

PUBLIC FINANCE

TENTH EDITION

Harvey S. Rosen
Princeton University

Ted Gayer
Brookings Institution

Abdülkadir Civan
Gediz University

Mc
Graw
Hill
Education

Brief Table of Contents

Part I

GETTING STARTED 1

- 1 Introduction 2
- 2 Tools of Positive Analysis 18
- 3 Tools of Normative Analysis 34

Part II

PUBLIC EXPENDITURE: PUBLIC GOODS AND EXTERNALITIES 53

- 4 Public Goods 54
- 5 Externalities 73
- 6 Political Economy 108
- 7 Education 132
- 8 Cost-Benefit Analysis 147

Part III

PUBLIC EXPENDITURE: SOCIAL INSURANCE AND INCOME MAINTENANCE 175

- 9 The Health Care Market 176
- 10 Government and the Market for Health Care 201
- 11 Social Security 222
- 12 Income Redistribution: Conceptual Issues 251
- 13 Expenditure Programs for the Poor 270

Part IV

FRAMEWORK FOR TAX ANALYSIS 295

- 14 Taxation and Income Distribution 296
- 15 Taxation and Efficiency 324
- 16 Efficient and Equitable Taxation 347

Part V

THE UNITED STATES REVENUE SYSTEM 373

- 17 The Personal Income Tax 374
- 18 Personal Taxation and Behavior 407
- 19 The Corporation Tax 430
- 20 Deficit Finance 452
- 21 Fundamental Tax Reform: Taxes on Consumption and Wealth 470

Part VI

MULTIGOVERNMENT PUBLIC FINANCE 497

- 22 Public Finance in a Federal System 498

Appendix 528

Glossary 550

References 559

Name Index 575

Subject Index 579

Table of Contents

Part I

GETTING STARTED 1

CHAPTER 1 INTRODUCTION 2

- Public Finance and Ideology 3
 - Organic View of Government 3
 - Mechanistic View of Government 4
 - Viewpoint of This Book 5
- Government at a Glance 5
 - The Legal Framework 6
 - The Size of Government 8
 - Expenditures 10
 - Revenues 11
 - Our Agenda 13
- Summary 13
- Discussion Questions 14
- Appendix: Doing Research in Public Finance 16

CHAPTER 2 TOOLS OF POSITIVE ANALYSIS 18

- The Role of Theory 18
- Causation versus Correlation 20
- Experimental Studies 21
 - Conducting an Experimental Study 22
 - Pitfalls of Experimental Studies 23
- Observational Studies 24
 - Conducting an Observational Study 25
 - Pitfalls of Observational Studies 26
- Quasi-Experimental Studies 27
 - Conducting a Quasi-Experimental Study 28
 - Pitfalls of Quasi-Experimental Studies 30
- Conclusions 31
- Summary 31
- Discussion Questions 32

CHAPTER 3 TOOLS OF NORMATIVE ANALYSIS 34

- Welfare Economics 34
 - Pure Economy Exchange 34
 - Production Economy 39

- The First Fundamental Theorem of Welfare Economics 41
- Fairness and the Second Fundamental Theorem of Welfare Economics 42
- Market Failure 46
 - Market Power 46
 - Nonexistence of Markets 47
 - Overview 48
- Buying into Welfare Economics 48
- Summary 50
- Discussion Questions 50

Part II

PUBLIC EXPENDITURE: PUBLIC GOODS AND EXTERNALITIES 53

CHAPTER 4 PUBLIC GOODS 54

- Public Goods Defined 54
- Efficient Provision of Public Goods 56
 - Deriving the Efficiency Condition 58
 - Problems in Achieving Efficiency 61
 - The Free Rider Problem 63
- Privatization 64
 - Public versus Private Provision 64
 - Public versus Private Production 65
- Public Goods and Public Choice 68
- Summary 69
- Discussion Questions 69
- Appendix: Preference Revelation Mechanisms 71

CHAPTER 5 EXTERNALITIES 73

- The Nature of Externalities 74
- Graphical Analysis 76
 - Implications 77
 - Conclusion 81
- Private Responses 81
 - Bargaining and the Coase Theorem 81
 - Mergers 83
 - Social Conventions 83

