

CHAPTER 1

Fundamental Principles of Public Finance

Why study public financial administration separately from business finance? Modern public financial administration liberally borrows the tools and concepts of business management. Financial management in business seeks to increase the value of the firm to its owners by judicious allocation and control of its resources. Public financial management uses similar analytic, technical, and managerial tools to allocate and control, but governments differ from private businesses in terms of resource constraints, ownership, and objectives. In particular, governments may tax to enlarge their resources, “ownership” is not clear because many stakeholders share a legitimate interest in government decisions, and the value of government services is neither easy to quantify nor reflected in a single measure (like the sales or profits of a business enterprise). And behind all these differences lies the unique power of government to tax, prohibit, and punish. This capacity to coerce, even in democracies, makes governments different from proprietary businesses and voluntary organizations; the reflection of those differences makes public financial administration distinct from many fundamental practices of business finance. Both sorts of entities are interested in *fiscal sustainability*, that is, the ability to operate over the long term without reducing the standards of life below those currently enjoyed and even to improve that standard.

Many different organizations—private businesses, nonprofit organizations, and governmental agencies—provide the goods and services that we use every day, including both those necessary for life itself and those that make life more enjoyable. Private businesses sell us food and clothing, cars and television sets, and so on: a vast range of commodities that we purchase for survival and enjoyment. The same applies to services: We go to movies run by private companies, travel across the country on privately operated airlines, and hire the neighbor to feed our cats when we go on vacation. All these and many more goods and services are provided under market principles of voluntary exchange: Businesses provide those services to us in exchange for the payment we make to them. No payment, no service. Much the same applies for many nonprofit organizations, like hospitals and social service

2 Chapter One: Fundamental Principles of Public Finance

organizations, that operate on the basis of charges and government contracts. Other services come from voluntary associations or clubs—the services of the county historical museum, the local neighborhood association, or a local youth organization. Their operations are financed by a variety of contributions and fees. Although most voluntary organizations do not require payment before service is rendered, they still need to be paid by someone, voluntarily, in order to survive, because those who provide the resources that are used in providing services (utilities, rents, supplies, etc.) need to be paid for those resources. Finally, we receive services of police departments, school systems, the judicial and regulatory systems, the social safety net, and so on, from governments. But these services are financed differently. Rather than operating from finance by voluntary exchange (market sales) or by voluntary contribution, governments provide goods and services paid by taxes or other revenues raised by law. This revenue comes not from voluntary purchase or contribution, but, even in a democracy, from the operation of a revenue system based on legal requirement for payment, backed, if necessary, by force or threat of force. That is coercion, something we dislike and distrust. In our open and free society, why have a public sector? The reason is that government services are uniquely essential to life: Most countries leave the provision of life's necessities—food, clothing, and usually shelter—to the private sector. But when government fails, the private sector cannot function and citizens are “bereft of even the most basic conditions of a stable existence: law and security, trust in contracts, and a sound medium of exchange.”¹ Without a government that does its job in at least some basic areas, the private sector itself cannot properly function.

Market Failure and the Functions of Government

Why can't private businesses selling their products in free markets be relied upon to provide all goods and services that ought to be available? The argument for the efficiency of markets is powerful. The President's Council of Economic Advisors explains: “If markets are competitive and function smoothly, they will lead to prices at which the amount sellers want to supply equals the amount buyers demand. Moreover, the price in any market will simultaneously equal the benefit that buyers get from the last unit consumed (the marginal benefit) and the cost of producing the last unit supplied (the marginal cost). These two conditions ensure efficiency: when they hold in all markets, the Nation's labor and other resources are allocated to producing a particular good or service if and only if consumers would not be willing to pay more to have those resources employed elsewhere.”² Markets cause the productive capacity of the economy to be used to produce what people want most and

¹International Bank for Reconstruction and Development/The World Bank, World Development Report 1997, *The State in a Changing World* (New York: Oxford University Press, 1997), 19.

²*Economic Report of the President Transmitted to the Congress February 1997* (Washington: U.S. Government Printing Office, 1997), 191.

cause the least possible amount of resources to be used in that production. In a world of limited resources, it is a valuable result.

But there remains an important role for government, even if private markets can deliver most goods and services, and deliver them at low cost. Indeed, there is an important cooperative relationship between healthy government and healthy markets. Markets need government to function efficiently: “Deals must be enforced and fraud discouraged. Without a governmental legal system to guarantee property rights and enforce contracts, corporate organizations and market exchange would be virtually impossible. Anarchy and the free market are not synonymous.”³ Government—at least its protective elements—is necessary if markets are to exist. And governments can obtain important information from market data, use markets as efficient mechanisms for implementing public policy, and acquire goods and services in market transactions to provide government services. The market economy needs government to function properly, and governments need the market economy if they are to serve the public interest.

The role of government, however, extends beyond simply allowing markets to operate, because a system of markets is not always able “to sustain ‘desirable’ activities or to stop ‘undesirable’ activities.”⁴ What makes some services a governmental responsibility? Why can’t private action be relied upon to provide police and urban fire protection, primary education, environmental protection, public health, national defense, and so on? Individuals demand these services, and we expect businesses to respond to customer demand in their quest for profit. Why do markets fail, and thereby create an economic need for government?

Public Goods⁵

Some goods will not be supplied in the market or, if supplied, will be supplied in insufficient amounts because of their very nature. The problem comes from two properties: (1) nonexhaustion, or nonrivalry, occurs when benefits of the service can only be shared, meaning that a given quantity of the service can be enjoyed by additional people with no reduction in benefit to the existing population, and (2) inability to exclude nonpayers occurs when benefits cannot be easily limited to those who have paid for the services. The properties reflected in Figure 1–1 distinguish private goods, public goods, and two intermediate kinds of goods—toll goods and common-pool goods.

³Ibid., 192.

⁴Francis M. Bator, “The Anatomy of Market Failure,” *Quarterly Journal of Economics* 72 (August 1958): 351. Public goods are only one type of market failure, but they form the basis for budgeting, taxation, and other parts of fiscal administration. Other failures create the need for government regulation of monopolies; these failures are not considered here.

⁵Some argue that individuals do not recognize their own best interest and that market evaluations made by individuals may be “wrong.” In other words, the market underprovides museums, ballets, and symphonies because people do not understand their true value. Therefore, it is argued that these institutions deserve support as merit goods. (Junk food, Saturday morning kids’ television, and country music could be viewed as merit bads.) Identifying what is good and what is bad is certainly not scientific (you may disagree with the examples listed here) and ends up in special-interest political battles.

Figure 1-1
The Elements of Nonappropriability

Exhaustion or Rivalry		
Alternate Use		Joint Use
Private Goods		Toll Goods
Feasible	Examples: Food, clothing, television sets	Examples: Turnpikes, toll bridges, motion pictures
Exclusion		
Common-Pool Resources		Public Goods
Not feasible	Examples: Aquifers, fishing grounds, petroleum reserves	Examples: National defense, system of justice, vector control

What do these public-good properties mean? When services are nonrival, use of the service by one person does not preclude concurrent full use by others at no additional cost of providing that service. The cost of providing service to additional users, once the service has been provided for someone, equals zero (its marginal cost is zero). Economic efficiency requires that the price paid by the buyer (the value of resources given up by the buyer to make the purchase) not exceed the additional cost of producing the purchased good or service. A private business will charge a price higher than zero, the efficient price, because it cannot afford to do otherwise. Therefore, too little of the good or service will be purchased and consumed, and its price will be too high, compared with quantities and prices in a fully functioning market. When exclusion of those who have not paid for the service is not feasible, a seller could not successfully charge a price; people not paying would receive the service as completely as those who paid. Private goods do not have appropriability problems: One person's use of the good eliminates the possibility of anyone else using it (additional service means extra cost, and sellers charge to cover that cost), and exclusion is feasible. Obviously, the full range of ordinary commodities and services (bread, milk, etc.) are private goods. The only way an individual can receive the benefits from a private good is by paying for it; there are no effects on others, and it is possible to separate payers from nonpayers.

