

Public Finance and Public Policy

A Political Economy Perspective on the
Responsibilities and Limitations of Government

Third Edition

Public Finance and Public Policy studies the responsibilities and limitations of government in a market economy. This third edition has been reorganized and fully updated, and features the same wealth of real-life examples and rigorous but accessible exposition of previous editions.

The traditional public-finance topics of public goods, externalities, unwanted markets, and asymmetric information are covered, and the quest for social justice is considered in terms of social insurance, moral hazard, and social mobility. Public choice concepts are applied to evaluating how politics affects societal efficiency and income distribution, and political economy is supplemented with behavioural concepts such as fairness, envy, and hyperbolic discounting. Empirical evidence is presented in detail, and the implications of experimental results are considered.

Suitable for advanced undergraduate and graduate students in economics, and students taking courses on public policy and government, this book offers an accessible introduction to the political economy of public finance and public policy without unnecessary technicality.

Arye Hillman's professional career has been spent as a professor of economics at Bar-Ilan University in Israel. He has been an invited professor and has taught at UCLA, Princeton, the University of Paris 1 (Panthéon-Sorbonne), the University of Freiburg, and the Australian National University, and has been an invited fellow of the Japanese Society for the Promotion of Science. He is a joint recipient with Heinrich Ursprung of the Max-Planck Prize for Humanities Sciences. He has an honorary doctorate from the University of Genoa. He has a BA (first-class honors and the University Medal) from the University of Newcastle NSW and a PhD in economics from the University of Pennsylvania.

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on the Responsibilities and
Limitations of Government

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For Jeannette

For the generations of our family

In memory of my parents for whom good government allowed a
new beginning

In memory of my siblings who I never knew and all the others

Themes

From the Ethics of the Fathers

If I am not for myself, who will be for me?

And if I am only for myself, what am I?

And if not now, when?

Hillel the Elder 110 BCE–10 CE

See also Adam Smith

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

R. Hanina, born around 20 CE

See also Thomas Hobbes

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 230 CE

See also Gordon Tullock

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Preface to the Third Edition

This book is a synthesis of public finance and public policy with political economy. This third edition has been reorganized, with updated literature and topics added, including political business cycles (interpreted as vote buying), motives for choosing to run for political office, and corruption. The book begins with Chapters 1 and 2 in Part I contrasting personal spending in markets with the financing of government. Part II (Chapters 3–6) sets out the traditional efficiency-related responsibilities of government (public goods; the missing markets of externalities; when or whether restraint on personal choice is justified) and also considers resolution of information limitations on public policy (preference-revelation mechanisms, cost–benefit analysis, and locational choice). Part III (Chapters 7–10) addresses questions of social justice. Social insurance is described as a public-policy response to failure of existence of insurance markets that would protect against inadequate income. “Optimal” taxation is investigated from a political-economy perspective. Social justice without government is also considered (social and economic mobility, charitable giving, and attitudes to fairness revealed in ultimatum, dictator, and power-to-take games). The rule of law is studied as a basic responsibility of government. Part IV (Chapters 11–14) introduces collective decisions and politics. A chapter on voting describes median-voter outcomes, logrolling, the common-pool problem of government revenue, and the role of checks and balances on majority voting. Politicized policies are described that affect efficiency and income distribution. The behavior of people in government is studied, as distinct from the effects of politics on policies. In Part V, a final chapter reviews the growth of government since Adam Smith and presents conclusions on the need for government. The core chapters provide policy examples of responsibilities and limitations of government; in addition, Appendix A applies concepts and conclusions to a wide range of public policies.

The formal structure of economic exposition is used. Deirdre McCloskey in *The Rhetoric of Economics*¹ observed that different economists use different forms of language to exposit economic concepts, ranging from descriptive to very technical. Formal analysis allows ideas to be set out with precision. There can, however, also be unnecessary technicality. Gordon Tullock, a principal founder of the public-choice school of political economy, proposed in *The Organization of Inquiry*² that excessive technicality is revealed by “very complex methods of

¹ (Madison, WI: University of Wisconsin Press, 1998).

² (Durham, NC: Duke University Press, 1996).

treating subjects which can be readily handled by simple methods.” This book avoids unnecessary technicality. Priority is given to understanding of ideas. Relevant concepts are explained from first principles, including Pareto efficiency, market and voting equilibria, principal–agent problems, Nash equilibrium, social mobility, moral hazard, adverse selection, the common-pool problem, and social justice. A clear distinction is maintained between “normative” and “positive” questions. Expositions that require extended technicality – such as general equilibrium including public goods, models of rent seeking, the model of collective action in quest of collective benefit, and the theory of political competition – are set out in Appendix B.

The past two editions of the book have been used in undergraduate economics classes and for postgraduate courses. For economics students, the book builds on a course in microeconomics or price theory. Because of beginnings from first principles, the book is also suitable for students in politics or government and international relations. The book has proved popular with students because of the simplicity and directness of exposition and the inclusion of real-life examples that make it clear that the subject matter is the world as it is. The topics of the book are important in all societies. Previous editions of the book have been translated into a number of languages. The line of enquiry has origins in my original investigations of the political economy of international trade policy: the question of why governments prevent or return to free trade is a conceptual beginning for the broader questions about the choice between markets and government that are addressed in this book.

Why a Book?

We live in an age of instantaneous access to information. We ask what we want and with the Internet at hand, an answer can be immediate. What, then, is the use of a book? A book has value because of the importance of choosing the questions to ask. The extensive literature amassed over the decades on public finance and public policy can be likened to a vast forest. When proposing questions of interest and suggesting answers, different paths through the forest can be taken. For questions about responsibilities and limitations of government, ideology can influence the path that is chosen. The influence of ideology can be implicit or, indeed, hidden with the unwritten premise that there are no competing ideologies but rather there is but one truth that needs to be told. This book identifies different possible ideologically influenced positions on markets and government. There is recognition that the “left” of the ideological spectrum is concerned about injustices of markets and emphasizes the ameliorative distributional role of government in being able to take from some people to give to others. On the “right,” the concern is that the monopoly of government on legal coercion can result in politicized policies that are self-benefiting for people in government and that diminish personal incentives to be productive. Influential past expositions of public finance and public policy have tended to present a single doctrinal view. Richard Musgrave in his influential book *Theory of Public*

*Finance: A Study in Public Economy*³ expounded a view that can be associated with the “left,” in particular through a proposed separation of efficiency and income-distribution objectives facilitated by lump-sum taxes that do not usually exist. Dennis Mueller’s book *Public Choice*⁴ set out public-choice concepts. Public choice is wary of government. Joseph Stiglitz’s book *Lectures on Public Economics*⁵ does not include a focus on public-choice concepts. Ideological differences can arise, for example, with regard to the magnitude of the excess burden of taxation as a social cost of government revenue, whether the Laffer curve “exists,” whether moral hazard or bad luck underlies lack of means of personal self-reliance, and whether governments and political decision makers can be influenced by re-election objectives and be susceptible to rent seeking and to catering to special interests.

I thank my students for pointing out where throughout the book clarification could be helpful and colleagues for comments on different topics. The literature cited reflects the geographic diversity of original contributors over time to topics in the book. Chapters or more so sections are intended to be self-contained. The references at the end of a chapter point to the origins of ideas and provide a guide for further reading. To provide sought continuity, material has often been added that was not previously covered in the literature. Questions for discussion after each chapter are designed for tutorial type interaction. Presentation files in Word for lectures are available on request, including all diagrams.

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³ (New York: McGraw-Hill, 1959).

⁴ (Cambridge University Press, 1979).

⁵ (New York: McGraw-Hill, 1980).