Public Responses to Externalities: Taxes and Subsidies 84

Taxes 84

Subsidies 85

Public Responses to Externalities: Emissions Fees and Cap-and-Trade Programs 87

Emissions Fee 88

Cap-and-Trade 91

Emissions Fee versus Cap-and-Trade 93

Command-and-Control Regulation 97

The Us Response 99

Progress with Incentive-Based Approaches 100

Implications for Income Distribution 101

Who Benefits? 101

Who Bears the Cost? 102

Positive Externalities 103

A Cautionary Note 104

Summary 105**Discussion Questions 105****CHAPTER 6****POLITICAL ECONOMY 108****Direct Democracy 108**

Unanimity Rules 109

Majority Voting Rules 110

Logrolling 114

Arrow's Impossibility Theorem 116

Representative Democracy 117

Elected Politicians 118

Public Employees 120

Special Interests 121

Other Actors 125

Explaining Government Growth 126

Conclusion 129

Summary 129**Discussion Questions 130****CHAPTER 7****EDUCATION 132****Justifying Government Intervention in Education 133**

Is Education a Public Good? 133

Does Education Generate Positive Externalities? 133

Is the Education Market Inequitable? 135

What Can Government Intervention in Education Accomplish? 136

Does Government Intervention Crowd Out Private Education? 136

Does Government Spending Improve Educational Outcomes? 137

Public Spending and the Quality of Education 139

Does Education Increase Earnings? 140

New Directions for Public Education 141

Charter Schools 142

Vouchers 142

School Accountability 144

Summary 145**Discussion Questions 146****CHAPTER 8****COST-BENEFIT ANALYSIS 147****Present Value 147**

Projecting Present Dollars into the Future 148

Projecting Future Dollars into the Present 148

Inflation 149

Private Sector Project Evaluation 150

Internal Rate of Return 152

Benefit-Cost Ratio 153

Discount Rate for Government Projects 154

Rates Based on Returns in the Private Sector 154

Social Discount Rate 155

Discounting and the Economics of Climate Change 156

Government Discounting in Practice 156

Valuing Public Benefits And Costs 157

Market Prices 157

Adjusted Market Prices 158

Consumer Surplus 159

Inferences from Economic Behavior 160

Valuing Intangibles 163

Games Cost-Benefit Analysts Play 163

The Chain-Reaction Game 163

The Labor Game 164

The Double-Counting Game 164

Distributional Considerations 164**Uncertainty 165****An Application: Are Reductions in Class Size Worth It? 166**

Discount Rate 167

Costs 167

Benefits 167

The Bottom Line and Evaluation 168

Use (and Nonuse) by Government	169
Summary	170
Discussion Questions	171
Appendix: Calculating the Certainty Equivalent Value	173

Part III

PUBLIC EXPENDITURE: SOCIAL INSURANCE AND INCOME MAINTENANCE 175

CHAPTER 9

THE HEALTH CARE MARKET 176

What's Special about Health Care? 176

The Role of Insurance	176
The Role of Risk Pooling	182
Adverse Selection in the Health Insurance Market	182
Insurance and Moral Hazard	186
Other Information Problems in the Health Care Market	191
Externalities of Health Care	192

Do We Want Efficient Provision of Health Care? 192

Paternalism	192
The Problem of the Uninsured	192
High Health Care Costs	195

Summary 198

Discussion Questions 199

CHAPTER 10

GOVERNMENT AND THE MARKET FOR HEALTH CARE 201

Private Health Insurance 202

The Implicit Subsidy for Employer-Provided Insurance	202
The Advantages of Employer-Provided Health Insurance	204
Employer-Provided Health Insurance and Job Lock	205
Cost Control and Private Insurance	205

Government Provision of Health Insurance:

Medicare and Medicaid 206

Medicare: Overview	206
Cost Control under Medicare	209
Medicare: Impacts on Spending and Health	211
Medicaid: Overview	212
Medicaid: Impacts on Health	213

Affordable Care Act of 2010 215

Alternative Paths to Health Care Reform	216
Single-Payer Approach	216
Market-Oriented Approach	218
Final Thoughts	219

Summary 220

Discussion Questions 220

CHAPTER 11

SOCIAL SECURITY 222

Why Have Social Security? 223

Consumption Smoothing and the Annuity Market	223
Adverse Selection and the Annuity Market	223
Other Justifications	224