Public goods include national defense, mosquito abatement, pollution control, and disease control. The common characteristics of these services are (1) once they are made available, denial to those who have not paid is impossible (nonexclusion), and (2) any number of people can consume the same good at the same time without diminishing the amount of that good available for anyone else to consume (nonexhaustion, or nonrivalry). Consider mosquito abatement. When a given level of control is provided, all people in the area of control receive the same service. Other people could enter the control district and receive that same service without

any additional abatement cost. Many people can simultaneously consume that service, once it has been provided, without diminishing the amount of service available to others (the marginal cost of service is zero), and there is no mechanism to deny service to those not paying for it. Individuals in the service area may value the abatement service differently (reaction to mosquito bites varies among individuals), but all receive the same level of service. This is completely different from the situation with a private good, like a hamburger: When you eat that burger, it is gone and not available for consumption by anyone else—no nonrivalry.

The failure of exclusion is the other public-good characteristic. Within the range of exclusion failure, if someone provides the services, all receive that service. When one structure in an urban area receives fire protection, given the propensity of fires to spread, nearby structures receive protection as well.⁶ (The public good is fire protection, not fire fighting; when the equipment is putting out the fire at Smith's house, it is not available to put out the fire anywhere else. Extinguishing Smith's fire, however, provides fire protection equally to many neighbors.) Obviously, there are geographic limits to that range of nonappropriability: Fire protection provided in Bloomington, Indiana, will not extend to the people in Jackson, Mississippi. Within a specific geographic area, however, all receive the service regardless of payment, whether they want it or not. Such is the special monopoly position of governments: Not only are alternative providers unavailable, but residents also do not have the option of not paying for the service because public revenue systems operate independently from service delivery. A governor of Kentucky recognized the difference between operating the state and operating his successful business: "Hell, governing Kentucky is easier than running Kentucky Fried Chicken. There's no competition."⁷ Payment regardless of preference or consumption is, of course, a unique feature of government provision.

Toll goods and common-pool goods have one public-good characteristic but not both (as shown in Figure 1–1). Toll goods are nonrival: One person can consume the service to its fullest while not reducing the amount of service someone else may consume. For these goods, however, exclusion is feasible; boundaries can separate payers and nonpayers. Examples include drive-in movies and toll roads: Up to a congestion point, a larger number of people can consume these services without exhausting the service concurrently available to others.

Common-pool goods are goods or services for which exclusion is not feasible, but there are competing and exhaustive uses. Examples include aquifers, oil and gas deposits, and fisheries. There are no normal means of exercising exclusive property rights on the resource, but when used, the resource becomes unavailable for others. Left to private processes, the resource may be rapidly exhausted because it is valuable and is not, in its natural state, subject to normal ownership controls. (First-come-first-served is a normal allocation principle, so getting those resources out of

⁶Private firms sell fire protection to individuals in some parts of Arizona. Neighbors are distant and fires seldom spread over desert land, so the service is a private good. Roger S. Ahlbrandt, Jr., *Municipal Fire Protection Services: Comparison of Alternative Organization Forms* (Newbury Park, Calif., and London: Sage Professional Papers in Administration and Policy Studies 03-002, 1973).

⁷The Honorable John Y. Brown, Jr., quoted in *Newsweek* (March 30, 1981).

6 Chapter One: Fundamental Principles of Public Finance

the ground as quickly as possible is advantageous to any private user—and is why governments frequently intervene in markets for natural resources. That is another element of market failure.) Sidebar 1–1 describes one common-pool resource problem and how government action sought to remedy it.

Externalities

Market transactions between buyer and seller may affect third parties. The consequences may be negative—as with the exhaust fumes from automobiles—or positive—as with the protection provided pregnant women when a boy receives a rubella vaccination—but, either way, that value is unlikely to be fully recognized in the market transaction. For these goods and services, the private return from their consumption is substantial, so the market will not fail to provide. It will not, however, provide at a socially reasonable level.

An attractive (or positive) externality causes the good in question to be underproduced. In the case of the rubella vaccination, those people who are vaccinated receive the benefit of reduced probability that they will contract the disease, a direct benefit to them for which they could be expected to pay. But they also provide protection against the disease to others in that they will not infect others if they themselves do not have the disease. That is a third-party, or external, effect of the vaccination. It is unlikely that everyone considering the vaccination will take full account of these benefits when weighing the advantages of vaccination against the disadvantages (minimal discomfort and some small risk of adverse reaction, time spent and inconvenience met in receiving the injection, and the out-of-pocket price of the service), and some will decide not to be vaccinated. Fewer people would be vaccinated than would be in the best economic interests of society, because of the external benefits from the personal choice about vaccination. Governments require young boys to get rubella vaccinations not simply to protect them—rubella itself is not much worse than a common cold—but because we do not want them to give the disease to a pregnant woman and cause birth defects in her child.⁸

An undesirable (or negative) externality has the opposite effect, an overproduction of the good. Automobile operators choose to pay the operating costs of their cars to enjoy the great personal value of mobility that cars provide, without full attention to the undesirable health and esthetic effects of the exhaust fumes produced by their vehicles or of the congestion delays caused by having many vehicles competing for highway space. Again, this leads to a misallocation of resources:

⁸Public health officials refer to the concept of “herd immunity:” if enough of a population is immunized against an infectious disease, even those without immunization will be protected because any invading germ will not be able to spread. There is no chain of transmission. When the “herd” is sufficiently immunized, those without immunization are able to enjoy free-rider protection. But if overall immunization levels fall below a critical threshold percentage of the population, that protection is gone. Hence, public health officials work to maintain immunization levels even when prevailing incidence of the disease is low, because protection of that “herd immunity” that provides protection for all.

Sidebar 1-1 Government Creates a Market for Fishing Rights

Market failure does not always require direct government provision of a service as a remedy. Sometimes, the government may intervene in ways that create a market where none could exist before. The Council of Economic Advisors provided one example in the *Economic Report of the President* for 1993:

There is no practical way to establish ownership rights of ocean fish stocks. Traditionally, fish have been free for the taking—a common pool resource. Theory teaches that such underpricing leads to overconsumption. In the halibut fisheries off Alaska, fishing fleets caught so many halibut that the survival of the stock was threatened. No single fishing boat had an incentive to harvest fewer fish since the impact on its own future catch would be minimal and others would only increase their take. This is an example of what is known as “the tragedy of the commons.”

Officials tried limiting the length of the fishing season. But this effort only encouraged new capital investment such as larger and faster boats with more effective (and expensive) fishing equipment. In order to control the number of fish caught, the season was shortened in some areas from 4 months to 2 days by the early 1990s. Most of the halibut caught had to be frozen rather than marketed fresh, and halibut caught out of season had to be discarded.

In late 1992, the federal government proposed a new approach: assigning each fisherman a permit to catch a certain number of fish. The total number of fish for which permits are issued will reflect scientific estimates of the number of fish that can be caught without endangering the survival of the species. Also, the permits will be transferable—they can be bought and sold. By making the permits transferable, the system in effect creates a market where one did not exist previously. The proposed system will encourage the most profitable and efficient boats to operate at full capacity by buying permits from less successful boats, ensuring a fishing fleet that uses labor and equipment efficiently. Moreover, the transferable permits system establishes a market price for the opportunity to fish—a price that better reflects the true social cost of using this common resource.

The cap-and-trade system for dealing with environmental protection applies a similar approach. Sources of emissions (like sulfur dioxide) are allocated an initial emissions limitation. The entity is permitted to meet the limit by whatever means it chooses (conservation, revised production technology, end-of-pipe controls, etc.), so each will select whatever method is least expensive. But the entity can exceed its limit by purchasing limit caps from other entities—those who have excess cap because of particularly efficient methods for limiting their emissions. By this means, the intended overall emission reduction is achieved at minimal cost to the economy. The market price for emission limits emerges, exactly in the same way as the price for the opportunity to fish was established.

