



Public finance and public policy: a new textbook

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A review of Public Finance and Public Policy: Responsibilities and Limitations of Government, Arye L. Hillman,
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Abstract

What are the responsibilities and limitations of government? By drawing on insights from normative public finance, public choice, and new political economy, Arye L. Hillman's textbook on public finance provides an engaging, clear, and well-organised introduction to the subject and defines a framework within which answers to this question can be given. The book will not only be of value to undergraduate teaching in public finance, but will also appeal to graduate students, academics and policymakers who want a concise and up-to-date overview of the main ideas and developments in the area.

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1. Introduction

Governments around the world are each year trusted with substantial resources by their citizens, in some cases more than 40% of GDP. What governments do with these resources as well as the methods they use to raise them in the first place greatly affect human wellbeing. Public finance, as an academic discipline, is devoted to the task of understanding the responsibilities and limitations of government, and, today, a rich and varied body of knowledge on the subject exists. A key task of university education in economics is to pass on this knowledge to students, who as citizens, as government officials, as politicians or in some other future capacity will have to make choices about public policy in one way or the other.

Arye L. Hillman's textbook, "Public Finance and Public Policy, Responsibilities and Limitations of Government," is devoted precisely to that task. By drawing on insights from normative public finance, public choice, and new political economy, it passes on this inheritance in an engaging, clear, and well-organised fashion that will give a boost to undergraduate teaching in public finance. A significant achievement of the book is to strike a fine balance between normative and positive aspects of public finance—a balance that is essential for a comprehensive understanding of what governments can and should do.

2. The content of the book

The book covers in 10 chapters and accompanying appendixes the entire canon of public economics: public goods, externalities, social justice and redistribution, and taxation and user prices; and thus provides a solid foundation on which critical (economic) thinking about the responsibilities and limitations of government can be based. Each chapter (with the exception of one) begins by asking whether the private sector could undertake the relevant activities in an efficient and equitable way and thus if government involvement is really needed, and is concluded with a selective, annotated reading list and questions for discussion. The reading lists contain an appropriate mixture of classical readings and the latest research findings. The book assumes little prior knowledge of economics and presents the material by means of verbal explanations, simple diagrams, and a few formulas.

The starting point, in Chapter 1 on "Markets and Property," is a discussion of the boundaries of government, ranging from minimal government limited to the task of securing the framework within which competitive markets can deliver the promised efficiency gains to maximum government with collective property rights. Most importantly, perhaps, the fundamental role of government in establishing and overseeing the rule of law and securing private property rights is given prominence with an extensive (game theoretical) treatment. For students, who live and study in societies where the rule of law is well established and for whom the inefficiencies and injustices that arise in its absence are largely unknown, the role of government in bringing about this state of affairs and maintaining it can too easily be overlooked. By bringing the rule of law to the forefront of the discussion of the responsibilities of

government, the chapter provides a refreshing point of departure that is rarely found in textbooks on public finance.

The subsequent chapters are devoted to public goods and externalities. Chapter 2 on “Collective Benefits” sets out the (normative) case for government involvement in the finance of public goods with an extensive discussion of cost–benefit analysis, the Samuelson rule, and Clarke taxes. In contrast to most other textbooks on public finance, Hillman provides an integrated analysis of taxation and provision of public goods. This is done through an extensive discussion of the Lindahl consensus solution and by introducing the excess burden of taxation in the chapter on public goods. Chapter 3 on “Voting and Public Goods” introduces political constraints that may limit the scope for efficient provision of public goods by democratically elected governments into the calculus. The discussion covers the political failures that can arise in a direct democracy where the median voter rules as well as those that can arise in a representative democracy with competition between candidates or parties. The chapter also includes a short discussion of the properties of different voting rules in achieving desirable results. While these are classical topics in public choice, the chapter successfully integrates insights from new political economy by stressing the agency problems (both adverse selection and moral hazard) that can arise not only between voters and politicians, but also within government bureaucracies. In Chapter 4 on “Market Corrections,” the role of government in solving externality problems, including environmental ones, is covered with an extensive discussion of Pigovian taxes and transferable environmental rights, and some private solutions, including the Coase Theorem and resource management based on social norms, are evaluated. The chapter also contains a valuable section on why some markets, including markets in drugs and people, are often prohibited despite the fact that there is both demand and supply available.

The next topic covered by the book is social justice and redistribution. Chapter 5 on “Social Justice” presents a normative case for government-sponsored redistribution centred on the concept of social justice. Hillman defines social justice as complete insurance in the face of income (and other) uncertainties. This is, of course, one particular definition of the concept among many others, but one that has considerable merit. More importantly, by defining social justice with reference to insurance, a surprisingly clear and coherent pedagogical structure within which one can discuss the normative foundation of redistribution is born. For example, standard Benthamite and Rawlsian social welfare functions emerge as optimal decision rules chosen by individuals behind a veil of ignorance who have a different degree of tolerance to inequality or a different willingness to accept the inefficiencies associated with the leaky buckets of redistribution. This normative theory of justice then sets the stage for a discussion of the relation between entitlements and incentives and the role of private charities in creating social justice without government intervention. The political economy of redistribution is taken up in Chapter 6 on “Politics and Redistribution,” which contains an enlightening discussion of how government-sponsored redistribution programs may be distorted by political factors. This includes the classical question of exploitation of the minority by the majority in a democracy with majority voting, as well as the role that special-interest groups and campaign contributions play in sustaining redistribution away from the majority in a representative democracy. The chapter concludes with an introduction to the literature on

rent seeking. The term rent seeking is widely used and sometimes misused. Rent seeking costs refer to the efficiency losses that are incurred when agents divert resources to influence political decisions about redistribution. By its very nature, the social cost of rent seeking is incurred *before* redistribution actually takes place and it arises because rents are contestability. As Hillman points out, in the absence of contestability, politically motivated redistribution does not entail rent-seeking costs, implying, for example, that not all forms of corruption are rent seeking.