Structure of Social Security 226

Basic Components	226
Distributional Issues	230
The Trust Fund	234

Effects of Social Security on Economic Behavior 235

Saving Behavior	235
Retirement Decisions	240
Implications	241

Long-Term Stresses on Social Security 241

Social Security Reform 243

Maintain the Current System	243
Privatize the System	245

Conclusions 248

Summary 248

Discussion Questions 249

CHAPTER 12

INCOME REDISTRIBUTION: CONCEPTUAL ISSUES 251

Distribution of Income 252

Interpreting the Distributional Data	253
--------------------------------------	-----

Rationales for Income Redistribution 256

Simple Utilitarianism	256
The Maximin Criterion	259
Pareto Efficient Income Redistribution	260
Nonindividualistic Views	261
Other Considerations	262

Expenditure Incidence 263

Relative Price Effects	263
Public Goods	264

Valuing In-Kind Transfers	264
Reasons for In-Kind Transfers	267
Conclusion	268
Summary	268
Discussion Questions	268
CHAPTER 13	
EXPENDITURE PROGRAMS	
FOR THE POOR	270
A Quick Look at Welfare Spending	270
TANF	271
Income Maintenance and Work Incentives	272
The Basic Trade-Offs	272
Analysis of Work Incentives	273
Work Requirements	278
Time Limits	279
Family Structure	279
National versus State Administration	279
The Earned Income Tax Credit	280
Supplemental Security Income	282
Medicaid	283
Unemployment Insurance	284
Benefits	285
Financing	285
Effects on Unemployment	285
Supplemental Nutrition Assistance Program (SNAP)	287
Housing Assistance	288
Programs to Enhance Earnings	289
Education	289
Employment and Job Training	290
Overview	290
Summary	292
Discussion Questions	293

Part IV

FRAMEWORK FOR TAX ANALYSIS 295

CHAPTER 14	
TAXATION AND INCOME	
DISTRIBUTION	296
Tax Incidence: General Remarks	297
Only People Can Bear Taxes	297
Both Sources and Uses of Income Should Be Considered	298
Incidence Depends on How Prices Are Determined	298

Incidence Depends on the Disposition of Tax Revenues	298
Tax Progressiveness Can Be Measured in Several Ways	299
Partial Equilibrium Models	301
Unit Taxes on Commodities	301
Ad Valorem Taxes	305
Taxes on Factors	307
Commodity Taxation without Competition	309
Profits Taxes	311
Tax Incidence and Capitalization	312
General Equilibrium Models	313
Tax Equivalence Relations	313
The Harberger Model	315
Analysis of Various Taxes	316
Some Qualifications	318
An Applied Incidence Study	319
Conclusions	320
Summary	321
Discussion Questions	321

CHAPTER 15	
TAXATION AND EFFICIENCY	324
Excess Burden Defined	325
Questions and Answers	328
Excess Burden Measurement with Demand Curves	332
Preexisting Distortions	334
The Excess Burden of a Subsidy	335
The Excess Burden of Income Taxation	336
Differential Taxation of Inputs	338
Does Efficient Taxation Matter?	341
Summary	342
Discussion Questions	342
Appendix A: Formula for Excess Burden	344
Appendix B: Multiple Taxes and the Theory of the Second Best	345

CHAPTER 16	
EFFICIENT AND EQUITABLE	
TAXATION	347
Optimal Commodity Taxation	347
The Ramsey Rule	348
Equity Considerations	351
Summary	352
Application: Taxation of the Family	352
Optimal User Fees	353

Overview	356
Optimal Income Taxation	356
Edgeworth's Model	356
Modern Studies	357
Politics and the Time Inconsistency Problem	358
Other Criteria for Tax Design	360
Horizontal Equity	360
Costs of Running the Tax System	362
Tax Evasion	363
Overview	369
Summary	370
Discussion Questions	370

Part V

THE UNITED STATES REVENUE SYSTEM 373

CHAPTER 17 THE PERSONAL INCOME TAX 374

Basic Structure	374
Defining Income	376
Items Included in H-S Income	376
Some Practical and Conceptual Problems	377
Evaluating the H-S Criterion	378
Excluded Forms of Money Income	379
Interest on State and Local Bonds	379
Some Dividends	380
Capital Gains	380
Employer Contributions to Benefit Plans	383
Some Types of Saving	383
Gifts and Inheritances	384
Exemptions and Deductions	384
Exemptions	384
Deductions	385
Impact on the Tax Base	391
Tax Expenditures	391
The Simplicity Issue	392
Rate Structure	392
Effective versus Statutory Rates	394
Taxes and Inflation	395
How Inflation Affects Taxes	396
Tax Indexing	397
The Alternative Minimum Tax	398
Choice of Unit and the Marriage Tax	399
Background	399

