

# Chapter One

## INTRODUCTION

*Public Finance is nothing else than a sophisticated discussion of the relationship between the individual and the state. There is no better school of training than public finance.*

—FORMER CZECH PRIME MINISTER VACLAV KLAUS

The year is 1030 BC. For decades, the Israelite tribes have been living without a central government. The Bible records that the people have asked the prophet Samuel to “make us a king to judge us like all the nations” [1 Samuel 8:5]. Samuel tries to discourage the Israelites by describing what life will be like under a monarchy:

This will be the manner of the king that shall reign over you; he will take your sons, and appoint them unto him, for his chariots, and to be his horsemen; and they shall run before his chariots . . . And he will take your daughters to be perfumers, and to be cooks, and to be bakers. And he will take your fields, and your vineyards, and your oliveyards, even the best of them, and give them to his servants . . . He will take the tenth of your flocks; and ye shall be his servants. And ye shall cry out in that day because of your king whom ye shall have chosen [1 Samuel 8:11–18].

The Israelites are undeterred by this depressing scenario: “The people refused to hearken unto the voice of Samuel; and they said: ‘Nay; but there shall be a king over us; that we also may be like all the nations; and that our king may judge us, and go out before us, and fight our battles’” [1 Samuel 8:19–20].

This biblical episode illustrates an age-old ambivalence about government. Government is a necessity—“all the nations” have it, after all—but at the same time it has undesirable aspects. These mixed feelings toward government are inextricably bound up with its taxing and spending activities. The king will provide things that the people want (in this case, an army), but only at a cost. The resources for all government expenditures ultimately must come from the private sector. As Samuel so graphically explains, taxes can be a serious burden.

Centuries have passed, mixed feelings about government remain, and much of the controversy still centers around its financial behavior. This book is about the taxing and spending activities of government, a subject usually called **public finance**.

This term is something of a misnomer, because the fundamental issues are not financial (that is, relating to money). Rather, the key problems relate to the use of real resources. For this reason, some authors prefer the label **public sector economics** or simply **public economics**.

We focus on the microeconomic functions of government, the way government affects the allocation of resources and the distribution of income. Nowadays, the macroeconomic functions of government—the use of taxing, spending, and monetary policies to affect the overall level of unemployment and the price level—are usually taught in separate courses.

The scope of public finance is sometimes unclear. Governmental regulatory policies have important effects on resource allocation. Such policies have goals that sometimes can also be achieved by government spending or taxing measures. For

### public finance

The field of economics that analyzes government taxation and spending policies.

### public sector economics

See public finance.

### public economics

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example, if the government wishes to limit the size of corporations, one possible policy is to impose large taxes on big corporations. Another is to issue regulations making firms that exceed a particular size illegal. However, while corporate taxation is a subject of intense study in public finance, antitrust issues receive only tangential treatment in public finance texts and are covered instead in courses on industrial organization. While this practice seems arbitrary, it is necessary to limit the scope of the field. This book follows tradition by focusing on governmental spending and revenue-raising activities.

## ► PUBLIC FINANCE AND IDEOLOGY

Public finance economists analyze not only the effects of actual government taxing and spending activities but also what these activities ought to be. Views of how government should function in the economic sphere are influenced by ideological views concerning the relationship between the individual and the state. Political philosophers have distinguished two major approaches.

### Organic View of Government

Society is conceived of as a natural organism. Each individual is a part of this organism, and the government can be thought of as its heart. Yang Chang-chi, Mao Tse-tung’s ethics teacher in Peking, held that “a country is an organic whole, just as the human body is an organic whole. It is not like a machine which can be taken apart and put together again” (quoted in Johnson [1983, p. 197]). The individual has significance only as part of the community, and the good of the individual is defined with respect to the good of the whole. Thus, the community is stressed above the individual. For example, in the *Republic* of Plato, an activity of a citizen is desirable only if it leads to a just society. Perhaps the most infamous instance of an organic conception of government is provided by Nazism: “National Socialism does not recognize a separate individual sphere which, apart from the community, is to be painstakingly protected from any interference by the State . . . Every activity of daily life has meaning and value only as a service to the whole.”<sup>1</sup>

The goals of the society are set by the state, which leads society toward their realization. Of course, the choice of goals differs considerably. Plato conceived of a state whose goal was the achievement of a golden age in which human activities would be guided by perfect rationality. On the other hand, Adolf Hitler [1971/1925, p. 393] viewed the state’s purpose as the achievement of racial purity: “The state is a means to an end. Its end lies in the preservation and advancement of a community of physically and psychically homogeneous creatures.” More recently, the Iranian Ayatollah Khomeini argued that “only a good society can create good believers.” He wrote that “Man is half-angel, half-devil,” and the goal of government should be to “combat [the devil part] through laws and suitable punishments” (quoted in Taheri [2003]).

<sup>1</sup> Stuckart and Globke [1968, p. 330]. (Wilhelm Stuckart and Hans Globke were ranking members of the Nazi Ministry of the Interior.)

Because societal goals can differ, a crucial question is how they are to be selected. Proponents of the organic view usually argue that certain goals are *natural* for the societal organism to pursue. Pursuit of sovereignty over some geographical area is an example of such a natural goal. (Think of the Nazi drive for domination over Europe.) However, although philosophers have struggled for centuries to explain what natural means, the answer is far from clear.