Both are clever ways to employ market-based approaches to deal with problems of initial market failure and achieve an efficient, effective, and low-cost solution.

more car miles traveled than would be the case if their operators based their choices on the full social cost (internal plus external) of using the car.

Governments regularly subsidize or tax to try to correct these market failures caused by externalities.⁹ For instance, governments may pay producers or consumers of goods with positive externalities to encourage more consumption of the good in recognition of benefits to third parties. They may also levy corrective taxes to make purchasers and sellers respond to the external damage done by other products. The idea is to make buyers and sellers respond to the external effects of the product, to bring the third-party effect into their decision-making in an economically tangible way.

Failure of Competition

The efficiencies of markets arise from competition among firms. When only a few firms serve a market, those firms may exercise monopoly power to charge prices higher than justified by economic conditions and, thereby, to collect excess profits. Governments watch markets to ensure that barriers do not prevent new firms from entering such markets, because entry of new firms in the industry is the best deterrent to monopoly pricing. And governments strictly police practices that unfairly restrain trade. Sometimes governments choose to regulate industries that, because of cost advantage to larger firms (or increasing returns to scale), seem destined to be dominated by a few large firms (the natural monopoly case). This may be the situation for electrical, telephone, water, and some other utilities, although new technologies (e.g., lower production cost for alternative electricity generators with small production capacity, and diverse telecommunication systems) have opened new competitive options in many such industries. As this occurs, governments have rightly moved from strategies of legalistic regulation of firm operations and the prices they charge to removing barriers to the entry of new firms, thereby allowing competition to allocate resources and establish reasonable prices for products. Nevertheless, expecting private businesses to regulate failures of competition—without the government's prompting—is not reasonable.

Incomplete Markets and Imperfect Information. Governments often intervene in markets when customers have incomplete information about products and there is fear that unfettered market forces will not provide necessary information in a timely fashion. Governments test (or supervise the testing of) new drugs, guard against the sale of hazardous products, establish certain disclosure standards, and so forth. The market may ultimately provide information—but not until after much grief and suffering by the unwary.

Insurance markets can present special problems of adverse selection and moral hazard. *Adverse selection* occurs when insurance purchasers impose higher-than-

⁹When transaction costs are negligible, bargaining between users of resources can internalize external effects and cause an efficient level of output with no more government action (i.e., no taxes, no subsidies, and no prohibitions) than to establish private rights to the use of resources. Ronald Coase, "The Problem of Social Cost," *Journal of Law and Economics* 3 (October 1960): 1–44.

average costs on sellers (in health insurance, for instance, those more likely to purchase insurance are those more likely to need care) or when sellers exclude such potential purchasers (health insurance companies seek to exclude those more likely to require care). It is a particular problem for provision of private prescription drug insurance (or the voluntary Medicare prescription drug benefit program): people vary widely in the extent to which they have high drug expenses, and both high- and low-expense people generally know into which group they fall. The only takers of a plan with premiums that reflect average prescription expenses would be those with high expenses, and, hence, the finances of the plan would be doomed. Insurance sellers rely on having both sets of people in the premium pool. *Moral hazard* is a problem when those with insurance have an incentive to cause the insured event to happen or to be less than diligent in averting the insured event. For example, with health insurance, there is a tendency for people to seek more treatment when the third party, the insurance company, is paying for it.¹⁰ In a case of government failure, federally subsidized flood insurance (premiums for the federal National Flood Insurance Program represent only about 38% of what a full premium would be) makes people more willing to build in floodplains and in coastal areas, thus increasing the loss when the inevitable flood occurs, as with Hurricane Katrina in 2005; and federal bank deposit insurance with coverage to high deposit levels makes people less interested in considering the financial strength of the institutions holding their deposits. Reasoned government intervention involves securing widespread coverage (to prevent adverse selection) and regulating markets to ensure that decision-makers see the accurate cost implications of those choices. Social insurance systems (public pension, health and disability, unemployment, etc.) throughout the world stem from these market problems.¹¹

Economic Stabilization. Governments seek to stabilize the macroeconomy, in other words, preventing high unemployment, controlling inflation that could erode purchasing power and distort financial markets, and improving the prospects for economic growth and a higher quality of life. Governments use monetary policy (manipulation of the money supply) and fiscal policies (changes in expenditure and taxation) to correct for these aggregate failures of the market, although there is continuing controversy about the extent to which those policies can make an active improvement in performance. Nevertheless, evidence does indicate that poor government decisions in use of national resources and financing of government programs in a misguided fashion can cause severe economic problems. Central governments worry about the condition of the national economy, whereas subnational units (states, regions, cities, etc.) seek to improve their own particular share of that national economy. And some governments attempt industrial policy, targeted subsidies and tax advantages designed to stimulate particular industries, in the belief

¹⁰Another illustration of moral hazard: There is some evidence that making private automobiles safer has encouraged drivers to be less cautious in their driving.

¹¹Another moral hazard: pitchers in the American League do not bat, so they do not face direct retaliation in the batter's box and are thus more likely to throw at opposing batters than are their counterparts in the National League, who do have to bat for themselves. J. C. Bradbury and D. J. Drinen, 2004. Identifying moral hazard: A natural experiment in Major League Baseball. Unpublished manuscript, The University of the South, Sewanee, TN. (Available online at: ddrinen.sewanee.edu/Plunk/dhpaper.pdf)

that they can increase economic growth and reduce unemployment by giving an extra boost to activities destined to be national or even global leaders. Again, the capacity of politicians and government bureaucrats to pick winners better than can markets is decidedly mixed, but that does not stop them from trying as they arrange the public finances. There is also not much evidence to support the idea that subnational government use of targeted tax and expenditure programs can have much of an effect on economic development, but that does not stop the political leaders from trying. The *Economist* succinctly explains why industrial and economic development policy, whether national, state, or local, has such a low success rate: “Neither economists nor emperors can be relied upon to pick winners. The best bet is entrepreneurial trial and error.”¹² Government money spent to assist particular industries is, sadly, often badly spent, because even the well-advised government usually guesses wrong. If lawmakers really knew how to do this, would there be poverty anywhere?

Redistribution. Markets distribute products of the economy to those people having resources (talents, properties, etc.), not distinguishing whether those resources were earned, inherited, stolen, or whatever. Those who own the resources get the goods. People with few resources—property or skills—may fall below acceptable living standards and may be destined to a life of poverty in a pure market economy. Governments may correct injustices in the distribution of affluence in society, seeking to improve the conditions faced by the less well-to-do that the market alone would leave them with. Some argue for a degree of redistribution out of a social conscience and a desire for a safety net for all humanity; others argue for a degree of redistribution out of a fear that the poor will revolt, taking property from the affluent. Regardless of motives, most politicians believe that the public wants some protection for the very poor and at least some mild redistribution by the government of the result produced by pure operation of the market. Those concerns are reflected both in government spending programs and in systems for finance of those programs.

Governments employ a variety of different approaches toward redistribution. These include tax structures that levy relatively higher tax burdens on high-affluence households than on low-affluence ones (income taxes that levy higher effective rates on high-income households), direct income payments to low-affluence families (the earned income tax credit), programs that provide assistance services for which only low-affluence families qualify (Medicaid), or programs available to all that low-income families use more heavily (unemployment benefit programs). However, the United States makes less aggressive use of active tax and transfer programs to handle problems of poverty than do other wealthy nations, preferring programs of economic expansion that benefit everyone, trusting that economic expansion will take care of the economic bottom as it benefits the economic top. As a result, the gap between highest and lowest incomes and the level of poverty in the United States is considerably wider than in other wealthy nations.

¹²“Finding Your Niche,” *Economist*, 21 March 2003: 70.

