

Cambridge University Press

978-0-521-73805-7 - Public Finance and Public Policy: Responsibilities and Limitations of Government: Second Edition

Arye L. Hillman

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Public Finance and Public Policy

Responsibilities and Limitations of Government: Second Edition

This book is the second edition of *Public Finance and Public Policy* (2003). The second edition retains the first edition's themes of investigation of responsibilities and limitations of government but has been rewritten and restructured. Public-choice and political-economy concepts and political and bureaucratic principal-agent problems that are the sources of limitations on government are introduced at the beginning for application to later topics. Concepts of behavioral economics and experimental results are integrated throughout this edition. Asymmetric information is a recurring theme. The book begins with the efficiency case for the competitive market and the minimal responsibility of government to ensure the rule of law. Subsequent chapters address questions concerning institutions and governance, public goods, taxation and bond financing of public spending, market corrections (externalities and paternalist public policies), voting, social justice, entitlements, and choice of the structure of taxation and the tax base. The final chapter summarizes evidence on and reasons for the growth of government and considers how trust or social capital affects the need for government. The purpose of the book is to provide an accessible introduction to the choice between relying only on personal decisions in markets and the use of public finance and public policy by governments to improve on market outcomes.

Arye L. Hillman is William Gittes Professor of Economics at Bar-Ilan University in Israel. He has taught at Princeton University, the University of California in Los Angeles, and Australian National University and has been an invited lecturer at universities in various countries. Professor Hillman received his Ph.D. in economics from the University of Pennsylvania. His professional research includes studies under the auspices of the International Monetary Fund and the World Bank. He is a former president of the European Public Choice Society. Professor Hillman was jointly awarded the Max Planck Prize in Economics for his contributions to political economy.

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ADDITIONAL PRAISE FOR *PUBLIC FINANCE AND PUBLIC POLICY*,
Second Edition

“This book provides a comprehensive and accessible account of the core issues in public finance and public policy. Although designed as a textbook, the book is also an organizing guide for practitioners and policymakers, who will find particularly useful the application of concepts to issues in income support and work incentives, education, health care, and the choice between tax financing and user prices.”

– Sanjeev Gupta, *Fiscal Affairs Department*,
International Monetary Fund, Washington, DC

“This fascinating book provides a clear account of the role of government through public finance and public policy. It gives a balanced and insightful analysis of the scope and limits of what government can and should do. Students will like the clear exposition, and researchers will benefit from the book as a reference volume.”

– Kai Konrad, *Max Planck Institute for Intellectual Property, Competition and Tax Law, Munich*

“This book is a gem. It brings alive the topics of public finance. The book is an extraordinary piece of work that enables students to achieve a balanced overview of market failures and government failures and thereby gain mature insight into desirable interactions between the market and the state. Teachers and students will benefit from this major achievement for years to come, making this book a classic.”

– Dennis Snower, *Kiel Institute for the World Economy and Christian-Albrechts University, Kiel*

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For Jeannette

*Tamara and Yitzi; Ilana and Hovav; Nachman Eliyahu and Galit,
Benjamin and Yael*

*Dafna, Yishai, Mayan, Ya'ara, Dov, Ze'ev, Shani, Lior, Hallel, Harel, Raphael,
Michal, Eyal, Ronni, Eliashiv, Eitan, and Libbi, and the others*

In memory of my parents, for whom good government allowed a new beginning.
In memory of my brothers and my sister and all the other children.

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From Sayings of the Fathers

The Individual and Social Justice

If I am not for myself, then who will be for me?
And if I am only for myself, then what am I?
And if not now, when?

*Hillel, 110 BCE – 20 CE**

The Individual and the Dilemma of Government

Pray for the peace of the government; for, except for the fear of that, we
should have swallowed each other alive.

R. Hanina, born around the year 20 CE

Be cautious with the government, for they do not make advances to a man
except for their own need. They seem like friends in the hour of their advantage,
but they do not stand by a man in his hour of adversity.

Rabban Gamliel, around the year 230 CE

* *BCE and CE* are universal ways of indicating dates. *BCE* indicates before the Common Era of counting and *CE* indicates the Common Era.

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Preface to the Second Edition

This book, a treatise on markets and governments, is presented as a text on public finance and public policy. The exposition incorporates concepts of public choice and political economy (which are, in large part, equivalent), as well as concepts and evidence from behavioral economics. Elements of moral philosophy are present, beginning with Adam Smith's description of virtue through personal behavior in markets and how perceptions of human nature affect views on the need for government. The book covers the basic topics of a course in public finance or public economics, or a course in the political economy of markets and governments.

The focus of the book is the achievement, whether through markets or the public finance and public policy of governments, of the social objectives of efficiency and social justice. There are objective criteria for efficiency. Social justice can be defined in different ways, as the natural right of possession, equality of opportunity, or ex-post equality of incomes after redistribution. Ideology can influence choice of the definition of social justice.

The book describes feasible policies. In particular, governments do not use lump-sum taxes. From the outset societies are shown to confront choices between the objectives of efficiency and equality.

This second edition retains the themes of the first edition. Although the themes are the same, the book has been rewritten and restructured. The objective retained from the first edition is to make ideas accessible. Economics can explain and enlighten. Yet, it is a curiosity of contemporary academic economic writings that an idea is often given more applause when the presentation is made arcane and inaccessible. This book presents in an accessible way the topics that arise when governments are called on to improve market outcomes. The book is the product of an ongoing inquiry – proceeding beyond the first edition – into the political economy of markets and government. The line of inquiry in this book has origins in my previous investigations focusing on the political economy of protection: the investigation of why governments prevent free trade is a beginning for the broader questions about markets and governments that are the topics of this book.

A course in intermediate microeconomics or price theory is a helpful prerequisite for using this book as a text, although an introductory course in economics is sufficient for many of the topics. A course in macroeconomics is not required. Questions to motivate discussion of the topics in each chapter are provided at

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the end of the book. For graduate students and professional readers, a guide to elaboration and more technical exposition of topics in the literature is provided at the end of each chapter.

Other than in setting out the historical perspective on the growth of government, the book does not present data on the composition of government budgets or the sources of government revenue. Such data differ, of course, among countries and also among states, cities, and localities that in fiscal-federal systems levy taxes, engage in public spending, and decide on public policies. The data, which change over time, are readily available from official sources. Issues involving data on government spending and sources of government revenue have been placed inside the topics for discussion. The topics may involve comparisons between government jurisdictions or may ask for contemporary descriptions of taxation, public spending, or public policy. The focus of the book is on ideas and concepts that will outlive the data applicable for any time – or for any place.

I thank Scott Parris of Cambridge University Press in New York for his confidence that a treatise on the need for and consequences of government could be an accessible textbook covering traditional topics of public finance and public policy.

I am thankful to the professors and instructors who chose the first edition of this book as the means for introducing students to the choice between markets and governments and for the support that took the first edition into three printings. The first edition was translated into Chinese by Wang Guohua and into Russian by Mark Levin. Toshihiro Ihori headed the team that translated the first edition into Japanese and provided insights that were incorporated into the second edition. Michael Brooks, Gene Gotwalt, and Heinrich Ursprung read the manuscript of the second edition and provided helpful suggestions. In preparing the second edition, I also benefited from helpful comments from Joel Guttman, Wolfgang Mayer, and Warren Young.