## Mechanistic View of Government

In this view, government is not an organic part of society. Rather, it is a contrivance created by individuals to better achieve their individual goals. As the American statesman Henry Clay said in 1829, “Government is a trust, and the officers of the government are trustees; and both the trust and the trustees are created for the benefit of the people.” The individual rather than the group is at center stage.

Accepting that government exists for the good of the people, we are still left with the problem of defining just what *good* is and how the government should promote it. Virtually everyone agrees that it is good for individuals when government protects them from violence. To do so government must have a monopoly on coercive power. Otherwise, anarchy develops, and as the 17th-century philosopher Thomas Hobbes [1963/1651, p. 143] noted, “The life of man [becomes] solitary, poor, nasty, brutish and short.” The example of Somalia, in which no effective national government exists and violence is widespread, confirms Hobbes’s observation. Similarly, in *The Wealth of Nations*, Adam Smith argued that government should protect “the society from the violence and invasion of other independent societies,” and protect “as far as possible every member of the society from the injustice or oppression of every other member of it” [1977/1776, Book V, pp. 182, 198].

The most limited government, then, has but one function—to prevent its members from being subjected to physical coercion. Beyond that, Smith argued that government should have responsibility for “creating and maintaining certain public works and certain public institutions, which it can never be for the interest of any individual, or small number of individuals, to erect and maintain” [1977/1776, Book V, pp. 210–211]. Here one thinks of items such as roads, bridges, and sewers—the infrastructure required for society to function.<sup>2</sup>

At this point, opinions within the mechanistic tradition diverge. Libertarians, who believe in a very limited government, argue against any further economic role for the government. In Smith’s words, “Every man, as long as he does not violate the laws of justice, is left perfectly free to pursue his own interest his own way” [1977/1776, Book V, p. 180]. Libertarians are extremely skeptical about the ability of governments to improve social welfare. As Thomas Jefferson pungently put it,

Sometimes it is said that man cannot be trusted with the government of himself. Can he, then, be trusted with the government of others? Or have we found angels in the forms of kings to govern him? Let history answer this question.

In contrast, those whom we might call social democrats believe that substantial government intervention is required for the good of individuals. These interventions can take such diverse forms as safety regulations for the workplace, laws banning

racial and sexual discrimination in housing, or welfare payments to the poor. When social democrats are confronted with the objection that such interventions impinge on individual freedom, they are apt to respond that freedom refers to more than the absence of physical coercion. An impoverished individual may be free to spend his income as he pleases, but the scope of that freedom is quite limited. Of course, between the libertarian and social democratic positions there is a continuum of views with respect to the appropriate amount of government intervention.

## Viewpoint of This Book

The notion that the individual rather than the group is paramount is relatively new. Historian Lawrence Stone [1977, pp. 4–5] notes that before the modern period,

It was generally agreed that the interests of the group, whether that of kin, the village, or later the state, took priority over the wishes of the individual and the achievement of his particular ends. “Life, liberty and the pursuit of happiness” were personal ideals which the average, educated 16th-century man would certainly have rejected as the prime goals of a good society.

Since then, however, the mechanistic view of government has come to dominate Anglo-American political thought. However, its dominance is not total. Anyone who claims that something must be done in the “national interest,” without reference to the welfare of some individual or group of individuals, is implicitly taking an organic point of view. More generally, even in highly individualistic societies, people sometimes feel it necessary to act on behalf of, or even sacrifice their lives for, the nation.

Not surprisingly, Anglo-American economic thought has also developed along individualistic lines. Individuals and their wants are the main focus in mainstream economics, a view reflected in this text. However, as stressed earlier, within the individualistic tradition there is much controversy with respect to how active government should be. Thus, adopting a mechanistic point of view does not by itself provide us with an ideology that tells us whether any particular economic intervention should be undertaken.<sup>3</sup>

This point is important because economic policy is not based on economic analysis alone. The desirability of a given course of government action (or inaction) inevitably depends in part on ethical and political judgments. As this country’s ongoing debate over public finance illustrates, reasonable people can disagree on these matters. We attempt to reflect different points of view as fairly as possible.

## ► GOVERNMENT AT A GLANCE

We have shown how ideology can affect one’s views with respect to the appropriate scope for governmental activity. However, to form sensible views about public policy requires more than ideology. One also needs information about how the government actually functions. What legal constraints are imposed on the public sector? What does the government spend money on, and how are these expenditures financed? Before delving into the details of the US system of public finance, we provide a brief overview of these issues.

<sup>2</sup> Some argue that even these items should be provided by private entrepreneurs. Problems that might arise in doing so are discussed in Chapter 4.

<sup>3</sup> This question really makes no sense in the context of an organic view of government in which the government is above the people, and there is an assumption that it should guide every aspect of life.

## The Legal Framework

The Founding Fathers' concerns about governmental intervention in the economy are reflected in the Constitution. We first discuss constitutional provisions relating to the spending and taxing activities of the federal government and then turn to the states.

**Federal Government** Article 1, Section 8, of the Constitution empowers Congress “to pay the Debts and provide for the common Defense and general Welfare of the United States.” Over the years, the notion of “general welfare” has been interpreted very broadly by Congress and the courts, and now this clause effectively puts no constraints on government spending.<sup>4</sup> The Constitution does not limit the size of federal expenditure, either absolutely or relative to the size of the economy. Bills to appropriate expenditures (like practically all other laws) can originate in either house of Congress. An appropriations bill becomes law when it receives a majority vote in both houses and the president signs it. If the president vetoes an expenditure bill, it can still become law if it receives a two-thirds majority vote in each house.