Privatization

Modern societies argue about where to draw the line between government provision and market provision of goods and services. Many governments have downsized the public sector to achieve efficiency, in the belief that market provision may offer more service options to the public, more flexibility in service response, and lower operating costs. With those possible advantages, it is no surprise that privatization of government operations is an attractive option. After considering the appropriate functions of government, as we did in the last section, it is also reasonable to explore the range for which various forms of privatization may be reasonable.

Privatization encompasses (1) transfer to the private sector of government-owned businesses that operate in goods and services markets that do not have significant market failures, (2) transfer to the private sector of government-owned businesses with natural monopoly power, especially telecommunications and electricity, and (3) contracting out of publicly financed services to private businesses, using service contracts or franchise agreements.¹³ This latter variety of privatization is possibly amenable to pure public goods; the former two may be accompanied by government regulation of prices, returns, or other conditions of operation.

Arguments Supporting Privatization. Several logical arguments have been offered in support of privatization.¹⁴ These are three of the most frequently used:

1. **Smaller government.** Some argue for a smaller public sector and fewer public bureaucrats, resulting in a shrunken scope of government, largely as a matter of philosophy. Because governments may spend without producing services (e.g., the check writing of the American Social Security system) and may be deeply involved in the private economy without even spending (e.g., the safety regulations applied to private industry), privatization, while reducing government production, may or may not reduce the size of government or state involvement in the economy. This therefore provides a weak basis for privatization.
2. **Operating efficiency and response to clients.** Governments produce under the political-bureaucratic system of central command and control, often driven from a desire to employ people with minimal attention to the need to at least cover costs of operation. State enterprises frequently lack a hard budget

¹³An excellent analysis of the economics of privatization is John Vickers and George Yarrow, "Economic Perspectives on Privatization," *Journal of Economic Perspectives* 5 (Spring 1991): 111–32.

¹⁴A recent study of American local government ownership and management of enterprises (gas, electric, and water utilities and public transport) finds that a desire to stem corruption was a major influence in nineteenth-century decisions to make ownership public. Reformers believed that managers of public organizations would have weaker incentives to capture profits for the enterprise from corrupt activities and to risk prison for profits not personally received. The study also suggests that public ownership is likely to create inefficient operation and excessively high government payrolls. (Edward L. Glaeser, "Public Ownership in the American City," *National Bureau of Economic Research Working Paper 8613*, December 2001.) The anti-corruption argument may have continued applicability in privatization discussions in the developing and transition environment, but it is not a clear call.

constraint and, when they operate at a loss, receive a government subsidy to cover it. This situation blunts any incentive for efficient operations. To survive, private businesses must respond to direct customer demand and must constrain prices out of concern for competition from other businesses. That environment drives private business toward operating efficiency (lower production cost) and improved responsiveness to customers, but only if the new private businesses face a competitive business environment. There is no reason to believe that a private monopolist city water company would be more efficient and responsive than a government monopolist city water company serving the same territory under the same regulatory conditions. The cost reduction associated with improved operating efficiency is a frequent objective of government privatizations in the United States. However, a number of studies have found the Veterans Health Administration hospital system to be a better performer than the systems available to other Americans.¹⁵ It is not always the case that a private system will outperform a government one—provided the incentives, direction, and will are strong.

3. **Cash.** Sale of government-operated enterprises may bring revenue to the government. The inflow, assuming a buyer can be found, would occur at sale. Operating profits (or losses) in the future would disappear, although the enterprise would then be subject to the tax system. Unfortunately, many government assets produce no revenue or produce revenue that is less than operating cost. That makes their value extremely low. This is a problem that countries of the former Soviet Union have had to face as they try to move into a market economy. Many state enterprises have high production costs and, even with private ownership, the product will not sell on national or international markets at a price sufficient to cover those costs. Although the old central plans invested heavily in these plants, their privatized value has proved to be low—except in natural resource sectors (oil, gas, etc.). In other environments, the revenues have proved substantial. The cumulative total has been estimated at over \$1 trillion through the second part of 1999; the annual flow of privatization proceeds has exceeded \$100 billion in the last part of the 1990s.¹⁶

Other motives behind privatization include lack of appropriate personnel or expertise to perform the service, provide greater operating flexibility, quicken implementation of the program, increase the pace of innovation, and improve quality of service. However, it is important to understand that all government services are not equally susceptible to outsourcing and not all motives will be satisfied in any particular privatization program.

The largest transactions involve formerly nationalized industries under old concepts of the economic role of government or of the need to keep “socially or eco-

¹⁵A number of studies are cited in Phillip Longman, “The Best Care Anywhere,” *Washington Monthly*, January/February 2005. With other incentives, the public sector compares badly: Jishnu Das and Jeffrey Hammer, “Money for Nothing: The Dire Straits of Medical Practice in Delhi, India,” World Bank Policy Research Working Paper 3669, July 2005.

¹⁶William L. Megginson and Jeffrey M. Netter, “From State to Market: A Study of Empirical Studies of Privatization,” *Journal of Economic Literature* 39 (June 2001): 321–89.

nomically significant” industries under state control: telecommunications, petroleum and petrochemicals, gas distribution, automobile manufacturing, electricity generation and distribution, airlines, steel making, and so on.¹⁷ Between 1990 and 2000, 36 percent of privatization proceeds came from telecommunications, 16 percent from power, 15 percent from financial institutions, 10 percent from oil and gas, and 17 percent from other industries.¹⁸ Government operation of these industries has been notoriously bad because of political influences on service decisions (e.g., a city gets served by the national airline because an important politician lives there) and on operations (e.g., the industry is seen as employer of last resort and the resulting bloated payrolls prevent it from ever producing its product at a competitive cost).¹⁹ Governments in the United States have been less active in recent privatization than those in Western Europe, Latin America, Asia, New Zealand, and Australia. Many of the big international privatizations, however, have been in industries never publicly owned in the United States. Privatization of roads, airports, the postal system, schools, and the like raise much more interesting social, political, and economic issues than the state sale of telephone or petrochemical companies.²⁰

Production/Provision. The American privatization issue frequently concerns the provision-production dichotomy.²¹ Goods and services provided by a government because of market failure need not be produced by that government. Provision means government intervention to ensure availability or, generally, to finance the service; it does not require production by the government. The production choice should be made according to which entity—a government department, a private entity (profit or nonprofit), or another government—would supply the desired quantity and quality of service at least cost to the citizens of the providing government.

The distinction between government and private production and provision can be clarified by example:

1. **Government provision/government production.** The city street department plows the streets after a heavy snowfall. The job uses department managers, department employees, department equipment, and department supplies.
2. **Government provision/private production.** The county hires a private appraisal firm to estimate values of real estate in the county for use in computing

¹⁷The largest of all was the sale of Nippon Telegraph and Telephone by the government of Japan. Share offerings in 1987 and 1988 raised almost \$80 billion; the \$40 billion offering in November 1987 is the largest security offering in history.

¹⁸William L. Megginson, *The Financial Economics of Privatization* (New York: Oxford University Press, 2005): 27–28.

¹⁹National airlines can face difficult political barriers to efficient operations. Keith Johnson and Luca Di Leo, “Alitalia Can’t Stanch Red Ink,” *Wall Street Journal* (April 21, 2004): A-16. Difficult staff reductions then being proposed would have brought Alitalia down to about 1,100 passengers per employee. That compared with about 9,000 passengers per employee for the competing discount carrier Ryanair.

²⁰The pioneer of privatization in the last decades of the twentieth century, Britain, has been unable to fully privatize its coal industry, so apparently technically simple decisions do get muddled by politics and other factors.

²¹It also encompasses application of user-pay concepts, including sale of service and tax payments based on the benefits received from particular government services. These mechanisms, while bringing some market-like principles, do not alter public provision and thus are discussed in the revenue section of this book.

property tax bills. The firm does the work with its managers, employers, equipment, and supplies. Another example: The U.S. Department of Defense hires private firms to provide food and other support services to military units in the field. Outsourcing is almost certainly the most common privatization practiced in the United States.²² It is a major element in President Bush's management agenda for the federal government, which intends competitive sourcing for federal tasks that are readily available in the commercial marketplace.²³

3. Private provision/government production. A racetrack pays a city for extraordinary traffic control services on race days.

