efficiency	284
15	Efficient and Equitable Taxation	308

P A R T    The United States Revenue System

# 5

16	The Personal Income Tax	337
17	Personal Taxation and Behavior	375
18	The Corporation Tax	400
19	Deficit Finance	424
20	Taxes on Consumption and Wealth	441

P A R T   **Multigovernment Public Finance**

---

# 6

21      **Public Finance in a Federal System**    471

**Appendix**    **Some Basic Microeconomics**    507

Glossary    529

Selected References    539

References    543

Author Index    559

Subject Index    565

# Table of Contents

## P A R T Introduction

---

### 1

- 1 Public Finance and Attitudes toward Government 3
  - Alternative Views of Government 4
    - Organic View 4
    - Mechanistic View 5
  - Viewpoint of This Book 6
  - Summary 7
  - Discussion Questions 8
  - Appendix: Doing Research in Public Finance 8

### 2

- 2 Government at a Glance 10
  - The Legal Framework 10
    - Federal Government 10
    - State and Local Governments 12
  - The Size of Government 12
    - Accounting Issues 13
    - Hidden Costs of Government 14
    - Some Numbers 15
  - Expenditures 16
  - Revenues 18
  - Our Agenda 20
  - Summary 20
  - Discussion Questions 21

## PART Tools of Public Finance

---

# 2

- 3 Tools of Positive Analysis 25
  - The Role of Theory 26
  - Methods of Empirical Analysis 29
    - Interviews 29
    - Experiments 29
    - Econometric Studies 31
  - Concluding Remarks 34
  - Summary 35
  - Discussion Questions 36
- 4 Tools of Normative Analysis 37
  - Welfare Economics 37
    - Pure Exchange Economy 38
    - Production Economy 43
  - The Fundamental Theorem of Welfare Economics 44
    - The Role of Fairness 46
  - Market Failure 49
    - Market Power 49
    - Nonexistence of Markets 50
    - Overview 51
  - Evaluation of Welfare Economics 52
  - Summary 53
  - Discussion Questions 53
  - Appendix: Consumer and Producer Surplus 55

## PART Analysis of Public Expenditure

---

# 3

- 5 Public Goods 61
  - Public Goods Defined 61
  - Efficient Provision of Public Goods 63
    - Public Good Case 65
    - The Free Rider Problem 69
  - The Privatization Debate 70
    - Public versus Private Provision 71
    - Public versus Private Production 72
  - National Defense 73

	Education	76
	What Do Expenditures for Public Education Accomplish?	79
	New Directions for Public Education	79
	Public Goods and Public Choice	81
	Summary	81
	Discussion Questions	82
	Appendix: Preference Revelation Mechanisms	83
<b>6</b>	Externalities	85
	The Nature of Externalities	86
	Graphical Analysis	87
	Implications	89
	Conclusion	92
	Private Responses to Externalities	92
	Mergers	92
	Social Conventions	92
	Public Responses to Externalities	93
	Taxes	93
	Subsidies	95
	Creating a Market	97
	Establish Property Rights	98
	Regulation	100
	Evaluation	102
	The US Response	102
	Market-Oriented Approaches	104
	Implications for Income Distribution	104
	Who Benefits?	104
	Who Bears the Costs?	105
	Positive Externalities	105
	A Cautionary Note	107
	Summary	109
	Discussion Questions	110
<b>7</b>	Political Economy	112
	Direct Democracy	113
	Unanimity Rules	113
	Majority Voting Rules	115
	Logrolling	119
	Arrow's Impossibility Theorem	122

	Representative Democracy	123
	Elected Politicians	124
	Public Employees	126
	Special Interests	129
	Other Actors	131
	Explaining Government Growth	132
	Bringing Government under Control	135
	Conclusions	139
	Summary	140
	Discussion Questions	140
<b>8</b>	<b>Income Redistribution: Conceptual Issues</b>	<b>142</b>
	Distribution of Income	143
	Interpreting Distributional Data	145
	Rationales for Income Redistribution	147
	Simple Utilitarianism	147
	The Maximin Criterion	150
	Pareto Efficient Income Redistribution	151
	Nonindividualistic Views	153
	Other Considerations	153
	Expenditure Incidence	154
	Estimating Effects on Relative Prices	155
	Public Goods	155
	Valuing In-Kind Transfers	156
	Conclusion	159
	Summary	160
	Discussion Questions	161
<b>9</b>	<b>Expenditure Programs for the Poor</b>	<b>162</b>
	A Quick Look at Welfare Spending	162
	Background: Welfare as We Knew It	163
	Income Maintenance and Work Incentives	164
	Welfare Dependence	168
	Two Possible Responses to the Incentive Problem	169
	The 1996 Welfare Reform	170
	The Earned Income Tax Credit	172
	Supplemental Security Income	173
	Medicaid	174
	Structure	175
	Has Medicaid Succeeded?	175
	Food Stamps and Child Nutrition	175
	Child Nutrition Programs	177