How does Congress finance these expenditures? Federal taxing powers are authorized in Article 1, Section 8: “The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises.” Unlike expenditure bills, “All Bills for raising Revenue shall originate in the House of Representatives” [Article 1, Section 7].

In light of the enormous dissatisfaction with British tax policy during the colonial period, it is no surprise that considerable care was taken to constrain governmental taxing power, as described in the following paragraphs:

1. “[A]ll Duties, Imposts and Excises shall be uniform throughout the United States” [Article 1, Section 8]. Congress cannot discriminate among states when it sets tax rates. If the federal government levies a tax on gasoline, the *rate* must be the same in every state. This does not imply that the per capita *amount* collected will be the same in each state. Presumably, states in which individuals drive more than average have higher tax liabilities, other things being the same. Thus, it is still possible (and indeed likely) that various taxes make some states worse off than others.<sup>5</sup>

2. “No . . . direct Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken” [Article 1, Section 9]. A direct tax is a tax levied on a *person* as opposed to a *commodity*. Essentially, this provision says that if State A has twice the population of State B, then any direct tax levied by Congress must yield twice as much revenue from State A as from State B.

In the late 19th century, attempts to introduce a federal tax on income were declared unconstitutional by the Supreme Court because income taxation leads to state tax burdens that are not proportional to population. Given this decision, the only way to introduce an income tax was via a constitutional amendment. The 16th Amendment, ratified in 1913, states, “Congress shall have power to levy and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to census or enumeration.” Today the individual income tax is one of the mainstays of the federal revenue system.

<sup>4</sup> Article 1 also mandates that certain specific expenditures be made. For example, Congress has to appropriate funds to maintain both an army and a court system.

<sup>5</sup> No tax law in history has ever been struck down for violating this clause. However, a close call occurred in the early 1980s. Congress passed a tax on oil that exempted oil from the North Slope of Alaska. A federal district court ruled that the tax was unconstitutional, but this decision was ultimately reversed by the Supreme Court.

3. “No person shall be . . . deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation” [Fifth Amendment]. From the point of view of tax policy, this clause means distinctions created by the tax law must be reasonable. However, it is not always simple to determine which distinctions are “reasonable” and doing so is an ongoing part of the legislative and judicial processes.

4. “No Tax or Duty shall be laid on Articles exported from any State” [Article 1, Section 9]. This provision was included to assure the southern states that their exports of tobacco and other commodities would not be jeopardized by the central government. It has had little impact on the development of the public finance system.

The federal government is not required to finance all its expenditures by taxation. If expenditures exceed revenues, it is empowered “to borrow Money on the credit of the United States” [Article 1, Section 8]. Recently, a constitutional amendment to require a balanced federal budget has received some support, but so far it has not passed.

**State and Local Governments** According to the 10th Amendment, “The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.” Thus, explicit authorization for states to spend and tax is not required. However, the Constitution does limit states’ economic activities. Article 1, Section 10, states, “No State shall, without the Consent of the Congress, lay any Imposts or Duties on Imports or Exports.” Thus, the federal government controls international economic policy. In addition, various constitutional provisions have been interpreted as requiring that the states not levy taxes arbitrarily, discriminate against outside residents, or levy taxes on imports from other states. For example, in 1986, the Supreme Court declared unconstitutional an Alaska law mandating that 95 percent of workers on public projects be Alaskans.

States can impose spending and taxing restrictions on themselves in their own constitutions. State constitutions differ substantially with respect to the types of economic issues with which they deal. In recent years, one of the most interesting developments in public finance has been the movement of some states to amend their constitutions to limit the size of public sector spending.

From a legal point of view, the power of local governments to tax and spend is granted by the states. As a 19th-century judge put it:

Municipal corporations owe their origin to, and derive their powers and rights wholly from, the [state] legislature. It breathes into them the breath of life, without which they cannot exist. As it creates, so it may destroy. If it may destroy, it may abridge and control [*City of Clinton v. Cedar Rapids*, 1868].

It would be a mistake, however, to view localities as lacking in fiscal autonomy. Many towns and cities have substantial political power and do not respond passively to the wishes of state and federal governments. An interesting development in recent years has been the competition of states and cities for federal funds. The cities often are more successful in their lobbying activities than the states!

## The Size of Government

In a famous line from his State of the Union address in 1996, President Bill Clinton declared: “The era of big government is over.” Such a statement presupposes that there is some way to determine whether or not the government is “big.” Just how does one measure the size of government?

One measure often used by politicians and journalists is the number of workers in the public sector. However, inferences about the size of government drawn from the number of workers it employs can be misleading. Imagine a country where a few public servants operate a powerful computer that guides all economic decisions. In this country, the number of government employees certainly underestimates the importance of government. Similarly, it would be easy to construct a scenario in which a large number of workers is associated with a relatively weak public sector. Although for many purposes the number of public sector employees is useful information, it does not cast light on the central issue—the extent to which society's resources are subject to control by government.