4. Private provision/private production. A private manufacturer patrols its factory site with its own security employees.²⁴ Neighboring properties may receive some protection spillover from this security activity.

Some cities, especially in California, have provided a full range of services entirely by contract. Such an arrangement is called the Lakewood Plan after an early contract city.²⁵ Production by contract is probably limited more than anything else by the ability to design a contract specifying the service qualities to be delivered. Even parts of the judicial system may be privately produced: California permits litigants to hire private jurists when court congestion or special expertise makes such a procedure attractive to both parties, and private firms have undertaken contractual operation of correction facilities.²⁶ School districts have similarly chosen private production through vouchers or charter schools.²⁷ In these systems, the school district provides financing but the educational service is actually produced by another entity.

The production choice should be kept open for possible privatization; the idea of government action is to provide services of desired quantity and quality at the least cost to the economy. When might contracting not be an efficient option? One study suggests that in-house production may be warranted when "(1) there are very few potential suppliers, (2) costs of switching from one producer to another are high, (3) information about the production process and supplier performance is

²²U.S. General Accounting Office, *Privatization: Lessons Learned by State and Local Governments*, GAO/GGD-97-48 (Washington: U.S. Government Printing Office, 1997).

²³The efforts by the Bush administration to outsource government operations is described in John Maggs, "Compete, or Else," *National Journal* (July 12, 2003): 2228–2237.

²⁴Businesses and individuals in the United States spend over twice as much for private security as governments spend on providing public safety. "Welcome to the New World of Private Security," *Economist* (April 19, 1997): 21.

²⁵Robert Bish, *The Public Economy of Metropolitan Areas* (Chicago: Markham, 1971), 85.

²⁶California Is Allowing Its Wealthy Litigants to Hire Private Jurists," *The Wall Street Journal* (August 6, 1980); and U.S. General Accounting Office, *Private and Public Prisons: Studies Comparing Operational Costs and/or Quality of Service*, GAO/GGD-96-158 (Washington: U.S. Government Printing Office, 1996). Correction facilities face an interesting incentive problem: it is against their economic interests to rehabilitate criminals in their care because successful rehabilitation reduces demand for their incarceration services.

²⁷Gary Putka, "Baltimore Test of Privatization Gets a Bad Start," *Wall Street Journal* (September 23, 1992). Voucher systems provide families an education grant—a subsidy for purchase of education—which may be spent on services from a variety of producers. Charter schools allow private entities to create schools outside the public system, with finance from public funds. Families pick among schools.

expensive to obtain, and (4) the good or service being provided cannot be clearly defined."²⁸ In other words, the option would be difficult if contracts would be especially difficult to write and the public would end up being confronted with a monopoly supplier. Otherwise, out-of-government production can be an efficient option.

Privatization of provision is a more difficult problem. For public goods, the market will not function because the private supplier will not charge an efficient price for the service because of nonrivalry and inability to exclude. Business firms provide goods and services because they intend to make money, not for the sheer enjoyment of providing the goods or services. If it is not possible to charge people for the good or service, a business firm will seldom provide it. Furthermore, the price will exceed the cost of providing service to an additional consumer (recall that the additional cost is zero).

The expectation of government provision of public goods is strong, but occasionally governments will provide private goods as well and often do a very bad job of it. Organizational problems, particularly lack of appropriate production incentives, cause high costs, undesirable production strategies, and a bland product designed by an uneasy consensus. Governments provide toll goods (highways, bridges, etc.), and sometimes they do about as well as the private producer would do. But even some toll goods are provided by private businesses. For instance, in France eight public/private joint ventures and one private company operate the toll highway/tunnel system, the most extensive auto toll system in Europe. Evidence indicates that fewer resources will be wasted if government avoids provision of private goods.

Some observers of public fiscal problems have suggested that privatization would relieve pressures on government finances. That is a realistic response if the service being privatized in fact lacks substantial public-good features; one wonders why, in such a case, the government got involved in its provision. On the other hand, to expect private firms to provide public goods at desirable levels is folly. At best, the private firm may be contracted to produce the public good provided (paid for) by the government.

Privatization cannot be a general and complete cure for fiscal problems, no matter how inefficient a troubled government might be. For public goods, efficient private provision cannot substitute for inefficient government provision of public goods. That does not mean that market incentives cannot help, however, in guiding provision by government.

Building Social Decisions from Private Preferences

The logic of moving from individual choice to choices made by society is built on three fairly simple tenets. First, individuals are the best judges of their own well-being and generally act to improve that well-being as they see it. There is no

²⁸John C. Hilke, *Competition in Government-Financed Services* (New York: Quorum Books, 1992), 8. Why does the federal government run its own printing house, the Government Printing Office? To learn more about mixed motives, see Graeme Browning, "Stop the Presses?" *National Journal* 25 (October 16, 1993): 2483–85.

scientific principle that leads us to reject or accept the judgments made by individuals about their own lives. Dictators or philosopher-kings may accurately make those determinations, but others should not assume that responsibility. Second, the welfare of the community depends on the welfare of the individuals in that community. In other words, communities are made up of people, and community welfare increases only if the welfare of those in the community is improved. From that comes the third tenet, judging the impact of a social action on the welfare of the community. The Pareto criterion, named after a nineteenth-century economist, holds that if at least one person is better off from a policy action and no person is worse off, then the community as a whole is unambiguously better off for the policy.²⁹ Does a social action harming anyone, despite improving the condition of many individuals, improve the welfare of society as a whole? It cannot be indisputably argued that such an action improves the well-being of society, regardless of the numbers made better off, because the relative worth of those harmed cannot scientifically be compared with those helped. Such a proposed policy would fail the Pareto criterion for judging social action.³⁰

With those standards, we can analyze the implications of nonappropriability on public provision. Suppose that only five people would be influenced by construction of a levee to protect a small area from periodic flooding of a river. The cost of that levee is \$20,000. Each individual in this community knows the maximum sacrifice that he or she would be willing to make to have that levee as compared to having no levee at all. Presumably it would not be larger than the individual damage avoided by having levee protection. These are the individual benefit numbers in Table 1–1. The levee, we assume, would be a public good: Each individual could use it without diminishing its availability to anyone else in the community, and exclusion of nonpayers is not feasible.

First, would the levee be built without public action, that is, by individual action only? The cost of the levee is \$20,000; the most that any single individual (individual D) will pay to get the levee built is \$9,000. Thus, the levee would not be produced by any single individual. If the levee only cost \$8,500 to construct, however, we suspect individual D would build the levee for his or her benefit, and four other people in the community would receive benefits from the levee without payment. (The four would be *free riders*.) Once the levee is there, it serves all because of its public-good features.³¹ The initially presumed construction cost, however, is such that the maximum individual benefit is less than the cost of the project, so the levee will not be built by private action.

Is the levee economically desirable for the community, in the sense that the value of the levee is greater than the resources going into the construction of the

²⁹Vilfredo Pareto, *Manuel d'Economie Politique*, 2d ed. (Paris: M. Giard, 1927), 617–18.

³⁰Benefit-cost analysis, an analytic technique that will be discussed in a later chapter, employs a less restricting and somewhat less appealing rule than the Pareto criterion. This is the Kaldor criterion, which holds that a social action improves community welfare if those benefiting from a social action could hypothetically compensate the losers in full and still have gain left over. Because no compensation need actually occur, losers can remain and the Pareto criterion would not be met.

³¹Voluntary associations (clubs) represent an intermediate option between a government with sovereign powers and individual action. Neighborhood associations offer an example popular in some regions.