	Housing Assistance	177
	Programs to Enhance Earnings	178
	Education	178
	Employment and Job Training	179
	Have Welfare Programs Helped?	179
	Summary	181
	Discussion Questions	181
<b>10</b>	<b>Social Insurance I: Social Security and Unemployment Insurance</b>	<b>183</b>
	Why Have Social Insurance?	184
	Adverse Selection	184
	Other Justifications	185
	Structure of Social Security	186
	Basic Components	186
	Distributional Issues	189
	Economic Status of the Aged	192
	Effects on Economic Behavior	192
	Saving Behavior	193
	Retirement Decisions	194
	Implications	195
	Long-Term Stresses on Social Security	195
	Social Security Reform	196
	Fiddle with the Current System	196
	Privatize the System	197
	Unemployment Insurance	199
	Benefits	200
	Financing	200
	Effects on Unemployment	201
	Conclusions	202
	Summary	203
	Discussion Questions	203
<b>11</b>	<b>Social Insurance II: Health Care</b>	<b>205</b>
	What's Special About Health Care?	205
	The US Health Care Market	208
	Private Insurance	208
	The Role of Government	210
	Medicare	210
	The Implicit Subsidy for Health Insurance	213



	The Twin Issues: Access and Cost	214
	Access	214
	Cost	215
	Should Government's Role in Health Care Increase?	218
	Individual Mandates	218
	Single Payer	218
	Managed Competition	219
	Current State of the Debate	220
	Summary	221
	Discussion Questions	222
12	Cost-Benefit Analysis	223
	Present Value	224
	Inflation	225
	Private Sector Project Evaluation	227
	Internal Rate of Return	228
	Benefit-Cost Ratio	229
	Public Sector Discount Rate	230
	Rates Based on Returns in the Private Sector	231
	Social Discount Rate	231
	Valuing Public Benefits and Costs	233
	Market Prices	233
	Adjusted Market Prices	234
	Consumer Surplus	235
	Inferences from Economic Behavior	236
	Valuing Intangibles	239
	Some Pitfalls	240
	The Chain-Reaction Game	240
	The Labor Game	240
	The Double-Counting Game	241
	Distributional Considerations	241
	Uncertainty	242
	An Application	243
	Discount Rate	244
	Costs	244
	Benefits	245
	Comments	246
	Use by Government	247
	Summary	248
	Discussion Questions	249
	Appendix: Calculating the Certainty Equivalent Value	250

# PART A Framework for Tax Analysis

---

## 4

13	Taxation and Income Distribution	255
	Tax Incidence: General Remarks	256
	Only People Can Bear Taxes	256
	Both Sources and Uses of Income Should Be Considered	257
	Incidence Depends on How Prices Are Determined	257
	Incidence Depends on the Disposition of Tax Revenues	258
	Tax Progressiveness Can Be Measured in Several Ways	258
	Partial Equilibrium Models	260
	Unit Taxes on Commodities	260
	Ad Valorem Taxes	265
	Taxes on Factors	266
	Commodity Taxation without Competition	268
	Profits Taxes	271
	Tax Incidence and Capitalization	272
	General Equilibrium Models	273
	Tax Equivalence Relations	274
	The Harberger Model	275
	Analysis of Various Taxes	276
	Some Qualifications	279
	An Applied Incidence Study	280
	Conclusions	281
	Summary	282
	Discussion Questions	282
14	Taxation and Efficiency	284
	Excess Burden Defined	285
	Questions and Answers	288
	Excess Burden Measurement with Demand Curves	292
	Preexisting Distortions	295
	The Excess Burden of a Subsidy	295
	The Excess Burden of Income Taxation	297
	Differential Taxation of Inputs	300
	Does Efficient Taxation Matter?	303
	Summary	303
	Discussion Questions	304
	Appendix A: Formula for Excess Burden	305
	Appendix B: Multiple Taxes and the Theory of the Second Best	306

15	Efficient and Equitable Taxation	308
	Optimal Commodity Taxation	308
	The Ramsey Rule	310
	Equity Considerations	313
	Overview	314
	Application to Taxation of the Family	314
	Optimal User Fees	315
	Overview	318
	Optimal Income Taxation	318
	Edgeworth's Model	318
	Modern Studies	319
	Politics and the Time Inconsistency Problem	322
	Other Criteria for Tax Design	323
	Horizontal Equity	323
	Costs of Running the Tax System	326
	Tax Evasion	327
	Overview	333
	Summary	333
	Discussion Questions	334