A more sensible (and common) approach is to measure the size of government by the volume of its annual expenditures, of which there are basically three types:

1. Purchases of goods and services. The government buys a wide variety of items, everything from missiles to services provided by forest rangers.
2. Transfers of income to people, businesses, or other governments. The government takes income from some individuals or organizations and gives it to others. Examples are welfare programs such as food stamps and subsidies paid to farmers for production (or nonproduction) of certain commodities.
3. Interest payments. The government often borrows to finance its activities and, like any borrower, must pay interest for the privilege of doing so.

The federal government itemizes its expenditures in a document referred to as the **unified budget**.<sup>6</sup> In 2005, federal expenditures (excluding grants made to state and local governments) were about \$2,190 billion. Adding state and local government expenditures made that year gives us a total of \$3,876 billion [*Economic Report of the President, 2006*, p. 379].<sup>7</sup> Figures on government expenditures are easily available and widely quoted. Typically when expenditures go up, people conclude that government has grown and vice versa. However, some government activities have substantial effects on resource allocation even though they involve minimal explicit outlays. For example, issuing regulations per se is not very expensive, but compliance with the rules can be very costly. Air bag requirements raise the cost of cars. Various permit and inspection fees increase the price of housing. Labor market regulations such as the minimum wage may create unemployment, and regulation of the drug industry may slow the pace of scientific development.

Some have suggested that the costs imposed on the economy by government regulations be published in an annual **regulatory budget**. In this way, an explicit accounting for the costs of regulation would be available. Unfortunately, it is exceedingly difficult to compute such costs. For example, pharmaceutical experts disagree on what new cures would have been developed in the absence of drug regulation. Similarly, it is hard to estimate the impact of government-mandated safety procedures in the workplace on production costs. In view of such problems, it is unlikely there will ever be an official regulatory budget.<sup>8</sup> Unofficial estimates, however, suggest that the annual costs of federal regulations may be quite high, perhaps over \$700 billion annually [Nivola 1998, p. 8].

#### unified budget

The document which itemizes all the federal government's expenditures and revenues.

#### regulatory budget

An annual statement of the costs imposed on the economy by government regulations. (Currently, there is no such budget.)

<sup>6</sup> The publication of some kind of budget document is constitutionally mandated: "a regular Statement and Account of the Receipts and Expenditures of all public Money shall be published from time to time" [Article 1, Section 9].

<sup>7</sup> Federal grants to state and local governments were \$358 billion in 2005.

<sup>8</sup> Regulation is not necessarily a bad thing just because it creates costs. Like any other government activity, it can be evaluated only by assessing the benefits as well as the costs. (Problems in doing cost-benefit analysis are discussed in Chapter 8.)

**Some Numbers** We reluctantly conclude that it is infeasible to summarize in a single number the magnitude of government's impact on the economy. That said, we are still left with the practical problem of finding some reasonable indicator of the government's size that can be used to estimate trends in its growth. Most economists are willing to accept conventionally defined government expenditure as a rough but useful measure. Like many other imperfect measures, it yields useful insights as long as its limitations are understood.

With all the appropriate caveats in mind, we present in Table 1.1 data on expenditures made by all levels of US government over time. The first column indicates that annual expenditures have increased by a factor of over 30 since 1960. This figure is a misleading indicator of the growth of government for several reasons:

1. Because of inflation, the dollar has decreased in value over time. In column 2, the expenditure figures are expressed in 2005 dollars. In real terms, government expenditure in 2005 was about 5.9 times the level in 1960.
2. The population has also grown over time. An increasing population by itself creates demands for a larger public sector. (For example, more roads and sewers are required to accommodate more people.) Column 3 shows real government expenditure per capita. Now the increase from 1960 to 2005 is a factor of about 3.6.
3. It is sometimes useful to examine government expenditure compared to the size of the economy. If government doubles in size but at the same time the economy triples, then in a relative sense, government has shrunk. Column 4 shows government expenditure as a percentage of Gross Domestic Product (GDP), the market value of goods and services produced by the economy during the year. In 1960, the figure was 24.3 percent, and in 2005, it was 31.1 percent.

**Table 1.1 State, local, and federal government expenditures**  
(selected years)

	(1) Total Expenditures (billions)	(2) 2005 Dollars (billions)*	(3) 2005 Dollars per Capita	(4) Percent of GDP
1960	\$ 123	\$ 655	\$ 3,627	24.3%
1970	295	1,201	5,858	28.4
1980	843	1,749	7,679	30.2
1990	1,873	2,574	10,289	32.3
2000	2,887	3,237	11,461	29.4
2005	3,876	3,876	13,066	31.1

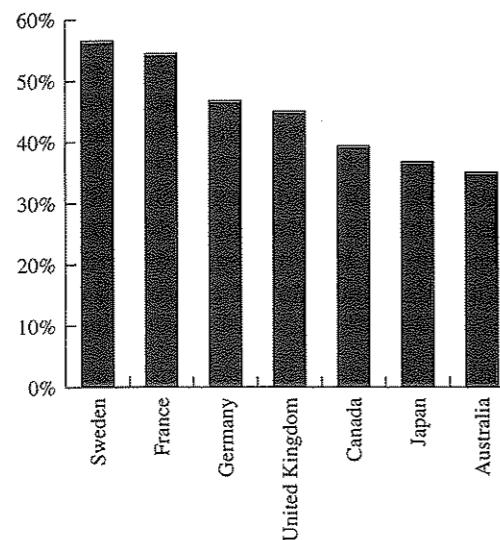
Conversion to 2005 dollars done using the GDP deflator.