Table 1–1
Individual Benefits from the Project: Example 1

Individual	Individual Benefit	
A	8,000	
B	7,000	
C	6,000	Total cost = \$20,000
D	9,000	
E	6,000	
Total benefit	\$36,000	

levee? The social cost, the value of the resources being used in the construction of the levee, equals \$20,000. The social benefit of the levee, the sum of the improved welfare of the individuals with the levee, equals \$36,000. Because social benefits are greater than social costs, it is a desirable project for the community.³² A responsive government would act to provide the levee and would raise sufficient funds through the revenue structure to finance the project. If the government levied an equal per-capita tax—a payment based on the coercive power of government rather than the voluntary payment of market exchange—on the community to finance the levee (\$4,000 each), all individuals would still be better off with the levee and the tax than without the combination.³³ Government can thus provide a desired service that public-good features prevent private action from providing.

A second example yields additional insights. Assume that the community receives benefits from a project as shown in Table 1–2. The project, possibly a levee in another location, is a public good. The cost of the project is \$20,000. Because the sum of individual benefits (\$19,000) is less than the cost of the project, the project resources would be worth more in other uses than in the particular use being considered. Suppose, however, that the project decision will be made at a referendum among the people in the community, with a simple majority required for passage. The referendum also includes the method to be used to finance the project: an equal per-capita tax (project cost divided by number of people in the community, or \$4,000 per person). If the people in the community vote according to their individual net gain or loss from the project (as computed in Table 1–2), it will be approved (three for, two against). Does voter approval make the project desirable for the community? Not at all, because the project misallocates resources: It consumes resources that would have a greater value in other use. The majority vote may misallocate resources when used for public decisions, as may any technique that does not involve comparisons of social cost and social return.

³²A small number of people may construct the levee without the full coercion of government. For instance, individuals A, B, and D could form a small property-owners association; the sum of benefits to those three exceeds the cost. These people might privately agree to build the levee for their protection—and benefits would spill over to C and E.

³³This tax “system” is selected for convenience alone. It is not a “model” or an “ideal” in any sense.

Table 1–2
Individual Benefits from the Project: Example 2

Individual	Individual Benefit	Cost Share	Individual Gain
A	\$5,000	\$4,000	\$1,000
B	5,000	4,000	1,000
C	2,000	4,000	–2,000
D	1,000	4,000	–3,000
E	6,000	4,000	2,000
<i>Total</i>	\$19,000	\$20,000	

A third example further illustrates the limits of scientific principles in public decision making. Table 1–3 presents individual benefits from a project with a total cost of \$12,500 and an equal per-capita tax method of distributing project costs. Total benefits do exceed total cost, so the project apparently represents an appropriate way to use scarce resources, and the project would be approved by majority vote if the people voted according to their individual gains or losses. The project, however, does leave one individual worse off. Is the loss to E less important to the community than the gains of A, B, C, and D? That answer requires a value judgment about the worth of the individuals to society, a judgment with which science and Pareto cannot help. One option would be to distribute costs in exactly the same proportion as individual benefits. That is the approach shown in the last column of Table 1–3. Any project for which total benefits exceed total cost has possible cost distributions from which all will be made better off. There is no redistribution of individual cost from which all will be made better off for projects like that demonstrated in Table 1–2, but choices about situations like that shown in Table 1–3 are difficult. Politicians make such decisions regularly, but not with scientific justification.

One voting rule would ensure that only projects that pass the Pareto criterion could be approved. That rule is unanimity, if we assume that people will not vote

Table 1–3
Individual Benefits from the Project: Example 3

Individual	Individual Benefit	Cost Share	Individual Gain	Individual Share of Total Benefits	Benefit-Based Cost Share
A	\$3,000	\$2,500	\$ 500	15%	\$1,875
B	5,000	2,500	2,500	25%	3,125
C	8,000	2,500	5,500	40%	5,000
D	3,000	2,500	500	15%	1,875
E	1,000	2,500	–1,500	5%	625
<i>Total</i>	\$20,000	\$12,500		100%	\$12,500

for policies contrary to their own best interest. This rule is seldom used, because reaching decisions often requires substantial costs. James Buchanan and Gordon Tullock identify two elements constituting the full cost of making a community decision.³⁴ The first element, the cost of reaching the decision, the “time and effort . . . which is required to secure agreement,”³⁵ rises as the agreement percentage required for the decision rises. As more of the group must agree on any issue, the effort invested in bargaining, arguing, and discussion normally rises. That investment is a real cost because the effort could have been directed to other uses. The second element, the external costs, or the cost from group “choices contrary to the individual’s own interest,”³⁶ falls as the agreement percentage rises. (These are the costs imposed by a simple majority choice on individuals C and D in Table 1–2. Those costs could have been prevented by requiring a higher vote for approval.) The optimal choice percentage—the lowest combination of the two cost elements—usually would require neither unanimity nor one-person rule because the former has excessive decision costs and the latter has excessive external costs. Certain decisions are more dangerous to minorities (the losers in decisions) than others. For instance, many juries must reach a unanimous verdict because of the very high external costs that juries can place on people. For similar reasons, constitutional revision has high-percentage vote requirements.

Politics, Representation, and Government Finance

Decisions about public spending, raising revenue, borrowing, and so on are not the product of mechanical rationality. They are intensely political and involve personal interests, interest groups, political parties, and the process of representation. Even the clearest preferences of any particular individual are usually filtered through representation, and that one preference becomes part of a vote that may or may not be in the majority whose choice prevails. The many elements that produce a fiscal choice are diverse, but a framework devised by Anthony Downs for exploring the process of representation can help with an understanding of what influences these decisions.³⁷ He hypothesizes that political parties in a democracy operate to obtain votes to retain the income, power, and prestige that come with being in office. Parties are not units of principle or of ideals but are primarily seekers of votes. A lack of perfect knowledge, however, permeates the system: Parties do not always know what citizens want; citizens do not always know what the government in power or its opposition has done, is doing, or should be doing to try to serve citizen interests. Information that would reduce this ignorance is expensive to acquire. The scarcity of knowledge obscures the path that would lead from citizen preferences to their votes. Neither political parties nor elected representatives know exactly

³⁴James M. Buchanan and Gordon Tullock, *The Calculus of Consent* (Ann Arbor: University of Michigan Press, 1962), chaps. 6–8.

³⁵*Ibid.*, 68.

³⁶*Ibid.*, 64.

³⁷Anthony Downs, *An Economic Theory of Democracy* (New York: Harper & Row, 1956).

what the voters want, and the voters do not know exactly what the government is up to.

Several consequences for the representative process result. First, some people are politically more important than others because they can influence government action. Democratic government will not treat everyone with equal deference in a world of imperfect knowledge. One person, one vote is the ideal slogan, but it doesn't represent political influence particularly well. Second, specialists in influencing people will appear, and some will emerge as representatives of the people. These individuals will try to convince the government that the policies they support, and that directly benefit them, are good for and desired by the electorate. Information provided by these individuals will be filtered to provide only data consistent with the supported cause. A rational government will discount these claims, but it cannot ignore them. Third, imperfect information makes a government party susceptible to bribery simply because the party in power needs resources to persuade voters to keep it in power. Parties out of power are susceptible as well, but they have less to sell. It is no accident that corruption scandals involve more Republicans when the Republicans are in power and more Democrats when the Democrats are in power. Political influence is a necessary result of imperfect information combined with the unequal distribution of income and wealth in society. Parties have to use economic resources to provide and obtain information.

Lobbying is a rational response to the lack of perfect information, but an important imbalance of interests influences the lobbying process. Suppose a direct subsidy to industry is being considered. This subsidy is of great total value to that industry. The total subsidy paid by taxpayers, of course, exactly equals the subsidy received by the industry. However, each taxpayer bears only a small individual share of that total subsidy. Who will undertake the expense of lobbying on the measure? The industry will, not the taxpayer, because the net benefit of lobbying is positive for the industry (comparing the substantial cost of lobbying with the substantial direct benefit to the industry) and negative for any taxpayer (because the substantial lobbying cost overwhelms the small individual share of the subsidy that could be saved).