## P A R T The United States Revenue System

# 5

16	The Personal Income Tax	337
	Basic Structure	337
	Defining Income	338
	Items Included in H-S Income	340
	Some Practical and Conceptual Problems	341
	Evaluating the H-S Criterion	341
	Excludable Forms of Money Income	343
	Interest on State and Local Bonds	343
	Capital Gains	344
	Employer Contributions to Benefit Plans	347
	Some Types of Saving	347
	Gifts and Inheritances	348
	Exemptions and Deductions	348
	Exemptions	348
	Deductions	349
	Impact on the Tax Base	355
	Tax Expenditures	355
	The Simplicity Issue	357

	Rate Structure	358
	Rates under the AMT	360
	Effective versus Statutory Rates	361
	Choice of Unit and the Marriage Tax	363
	Background	363
	Analysis of the Marriage Tax	365
	Taxes and Inflation	366
	How Inflation Can Affect Taxes	366
	Coping with the Tax/Inflation Problem	368
	Treatment of International Income	369
	State Income Taxes	371
	Politics and Tax Reform	371
	Summary	372
	Discussion Questions	373
17	Personal Taxation and Behavior	375
	Labor Supply	376
	Theoretical Considerations	376
	Empirical Findings	379
	Some Caveats	380
	Labor Supply and Tax Revenues	382
	Overview	385
	Saving	385
	Econometric Studies of Saving	392
	Impact of Tax-Preferred Savings Accounts	392
	Taxes and the Capital Shortage	393
	Housing Decisions	394
	Proposals for Change	396
	Portfolio Composition	397
	A Note on Politics and Elasticities	398
	Summary	399
	Discussion Questions	399
18	The Corporation Tax	400
	Why Tax Corporations?	400
	Structure	401
	Employee Compensation Deducted	402
	Interest, but Not Dividends, Deducted	402
	Depreciation Deducted	402
	No Investment Tax Credit	404
	Treatment of Dividends versus Retained Earnings	404
	Effective Tax Rate on Corporate Capital	405

	Incidence and Excess Burden	405
	A Tax on Corporate Capital	406
	A Tax on Economic Profits	407
	Effects on Behavior	408
	Total Physical Investment	408
	Types of Asset	412
	Corporate Finance	412
	State Corporation Taxes	415
	Taxation of Multinational Corporations	416
	Evaluation	417
	Corporation Tax Reform	420
	Nature of the Corporation	420
	Administrative Feasibility	421
	Effects on Efficiency	421
	Effects on Saving	422
	Effects on the Distribution of Income	422
	Overview	422
	Summary	422
	Discussion Questions	423
<b>19</b>	<b>Deficit Finance</b>	<b>424</b>
	The Size of the Debt	424
	Interpreting Deficit and Debt Numbers	426
	Summing Up	429
	The Burden of the Debt	430
	Lerner's View	430
	An Overlapping Generations Model	431
	Neoclassical Model	433
	Ricardian Model	434
	Overview	435
	To Tax or to Borrow?	435
	Benefits-Received Principle	436
	Intergenerational Equity	436
	Efficiency Considerations	436
	Macroeconomic Considerations	437
	Moral and Political Considerations	438
	Overview	438
	Summary	439
	Discussion Questions	440

<b>20</b>	<b>Taxes on Consumption and Wealth</b>	<b>441</b>
	Retail Sales Tax	441
	Rationalizations	442
	Efficiency and Distributional Implications	444
	A National Retail Sales Tax?	445
	Transitional Issues	446
	Value-Added Tax	446
	Implementation Issues	447
	A VAT for the United States?	448
	Hall-Rabushka Flat Tax	450
	Cash-Flow Tax	451
	Efficiency and Fairness of Personal	
	Consumption Taxes	452
	Efficiency Issues	452
	Equity Issues	453
	Income versus Consumption Taxation	456
	Wealth Taxes	459
	Why Tax Wealth?	459
	Estate and Gift Taxes	460
	Rationalizations	461
	Provisions	463
	Reforming Estate and Gift Taxes	466
	Summary	466
	Discussion Questions	467

## **P A R T** **Multigovernment Public Finance**

# **6**

<b>21</b>	<b>Public Finance in a Federal System</b>	<b>471</b>
	Background	472
	Community Formation	473
	The Tiebout Model	475
	Tiebout's Assumptions	476
	Tiebout and the Real World	478
	Optimal Federalism	478
	Disadvantages of a Decentralized System	479
	Advantages of a Decentralized System	481
	Implications	483
	Public Education in a Federal System	484
	Federalism and the Urban Crisis	485

Property Tax	486
Incidence and Efficiency Effects	487
Why Do People Hate the Property Tax So Much?	493
Intergovernmental Grants	495
Types of Grants	497
The Flypaper Effect	502
Application: The 1996 Welfare Reform	503
Intergovernmental Grants for Education	503
Overview	504
Summary	505
Discussion Questions	505

## **Appendix**     Some Basic Microeconomics     507

Glossary	529
Selected References	539
References	543
Author Index	559
Subject Index	565