Source: Calculations based on *Economic Report of the President, 2006* (pp. 280, 284, 323, 379).

Adjusting for inflation, total government expenditures have increased by a factor of 31.5 since 1960. Real expenditures have increased by a factor of 5.9, and per capita expenditures have increased by a factor of 3.6. In 1960, government expenditures were 24.3 percent of Gross Domestic Product; in 2005 they were 31.1 percent.

**Figure 1.1**  
Government expenditures as a percentage of Gross Domestic Product (2005, selected countries)

Compared to the United States, other developed countries have higher government expenditures as a percentage of Gross Domestic Product.



Source: Organization for Economic Cooperation and Development [2006a]. Figures are for 2005.

In light of our previous discussion, the figures in Table 1.1 convey a false sense of precision. Still, there is no doubt that in the long run the economic role of government has grown. With almost a third of GDP going through the public sector, government is an enormous economic force.

Some international comparisons can help put the US data in perspective. Figure 1.1 shows figures on government expenditure relative to Gross Domestic Product for several developed countries. The data indicate that the United States is not alone in having an important public sector. Indeed, compared to countries such as Sweden and France, the US public sector is quite small. While relative public-sector sizes differ across nations for many reasons, the ideological considerations discussed earlier in this chapter probably play an important role.

One explanation for the large public sector in Sweden, for example, is that the government pays for most of health care, which is thought of as a community responsibility. In the United States, on the other hand, health care is viewed as more of an individual responsibility, so the bulk of health care expenditures are made in the private sector.

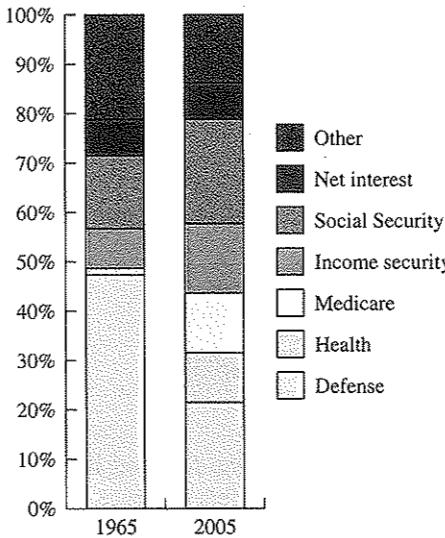
## Expenditures

We now turn from the overall magnitude of government expenditures to their composition. It is impossible to reflect the enormous scope of government spending activity in a brief table. In the federal budget for fiscal year 2007, the list of programs and their descriptions required almost 1,300 pages! (Details are provided at the Web site: <http://www.gpoaccess.gov/usbudget/>.)

The major categories of federal government expenditure in 1965 and the present are depicted in Figure 1.2; the state and local expenditure data are in Figure 1.3.

**Figure 1.2** Composition of federal expenditures (1965 and 2005)

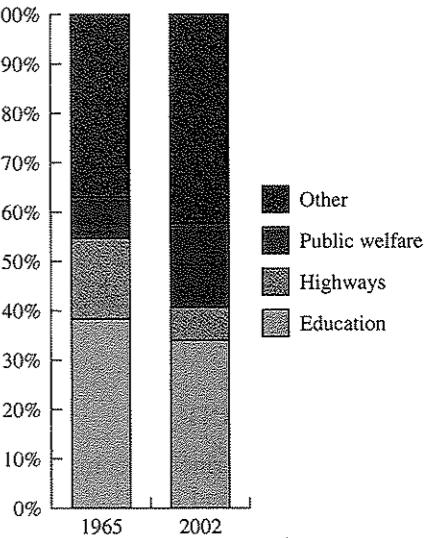
Compared to 1965, the federal government currently devotes a smaller share of its budget to national defense. It devotes a larger share of its budget to health programs, income security programs, and Social Security.



Source: Economic Report of the President, 2006 [p. 377].

**Figure 1.3** Composition of state and local expenditures (1965 and 2002)

Compared to 1965, state and local governments currently devote a smaller share of their budgets to highways. They devote a larger share of their budgets to public welfare programs.



Source: Economic Report of the President, 2006 [p. 383].

The following aspects of the figures are noteworthy:

- National defense is an important component of government expenditure, but its relative importance has decreased over time. In 1965, it was 47 percent of the federal budget; this figure is now down to 21 percent.
- Social Security has grown enormously. Among other things, this program transfers income to individuals who are retired. It is now virtually tied with defense spending as the single largest spending item in the federal budget.
- Medicare, a health insurance system for the elderly, did not even exist in 1965; it now absorbs 12.1 percent of the federal budget.
- Public welfare activities have increased. As shown in Figure 1.3, between 1965 and 2002, their share of state and local budgets roughly doubled from 8.5 to 17.1 percent. At the same time, the share of state and local spending devoted to highways has fallen considerably.
- Payments of interest on debt have remained roughly constant as a proportion of federal expenditures since 1965. They now account for about 7.4 percent of federal expenditures.

Note that fast-growing areas such as Social Security and interest payments are relatively fixed in the sense that they are determined by previous decisions.