Analyzing the Marriage Tax	402
Treatment of International Income	403
State Income Taxes	404
Summary	405
Discussion Questions	405

CHAPTER 18 PERSONAL TAXATION AND BEHAVIOR 407

Labor Supply	407
Theoretical Considerations	408
Some Caveats	411
Labor Supply and Tax Revenues	414
Saving	416
Tax-Preferred Savings Accounts	422
Taxes and the Capital Shortage	423
Housing Decisions	424
Proposals for Change	425
Portfolio Composition	426
A Note on Politics and Elasticities	427
Summary	428
Discussion Questions	428

CHAPTER 19 THE CORPORATION TAX 430

Why Tax Corporations?	430
Structure	431
Employee Compensation Deducted	431
Interest, but Not Dividends, Deducted	431
Depreciation Deducted	432
Investment Tax Credit	434
Treatment of Dividends versus Retained Earnings	434
Effective Tax Rate on Corporate Capital	435
Incidence and Excess Burden	435
A Tax on Corporate Capital	435
A Tax on Economic Profits	436
Effects on Behavior	437
Total Physical Investment	437
Types of Assets	440
Corporate Finance	440
State Corporation Taxes	443
Taxation of Multinational Corporations	443
Global versus Territorial Taxation	445
Corporation Tax Reform	446
Full Integration	447

Dividend Relief 448
 Summary 449
 Discussion Questions 450

CHAPTER 20
DEFICIT FINANCE 452

How Big Is the Debt? 452
 Interpreting Deficit and Debt Numbers 453
 Summing Up 456
The Burden of the Debt 456
 One Hand Borrows from the Other 457
 An Overlapping Generations Model 457
 Neoclassical Model 459
 Ricardian Model 461
 Overview 461
To Tax or to Borrow? 462
 Benefits-Received Principle 462
 Intergenerational Equity 462
 Efficiency Considerations 462
 Deficits and Functional Finance 463
 Federal Debt and the Risk of a Fiscal Crisis 464
 Moral and Political Considerations 465
 Controlling the Deficit 465
Overview 467
Summary 468
Discussion Questions 468

CHAPTER 21
FUNDAMENTAL TAX REFORM: TAXES ON CONSUMPTION AND WEALTH 470

Efficiency and Equity of Personal Consumption Taxes 470
 Efficiency Issues 471
 Equity Issues 472
Retail Sales Tax 475
 Rationalizations 476
 Efficiency and Distributional Implications of State Sales Taxes 477
 A National Retail Sales Tax? 478
Value-Added Tax 479
 Implementation Issues 480
 A VAT for the United States? 480
Hall-Rabushka Flat Tax 482
Cash-Flow Tax 483
Income versus Consumption Taxation 484
 Advantages of a Consumption Tax 484
 Disadvantages of a Consumption Tax 485

Problems with Both Systems 486
Wealth Taxes 487
Estate and Gift Taxes 488
 Rationales 488
 Provisions 490
 Reforming Estate and Gift Taxes 493
Prospects for Fundamental Tax Reform 494
Summary 494
Discussion Questions 495

Part VI
MULTIGOVERNMENT PUBLIC FINANCE 497

CHAPTER 22
PUBLIC FINANCE IN A FEDERAL SYSTEM 498

Background 499
Community Formation 500
The Tiebout Model 501
 Tiebout's Assumptions 502
 Tiebout and the Real World 504
Optimal Federalism 504
 Disadvantages of a Decentralized System 505
 Advantages of a Decentralized System 507
 Implications 509
 Public Education in a Federal System 510
Property Tax 511
 Incidence and Efficiency Effects 512
 Why Do People Hate the Property Tax So Much? 517
Intergovernmental Grants 518
 Types of Grants 520
 The Flypaper Effect 524
Overview 525
Summary 525
Discussion Questions 526

APPENDIX:
SOME BASIC MICROECONOMICS 528

GLOSSARY 550

REFERENCES 559

NAME INDEX 575

SUBJECT INDEX 579