As mentioned above, Hillman explicitly discusses public finance for public goods in Chapter 2, but he returns to the question of finance in Chapters 7 and 8. Chapter 7 on “Taxation” covers the key results of optimal tax theory (Ramsey rules and the optimal nonlinear income tax) and contains a practical guide to the choice of tax base. The important issue of tax evasion is also given a prominent role. The discussion on taxation is followed up in Chapter 8 on “User Prices,” which are presented as an alternative to tax finance. This chapter also contains a discussion of congestion charges and a short introduction to regulation of natural monopolies.

The last two chapters are devoted to applications. Chapter 9 on “How Much Government?” provides answers to this question by drawing on insights from the literature on fiscal federalism and the recent literature on trust and social capital. It concludes with an account of the growth in government observed during the 20th century in most developed countries and presents a case for constitutional constraints. Chapter 10 contains a short discussion of the role of government in the provision of health, education, and pensions drawing on the core material covered elsewhere in the book. The exposition is kept at a general level and thus avoids getting tied down in institutional details applicable only to a few particular countries.

3. An evaluation

The main target group of the book is undergraduate students with little prior exposure to economic theory in general and public economics in particular. There can be no doubt that the book is extremely successful in catering for this group: assuming little more than knowledge of simple demand and supply analysis, elementary game theory and a bit of welfare economics, Hillman manages to bring to light many of the key results of public finance, public choice, and new political economy in a way that will be appreciated by students at this level and which, most importantly, will encourage them to think critically about what they can and should expect of their governments. This, I believe, is the major strength of the book and what makes it a very strong contender as the first choice for first or second year undergraduate courses in public economics.

The book also attempts to cater for advanced undergraduates who have a more comprehensive prior knowledge of microeconomic theory. This is done through a set of appendixes that chapter-by-chapter deals with technical or advanced material. While this approach has merit and the appendixes contain key material suitable for advanced undergraduates, on their own they appear to be too limited in scope to provide adequately for this group of students. Fortunately, the annotated reading lists that follow each chapter partly compensate for this. They provide an up-to-date list of relevant references that allow

advanced undergraduates (as well as graduate students and other interested scholars) to enter the literature at low cost. Thus, the book can be used as a starting point in advanced undergraduate courses, but would, in most cases, have to be supplemented with additional material.

4. Comparison with other textbooks

It may be useful briefly to compare Hillman's textbook with some alternatives. One alternative is John Cullis and Philip Jones, "Public Finance and Public Choice" (Cullis and Jones, 1998). The two books cover much the same material (with some important exceptions discussed below), but differ in style and in the level of detail at which the material is covered. Cullis and Jones's textbook assumes more prior knowledge and goes into more technical detail. In contrast, each chapter in "Public Finance and Public Policy" provides a fine story line—motivated by broad questions to spark interest—which takes the reader through the arguments and concepts without dwelling on unnecessary details, which are relegated to the appendixes. Another alternative is Joseph E. Stiglitz, "Economics of the Public Sector" (Stiglitz, 2000). This textbook is widely used in undergraduate courses in public finance in the US and assumes about the same (limited) prior knowledge of economics as "Public Finance and Public Policy." Hillman covers more theoretical ground, in particular in relation to positive public finance, than Stiglitz, and thus provides the student with a broader theoretical framework for making informed judgments about the responsibilities of government. On the other hand, Stiglitz's textbook contains a wealth of applications, albeit mostly to US policies and institutions. Hillman has chosen not to include examples of this type in his book, but instead to direct the student towards applications at the end of each chapter. This choice has the clear advantage of making the book more universal and of interest to students of public finance everywhere.

5. Conclusion

The feedback from the students at Cambridge (UK) that have read the book suggests that it is going to be a hit with undergraduates in the early stages of their studies. One student even suggested an alternative way of approaching the book: read the questions at the end of the chapter first and try to answer them; then read the chapter, and go over the questions again to see if you have changed your mind. It will also be a useful starting point for more advanced students, scholars and policymakers who want a well-organised, up-to-date, and non-technical overview of key ideas and an entry to the latest literature. What makes "Public Finance and Public Policy" special and of interest to a broader audience is in large part (i) the comprehensive discussion of the role of government in overseeing the rule of law; (ii) the integrated discussion of the cost of taxation and provision of public goods (and services); (iii) the suggestion that social justice can be understood as social insurance. In conclusion, "Public Finance and Public Policy" is a well-integrated and engaging text that has the potential to become the industry standard in undergraduate public finance courses.

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