Indeed, much of the government budget consists of so-called **entitlement programs**—programs with cost determined not by fixed dollar amounts but by the

### entitlement programs

Programs whose expenditures are determined by the number of people who qualify, rather than preset budget allocations.

number of people who qualify. The laws governing Social Security, many public welfare programs, farm price supports, and so forth include rules that determine who is entitled to benefits and their magnitude. Expenditures on entitlement programs are, therefore, out of the hands of the current government, unless it changes the rules. Similarly, debt payments are determined by interest rates and previous deficits, again mostly out of the control of current decision makers. According to most estimates, about three-quarters of the federal budget is relatively uncontrollable. In Chapter 6, we discuss whether government spending is in fact out of control and if so, what can be done about it.

It is useful to break down total expenditures by level of government. The federal government accounts for about 45 percent of all direct expenditures, the states for 25 percent, and localities for 30 percent. State and local governments are clearly important players. They account for the bulk of spending on items such as police and fire protection, education, and transportation. Substantial public welfare expenditures are also made through the states. Chapter 22 discusses the complications that arise in coordinating the fiscal activities of different levels of government.

## Revenues

The principal components of the federal tax system are depicted in Figure 1.4; the state and local tax information is in Figure 1.5. At the federal level, personal income taxation is currently the single most important source of revenue, accounting for about 43 percent of tax collections. Note the importance of the “Social Insurance” category in Figure 1.4. These are payroll tax collections used to finance Social Security and Medicare. They now account for more than a third of federal revenue collections. The fall in the importance of the federal corporate income tax is also of some interest. In 1965 it accounted for about 22 percent of federal revenues; the figure is now only 13 percent. In the state and local sector, the two most striking changes over time are the decreased importance of the property tax and the increased reliance on individual income taxes.

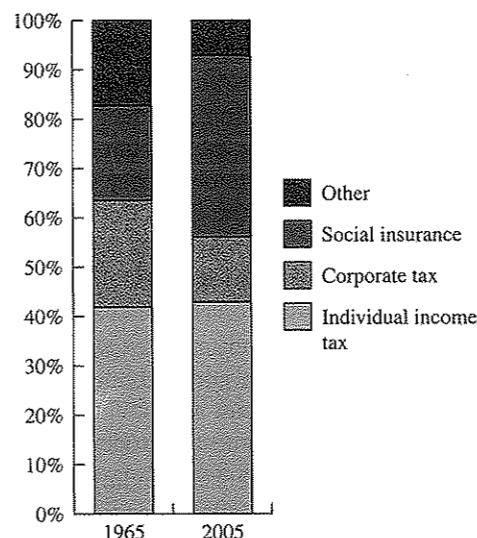
**Changes in the Real Value of Debt** In popular discussions, taxes are usually viewed as the only source of government revenue. However, when the government is a debtor and the price level increases, changes in the real value of the debt may be an important source of revenue. To see why, suppose that at the beginning of the year you owe a creditor \$1,000, which does not have to be repaid until the end of the year. Suppose further that during the year, prices rise by 10 percent. Then the dollars you use to repay your creditor are worth 10 percent less than those you borrowed from her. In effect, inflation has reduced the real value of your debt by \$100 (10 percent of \$1,000). Alternatively, your real income has increased by \$100 as a consequence of inflation. Of course, at the same time, your creditor’s real income has fallen by \$100.<sup>9</sup>

At the beginning of fiscal year 2005, the federal government’s outstanding debt was about \$4.3 trillion. During 2005, the inflation rate was about 3.4 percent.

<sup>9</sup> If the inflation is anticipated by borrowers and lenders, one expects that the interest rate will increase to take inflation into account. This phenomenon is discussed in Chapter 17 under “Taxes and Inflation.”

Figure 1.4 Composition of federal taxes (1965 and 2005)

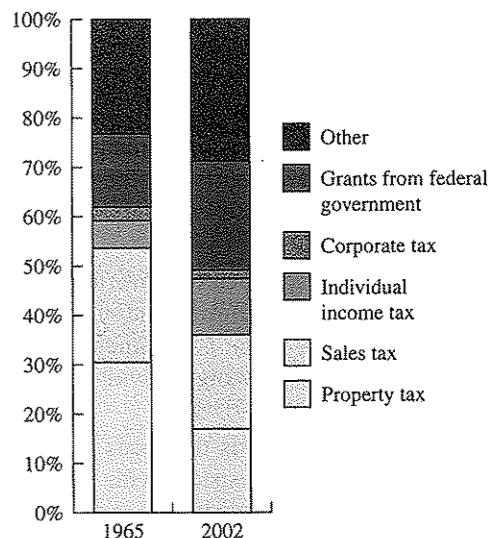
Compared to 1965, the federal government currently relies more on the individual income tax, which at 43% of the total makes it the largest source of federal revenue. Tax payments for social insurance (which includes Social Security and Medicare) also make up a larger share of total tax revenue, currently amounting to 37% of total federal revenue. The share of revenue from the corporate tax has decreased over this period, and is currently at 13% of total federal revenue.



Source: *Economic Report of the President, 2006* [p. 377].

Figure 1.5 Composition of state and local taxes (1965 and 2002)

Compared to 1965, state and local governments currently rely more on the individual income tax and much less on the property tax.



Source: *Economic Report of the President, 2006* [p. 383].