These efforts to influence fiscal decisions take two general forms. Traditional lobbying is personal: "Affable men in suits would hang around swarming, sweaty legislative chambers, buttonholing lawmakers as they swaggered through lustrous bronzed doors, whispering in ears, slapping backs, winking knowingly."³⁸ The lobbyists know the elected representative and have access to them (usually because they can be counted on for contributions and other campaign assistance), know the unelected administrators carrying out public policies, and use these contacts to deliver the message of their clients on issues. Many former legislators and agency administrators—federal and state—develop lucrative careers as lobbyists, using contacts and friendships to help deliver the message of the interests they represent;

³⁸Ron Faucheux, "The Grassroots Explosion," *Campaigns and Elections* (December 1994–January 1995). Lobbying state legislators can be crass: "It's one of the accepted rules in the unwritten guide to being a lobbyist. The way to get a lawmaker's ear is to get him a drink first." (Christi Parsons and Rick Pearson, "Springfield Has a Gift for Grab," *Chicago Tribune*, 6 July 1997.)

their value is in their access to the people who remain in government. In one recent example, the member of Congress primarily responsible for the Medicare Prescription Drug Improvement and Modernization Act of 2003 (P.L.108173), an act that provided significant new revenue for the pharmaceutical industry and avoided price constraints on prescription medicines, left Congress for a position as chief lobbyist for brand-name drug companies.³⁹ Many call this easy mobility between legislative or executive positions and interested private entities “a revolving door,” and few believe it to be contributory to fiscal decisions in the public interest. But it is part of the way in which public policies get adopted today.

Grassroots lobbying is the mobilization of constituent action, reflected in letters, phone calls, e-mails, faxes, and other direct contacts to the elected representative. Mass campaigns had great successes in getting civil-rights legislation and in shaping other policies, but communications and information technologies make it much easier to generate what appears to be a groundswell of interest and masses of constituent communications of public policy questions, including those of government expenditure and taxation.

A related influence on representative government is the principle of rational ignorance. Citizen effort to acquire information to cast an informed vote is usually irrational.⁴⁰ Although the cost of obtaining information may be low, the expected return from an informed vote is even lower. If others vote in an informed manner, a citizen’s uninformed vote is irrelevant because the informed majority choice wins. If others vote in an uninformed manner, a citizen’s informed vote is irrelevant because the choice of the uninformed majority wins. In either case, the action of the majority produces the election result, so individual effort to become informed yields no return. Thus, electorate choices produce indivisible benefits or costs. Information gathering to cast informed votes produces no electoral benefits for an individual. That, of course, is a crucial problem in any democratic society. Fortunately, many individuals become informed for other motives, including pure enjoyment. The power of the vote is an important reason why free, high-quality primary and secondary education is so critical for democratic government.

A final important point in the process of representation deals with the intensity of preference. In ordinary voting, there are no methods of representing intensity of preference on particular issues. Each vote has equal weight. In a legislative body, however, the flow of many issues allows legislators to trade a vote on a minor issue (according to that person’s preferences) for a vote on a more important one. Trading votes allows adjustments according to intensity of preference. For example, a member of Congress may be particularly interested in the outcome on issue B, but have little concern about issue A. That representative may trade his or her vote on issue A for some other representative’s vote on issue B. This process, called *logrolling*, can produce wasteful spending (an irrigation project yielding benefit to a

³⁹As Robert L. Livingston, former head of the House Appropriations Committee who became president of a lobbying firm, said about lobbying: “There’s an unlimited business out there for us.” (Jeffrey H. Birnbaum, “The Road to Riches is Called K Street,” *Washington Post* 22 June 2005: A1.) K Street in Washington is where the offices of the major lobbyists are located.

⁴⁰Downs, Chapter 18.

small area at great national cost, for instance), but it can also improve the responsiveness of government by ensuring that intense preferences get recognized. Furthermore, the representative process has special devices for protecting the interests of minorities. These do not appear in the general referendum process of choice by direct vote:

The required majority of those voting (in a referendum) can inflict severe cost on the rest of society with dramatic consequences for the social fabric. Their major disadvantage must emerge from the absence of minority power in the direct legislation system. An initiated referendum has no provision for executive veto, creation of political stalemates in the legislative process, or changed negotiating positions in committees, all vital positions of lawmaking which can serve to protect minorities.⁴¹

The Layers of Government

In the United States three layers of governments with sovereignty of their own (not a single government) provide public services, levy taxes, and borrow money. Indeed, there are more than 86,000 governments in the United States, counting federal, state, and local entities. Not all nations are governed in this fashion. Some governments are unitary, meaning that a single national government has legislative authority over the entire country. There may be local councils with certain powers, but they function only on the approval of the national government. In many unitary states, local revenue and expenditure programs must be approved by the national government, and a single consolidated financial program (or budget) exists for the entire country. Unitary states include Belgium, France, the Netherlands, Norway, Poland, and many countries of the former Soviet Union (but not Russia). The United Kingdom, historically unitary, is devolving some powers to regional parliaments in Scotland and Wales. Other nations are federal: Subnational governments have considerable autonomous authority to make decisions, including difficult decisions about taxing and spending. In no sense are these subnational units a dependent department of the central government, as they may be in a unitary state. In the United States, states exist as an independent layer of government with full powers (including independent financial authority) and all residual powers.⁴² Other important federal states include Argentina, Australia, Austria, Brazil, Canada, Germany, India, Mexico, and the Russian Federation (although recent changes there to reduce sovereign powers of regional and local governments and move them to the national government have moved the nation closer to being a unitary state). In each instance, to understand government finances—spending, taxing, and borrowing—one must understand the intergovernmental structure in the country.

⁴¹John L. Mikesell, "The Season of the Tax Revolt," in *Fiscal Retrenchment and Urban Policy*, ed. John P. Blair and David Nachimias (Newbury Park, Calif.: Sage, 1979), 128.

⁴²The national government under the Articles of Confederation, precursor to the Constitution, lacked the power to tax. Payments from the states proved inadequate, so it is no wonder that it resorted to finance by printing money, which proved to be disastrously inflationary.

In the U.S. federal system, constitutional terms define the elemental financial powers and limits under which the levels function. First, there are powers and limits to national (federal) authority: Article I, Section 8, lists fiscally significant powers. These include the powers

To lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defense and general welfare of the United States; but all duties, imposts and excises shall be uniform throughout the United States.

To borrow money on the credit of the United States.

To regulate commerce with foreign nations, and among the several States, and with the Indian tribes.

To coin money, regulate the value thereof, and of foreign coin, and fix the standard of weights and measures.

To establish post-offices and post-roads.

To raise and support armies, but no appropriation of money to that use shall be for a longer term than two years.

To provide and maintain a navy.

Article I, Section 9, establishes some fiscal constraints:

No capitation, or other direct, tax shall be laid, unless in proportion to the census of enumeration herein before directed to be taken.

No tax or duty shall be laid on articles exported from any State.

No money shall be drawn from the Treasury, but in consequence of appropriations made by law; and a regular statement and account of the receipts and expenditures of all public money shall be published from time to time.

Of course, legislation and court decisions have, over the years, specifically defined what these powers and constraints mean in practice.

The Constitution similarly identifies, in Article I, Section 10, powers specifically denied the states. Of fiscal significance is the prohibition against coining money. The commerce clause (Article I, Section 8, paragraph 3, listed above) prevents state interference with international commerce and commerce among the states, a particularly significant limit on taxing power and regulatory authority in a global economy. This is referred to as the Commerce Clause, and it plays an important role in many facets of state taxation. A later amendment (Article XIV, Section 1) requires states to follow due process in their actions and to afford equal protection of the law to all within their jurisdictions. These provisions have had substantial impact on service provision in the states, as courts have reminded state and local governments that fiscal processes must meet federal constitutional tests.⁴³ The federal equal-protection

⁴³Two examples: Public schools, as examined in Rosemary O'Leary and Charles R. Wise, "Public Managers, Judges, and Legislators: Redefining the 'New Partnership,'" *Public Administration Review* 51 (July/August 1991): 316–27; and jails, as examined in Jeffrey D. Straussman and Kurt Thurmaier, "Budgeting Rights: The Case of Jail Litigation," *Public Budgeting & Finance* (Summer 1989): 30–42.