Applying the same logic as previously, inflation reduced the real value of the federal debt by \$146 billion (\$4.3 trillion  $\times$  0.034). In effect, this is as much a receipt for the government as any of the taxes listed in Figure 1.4. However, the government’s accounting procedures exclude gains due to inflationary erosion of the debt on the revenue side of the account. We defer to Chapter 20 further discussion of issues related to the measurement of the debt and its economic significance.

## Our Agenda

This section has set forth a collection of basic “facts”—facts on governmental fiscal institutions, on the size and scope of government spending, and on the methods used by government to finance itself. Parts of the rest of this book are devoted to presenting more facts—filling in the rather sketchy picture of how our fiscal system operates. Just as important, we explore the significance of these facts, asking whether the status quo has led to desirable outcomes, and if not, how it can be improved.

## Summary

- Public finance, also known as public sector economics or public economics, focuses on the taxing and spending activities of government and their influence on the allocation of resources and distribution of income.
- Public finance economists both analyze actual policies and develop guidelines for government activities. In the latter role, economists are influenced by their attitudes toward the role of government in society.
- In an organic view of society, individuals are valued only by their contribution to the realization of social goals. These goals are determined by the government.
- In a mechanistic view of society, government is a contrivance erected to further individual goals. It is not clear how the government can reconcile sometimes conflicting individual goals.
- Individual decision making is the focus of much economics and is consistent with the mechanistic view of society adopted in this book. This does not eliminate much controversy over the appropriate role of the government in our economy.
- The Constitution embodies constraints on federal and state government economic activity.
- The federal government may effectively undertake any expenditures it wishes and may use debt and taxes to finance them.

## Discussion Questions

1. Indicate whether each of the following statements is consistent with an organic or mechanistic view of government:
  - a. “A strong state for Russians is not an anomaly, not something that must be fought against, but on the contrary is . . . the initiator and main driving force of all change” [Russian President Vladimir Putin].
  - b. “Freedom of men under government is to have a standing rule to live by, common to every one of that society, and made by the

The federal government may not discriminate among states when choosing tax rates and may not place a levy on state exports. The 16th Amendment empowers the federal government to tax personal incomes.

- State governments are forbidden to levy tariffs on imports, discriminate against outside residents, or tax other states’ products. Most states have balanced budget requirements.
- All common measures of the size of government—employees, expenditures, revenues, etc.—involve some deficiency. In particular, these items miss the impact of regulatory costs. Nonetheless, there is strong evidence that the impact of the government on the allocation of national resources has increased over time.
- The level of government expenditures has increased in both nominal and real absolute terms, in per capita terms, and as a percentage of Gross Domestic Product.
- The share of defense spending in federal expenditure has fallen over time, while Social Security, public welfare, and payments on outstanding debt have increased in importance. The combination of entitlement programs and interest payments reduces yearly control over the level of expenditures.
- Personal income and Social Security payroll taxes are currently the largest sources of government revenue.

- d. A law prohibiting prostitution
- e. A law prohibiting polygamy
- f. A law requiring all commercial signs be written in the country’s native language.
3. Obesity is perceived to be a national health problem in the United States. One suggestion to deal with this problem is a “fat tax.” The idea is to levy a tax on foods containing more than a government prescribed percentage of the daily minimal fat intake. Is such a tax consistent with a mechanistic view of government?
4. In each of the following circumstances, decide whether the impact of government on the economy increases or decreases and why. In each case, how does your answer compare to that given by standard measures of the size of government?
  - a. Normally, when employers offer health insurance benefits to their workers, these benefits extend to the spouses of the workers as well. Several years ago, San Francisco passed a law requiring firms that do business with the city to offer health and other benefits to both same- and opposite-sex unwed partners.
  - b. The federal government requires that automakers increase the average number of miles per gallon of the passenger vehicles they produce.
  - c. The ratio of government purchases of goods and services to Gross Domestic Product falls.
  - d. The federal budget is brought into balance by reducing grants-in-aid to state and local governments.
5. During 2004, the inflation rate in the United Kingdom was about 1.6 percent. At the beginning of that year, the national debt of the United Kingdom was about £420 billion. Discuss the implications of these facts for measuring government revenues in that country during 2004.
6. As noted in the text, in 1996 President Clinton declared that the era of big government is over. Has the size of government fallen since then? Provide an answer based on the following data: In 1996, federal government spending was \$1.56 trillion and Gross Domestic Product (GDP) was \$7.82 trillion. In 2005, federal spending was \$2.47 trillion and GDP was \$12.48 trillion. During this period, prices increased by about 24 percent. What additional data would you seek to provide a more complete answer to this question?
7. From 1981 to 1985, the US federal government increased defense spending from \$153.9 billion to \$245.1 billion per year, while over the same period Gross Domestic Product rose from \$3.128 trillion to \$4.220 trillion. From 2001 to 2005, the US federal government increased defense spending from \$290.3 billion to \$474.2 billion, while over the same period Gross Domestic Product rose from \$10.128 trillion to \$12.479 trillion. Which increase in defense spending was larger relative to Gross Domestic Product?