24 Chapter One: Fundamental Principles of Public Finance

clause has been often copied in state constitutions. The dramatic change in school finance in California generated by the court case *Serrano v. Priest*⁴⁴ resulted from state constitutional provisions copied after those in the federal law.

The major constitutional provision for states appears in the tenth amendment of the Constitution: “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.” The states thus have *residual powers*. The Constitution does not need to provide specific authority for a state government to have a particular power: Constitutional silence implies that the state can act in the area in question, thus establishing states as the sovereign “middle layer” in the federal system.

Local governments in the United States typically appear as captive creatures of their states, unless state action has specifically altered that relationship. This principle was defined by Judge J. F. Dillon of Iowa:

It is a general and undisputed proposition of law that a municipal corporation possesses and can exercise the following powers and no others: First, those granted in express words; second, those necessarily or fairly implied in or incident to the powers expressly granted; third, those essential to the declared objects and purposes of the corporation—not simply convenient, but indispensable. Any fair, reasonable, substantive doubt concerning the existence of power is resolved by the courts against the corporation, and the power denied.⁴⁵

Dillon’s rule thus holds that if state law is silent about a particular local power, the presumption is that the local level lacks power. In state-local relationships, state government holds all powers. That is a critical limitation on local government fiscal activity.

Several states have altered Dillon’s rule by granting home-rule charter powers to particular local governments. Such powers are particularly prevalent in states containing a small group of large metropolitan areas with conditions substantially different from the environment in other areas of the state. The special conditions of such large cities can be handled by providing them home-rule charter power to govern their own affairs. State law can thus proceed without being cluttered by numerous special enactments for the larger units. When charter powers have been provided, local governments can act in all areas unless state law specifically prohibits those actions. Many times, however, fiscal activities are included in the range of areas that are prohibited under charter powers. Thus, it is better to presume limits than to presume local freedom to choose in fiscal affairs. That presumption is accurate if Dillon’s rule applies or if charter powers have been constrained in fiscal activities.

Conclusion

An overview of the basis for government action certainly indicates that government choices made in budgeting and revenue raising will not be simple. Government will

⁴⁴Cal. 3d 584, 487 P. 2d 1241, 97 California Reporter 601 (1971).

⁴⁵John F. Dillon, *Commentaries on the Law of Municipal Corporations*, 5th ed. (Boston: Little, Brown, 1911); vol. 1, sec. 237. See *City of Clinton v. Cedar Rapids and Missouri Railroad Company* (1868).

be unable to sell its services because these services are nonappropriable (neither excludable nor exhaustible). That means that government will not have normal market tests available to help it with choices.

Governments surely do not want to waste resources—after all, resources are scarce, and most things used by government do have alternative uses—so the benefits to society from government action ought to exceed the cost to society from that action. Determining whether actions really improve the conditions of the community gets complicated, however, when there is no basis for making comparison of the worth of individuals. The Pareto criterion for the welfare of a community does not require interpersonal judgments, but it leaves many choices open to political decision. Despite sophistication and rigor, science and analysis will not provide definitive answers to many government choices. Votes, either on issues or for representatives, will settle many decisions. Direct votes, however, will neither guarantee no wasteful public decisions nor choices that satisfy the Pareto criterion for improving society. They may well cause the imposition of substantial costs on minorities. Some problems of direct choice are reduced when representatives make decisions, but there will remain imbalances of influence and posturing to continue in office rather than to follow clearly defined principles. Lobbying—direct or grassroots—is one way in which some interests obtain extra influence.

Finance in a representative democracy is not simple. Governments should be judged on their responsiveness to public preferences and on their refusal to ignore minority positions. Not all governments can meet those simple standards, and not all budget systems used in the United States do much to contribute to those objectives. The U.S. structure delivers and finances services using three tiers of government—federal, state, and local. Although independent in some respects, there are important mutual constraints. The federal level has powers delimited in the Constitution; the states have residual powers. Local governments—under Dillon’s rule—have only powers expressly granted by their states. Some states grant local home rule, giving localities all powers save those expressly prohibited. Few home-rule authorizations are complete, however. Thus, budget and finance functions vary widely across the country.

QUESTIONS AND EXERCISES

1. A community project (a public good) will cost \$2,500 and will benefit the five members of the community as follows:

Resident	Individual Benefit (\$)	Cost Share (\$)
A	800	500
B	800	500
C	300	500
D	350	500
E	450	500

- a. Is the project economically feasible?
 - b. Would the project be approved by a majority at a referendum?
 - c. Does the project meet the Pareto criterion?
 - d. If possible, revise the cost shares to allow the project to meet the Pareto criterion and to pass a referendum.
2. Determine for your state the budget and finance constraints that the state places on local government. Does Dillon's rule apply? Do some units have home-rule powers? What is the extent of any such powers?
 3. Private businesses have a great interest in quality primary and secondary education because today's students are tomorrow's employees. However, private businesses make limited financial contributions to this sector of education (excluding the taxes they pay to public school systems), even to market-oriented programs like vouchers and charter schools. What do you suppose explains this low contribution level? (Hint: consider what sort of good primary and secondary education might be.)

CASE FOR DISCUSSION

CASE 1-1

Market Interplay, Municipal Utilities, and a Common-Pool Resource

Governments often are surprised by private responses to what appear to be relatively straightforward and sensible public decisions. It should be no surprise that businesses respond to higher prices for their purchases by trying to economize on their use of those more expensive resources. What may be surprising is how these reactions themselves create even more complex problems for the government. In the case described here, the normal business response is particularly interesting because it crosses between the operation of a municipal utility and the exploitation of a common-pool resource. Here is a case from *The Wall Street Journal*.

Consider These Questions

1. Identify the various types of goods (private, public, and in between) involved in this case. What was the primary objective being sought and how was it being financed? Is that financing approach appropriate for the type of good involved?
2. What options might governments in the Boston area have?
3. What would you recommend to prevent further damage?

SOURCE: *Wall Street Journal*, (20 January 1993), B-1. Reprinted by permission of the *Wall Street Journal*, © 1993 Dow Jones & Company, Inc. All rights reserved worldwide.

City Dwellers Drill for Precious Fluid¹

As water rates go up, some Bostonians are going down—about 900 feet to find water. Average water and sewer bills in Boston have more than tripled since 1985 to cover costs of cleaning up Boston harbor. To cut their bills, several Boston businesses have recently drilled their own wells.

“It’s a very alarming trend,” says Jonathan Kaledin, executive director of the National Water Education Council, a Boston-based group that tracks water-project funding issues. As customers “leave the system,” those who remain must shoulder higher funding burdens.

If such drilling becomes a trend, it could undermine funding in a number of cities for projects to comply with clean-water laws. New York City water projects, for example, are expected to cost more than \$10 billion during the 1990s, according to a recent report by Mr. Kaledin’s group.

Boston officials also worry that buildings in the city’s Back Bay area, a fill-in swamp, may sink if wells lower the water table. Structures there rest on immersed wooden pilings that “will rot in two or three years” if exposed to air as the water level drops, warns Boston City Councilman David Scondras. City officials, citing over 400 known hazardous-spill sites in Boston, also fret that wells may tap into polluted water.

But the economic arguments for drilling are overwhelming, says Roger Berkowitz, co-owner of Legal Sea Foods, a Boston restaurant chain that recently drilled a well. Its 15,000 gallon-a-day gusher saves the company \$2,500 a month by providing water for laundry and other uses. Though it isn’t used for drinking, Mr. Berkowitz says, tests show water from the chain’s well surpasses Boston’s municipal water in purity.