## Appendix: Doing Research in Public Finance

Throughout the text, we cite many books and articles. These references are useful for those who want to delve into the various subjects in more detail. Students interested in writing term papers or theses on subjects in public finance should also consult the following journals that specialize in the field:

- International Tax and Public Finance*  
*Journal of Public Economics*  
*National Tax Journal*

*Public Finance*  
*Public Finance Quarterly*

In addition, all the major general-interest economics journals frequently publish articles that deal with public finance issues. These include, but are not limited to:

*American Economic Review*  
*Journal of Economic Perspectives*  
*Journal of Political Economy*  
*Quarterly Journal of Economics*  
*Review of Economics and Statistics*

Articles on public finance in these and many other journals are indexed in the *Journal of Economic Literature* and can be searched on the Internet.

In addition, students should consult the volumes included in the Brookings Institution's series *Studies of Government Finance*. These books include careful and up-to-date discussions of important public finance issues. The Congressional Budget Office also provides useful reports on current policy controversies. A list of documents is provided at its Web site, <http://www.cbo.gov>.

The working paper series of the National Bureau of Economic Research, available through university libraries, is another good source of recent research on public finance. The technical difficulty of these papers is sometimes considerable, however. Papers can be downloaded at its Web site, <http://www.nber.org>.

Vast amounts of data are available on government spending and taxing activities. The following useful sources of information are published by the US Government Printing Office and are available online as indicated:

*Statistical Abstract of the United States*  
(<http://www.census.gov/compendia/statab/>)  
*Economic Report of the President* (<http://www.gpoaccess.gov/eop/index.html>)  
*Budget of the United States* (<http://www.gpoaccess.gov/usbudget>)  
*US Census of Governments* (<http://www.census.gov/govs/www/>)

All the preceding are published annually, except for the *US Census of Governments*, which appears every five years. *Facts and Figures on Government Finance*, published annually by the Tax Foundation, is another compendium of data on government taxing and spending activities. For those who desire a long-run perspective, data going back to the 18th century are available in *Historical Statistics of the United States from Colonial Times to 1970* [US Government Printing Office]. Readers with a special interest in state and local public finance will want to read the reports issued by the US Advisory Commission on Intergovernmental Relations.

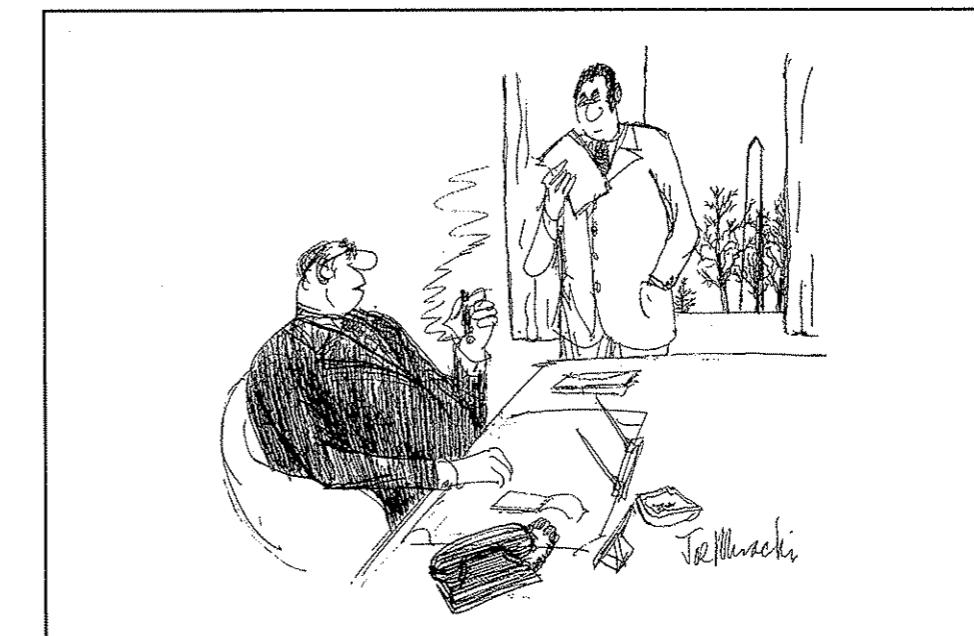
A great deal of public finance data is available on the Internet. A particularly useful site is *Resources for Economists on the Internet* (<http://www.rfe.org>). It lists and describes more than 900 Internet resources. The home page of the US Census Bureau (<http://www.census.gov>) is also very useful. Finally, for up-to-date information on tax policy issues, consult the Web site of the University of Michigan's Office of Tax Policy Research (<http://www.otpr.org>) and the Urban-Brookings Tax Policy Center (<http://www.taxpolicycenter.org>).

## TOOLS OF POSITIVE ANALYSIS

*Numbers live. Numbers take on vitality.*

—JESSE JACKSON

A good subtitle for this chapter is "Why Is It So Hard to Tell What's Going On?" We constantly hear economists—and politicians—disagree vehemently about the likely consequences of various government actions. For example, when George W. Bush proposed reducing tax rates in 2006, many conservatives argued that lower tax rates create incentives for people to work harder. Many liberals were skeptical, arguing that taxes have little effect on work effort. Each side had economists testifying that their opinion was correct. Is the cynicism expressed in the cartoon below really surprising?



"That's the gist of what I want to say. Now get me some statistics to base it on." © The New Yorker Collection 1977 Joseph Mirachi from cartoonbank.com. All Rights Reserved.

This kind of discussion occurs virtually whenever economists and policymakers consider the impact of a government program. Economists debate whether environmental regulations improve health outcomes, whether government-provided health insurance decreases mortality, whether school vouchers improve test scores, whether