Example 1.1
The European Roots of Modern Public Sector Economics*

Adam Smith's *The Wealth of Nations*, published in 1776, is generally considered to mark the beginning of modern economic theory. Among Smith's accomplishments in that text was a description of the appropriate economic role of the public sector. He believed that the government needed to provide three essential services: the national defense; a legal system of justice to protect people from harming each other; and necessary public works, such as networks of highways, that private firms could not profitably supply. Throughout the 1800s and early 1900s, a number of European economists, following Smith, tried to develop a coherent economic theory of the public sector. They were never entirely successful, but their research led to a number of the principles that underpin both the modern mainstream theory of the public sector and Buchanan's theory of public choice.

The main contributions to public sector theory came from Germany, Great Britain, Italy, Austria, and Sweden. The economists in these countries brought their own distinctive points of view to the analysis of the public sector, centered on three main issues:

1. How were government expenditures and taxes to be determined? Included in this was the issue of how the benefits of the expenditures and the costs of the taxes should be evaluated.
2. How could the government achieve efficient and equitable outcomes? The emphasis on efficiency and equity varied across the countries.
3. What was the appropriate relationship between the government and the citizens? In particular, to what extent must the government be coercive in carrying out its functions and levying taxes?

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* This example is based on O. Kayaalp, *The National Element in the Development of Fiscal Thought* (London: Palgrave Macmillan, 2004). The brief accounts here do not do justice to the various subtleties and elaborations offered by the economists within each country. Interested readers should consult Kayaalp's book for a complete account of the development of public sector theory in Europe.

The Germans were the outliers among the Europeans. The economists in the other four countries viewed the state from an individualistic perspective. They saw government officials as agents acting on behalf of the preferences of the citizens, which is one of the foundational principles of the modern mainstream theory. The Germans, in contrast, adopted an organic theory of the state. They understood that people had their individual lives to lead and would properly engage in self-interested economic activity in the private sector. At the same time, however, they recognized that people had a broader social identity as citizens of a nation, an identity that gave rise to a collective will or utility. The collective utility is not simply economically based; it is determined in large part by historical, political, and cultural values, and thereby varies from country to country and even within a country over time. The collective utility takes precedence over the citizens' individual utilities, and the primary economic function of the state is to promote the collective utility in the interests of preserving social cohesion. Moreover (argued the German theorists), individual citizens do not have the intellectual ability to understand the collective utility nor the resources to pursue it. Therefore, all public expenditure decisions to promote the collective utility are made by experts employed by the state. The government experts also design tax policies with the goal of minimizing the loss in the collective utility.

The Germans' organic view of the state posed a conundrum for Western economists raised in the humanistic tradition that has only deepened over time. Governments do confront highly complex problems that require the input of experts. But to place all the decision making in the hands of the experts risks a high degree of coercion. Where, then, should the influence of the experts end in forming government policies? The German economists did not see coercion as a threat because the government and the citizens are not in an adversarial relationship. In their view, the people fully accept the role of the state in promoting the collective utility. Their view is problematic, to say the least.

The British differed in two respects from the economists in the other three countries who adopted an individualistic view of the state. They focused their attention exclusively on taxation, and their only concern was achieving equity in taxation. In contrast, the economists in the other three countries gave equal attention to expenditures and taxes and thought about how to achieve an efficient public sector.

Regarding the British focus on taxation, the functions of government enumerated by Smith were simply accepted without much more thought given to them. They were viewed as necessary evils, either protecting citizens from foreign predators and from each other or providing essential but unprofitable goods and services. There was no question that the government had to provide these functions; the only issue considered was how to raise the taxes to pay for them. The answer they gave was to minimize the aggregate tax burden to the citizens, which was accomplished by taxes in accordance with people's ability to pay. People with higher incomes would pay more to support the necessary public expenditures than people with lower incomes. Taxing according to people's ability to pay became established as an equitable way of paying for public services in Western economic thought by the 1920s, and it remains a central principle in the discussion of tax policy to this day.

The Italians, Austrians, and Swedes shared two views in common. One was the individualistic perspective of the government as an agent acting on behalf of the citizens. The other was that a theory of the public sector has to explain how to determine expenditures and taxes simultaneously. Unlike the British, they did not take government expenditures as a given.

The Italians viewed the provision of public goods as equivalent to the provision of private goods. Taxes were seen as prices for the public goods – in this case, prices that reflect the opportunity cost of the private goods given up for the public good. Accordingly, each citizen demands a public good such that the marginal benefit of the good to him or her just equals the tax paid for the good – the same decision rule that applies to the purchase of private goods. Taxing in this manner is called the benefits-received principle of taxation – citizens pay for public goods on the basis of the (marginal) benefits they receive from the goods. Moreover, the benefits-received principle of taxation leads to an efficient provision of the goods, just as it does for private goods. The benefits-received principle of taxation is another central tenet of modern public sector theory.

The Italian view of the public sector was not purely individualistic, however. The caveat was that the Italians were used to a ruling class, so it was assumed that the elite ruling class would run the government and make the required marginal benefit and cost calculations for the citizens. Since citizens have different tastes, the decisions of the public officials would reflect the desires of the average citizen. The potential for coercion on the part of the ruling class was an issue, and a troubling one, but it was argued that the government agents would have an incentive to follow the desires of the citizens so that they could remain in office.

The Austrians pushed the individualistic perspective to the limit. They added to the Italian economists' theory by distinguishing between '*partikular*' goods that offer specific and measurable benefits to each citizen, and 'collective' (nonexclusive) goods such as national defense, whose benefits are available equally to all citizens and are not so easily measured. The partikular goods are paid for in accordance with the benefits-received principle, with the taxes serving as prices. The collective goods cannot be taxed according to the benefits-received principle. Nonetheless, the Austrian theorists argued, the citizens willingly contribute to them even if they believe that their tax payments exceed the benefit they personally receive from these goods. They agree to this because people see themselves as part of the larger society and seek a balance between their self-interest and society's collective interest. They view their relationship to the government as equivalent to their relationships to voluntary trade associations, in which dues are paid for the benefit of all the members of the association. Coercion by the government is not an issue given the assumed attitude of the citizens. People are seen, in effect, as voluntarily taxing themselves to pay for partikular and collective goods.

The Swedes also believed in the individualistic perspective of government, but they did not accept the Italian and Austrian view that the people would simply acquiesce to the decisions of the government. They understood that people might attempt to free-ride on others in the provision of nonexclusive goods. They also worried about the people who feel that the value of their benefits from the public expenditures is less than the taxes they are being asked to pay. They assumed that these people would feel that they were being coerced by the government, and the Swedes had an antipathy towards government coercion. They also placed a high value on political and social justice. Achieving efficiency was important, but no more so than equity.

These concerns led Knut Wicksell to think about the problem of collective choice within a democratic government, that is, the political process that citizens would use to determine public expenditures and taxes. He agreed with the Italian and Austrian economists that expenditures and taxes had to be simultaneously determined, and he assumed that people would vote directly or through representatives for different spending and tax packages. He concluded that the only way to guarantee efficiency and equity was to require a unanimous vote to approve government policies – a decision rule that he knew was impractical. As noted in Chapter 1, Wicksell's theories were the basis for Buchanan's theory of public choice.

The other great Swedish economist of the period, Eric Lindahl, described a method for providing nonexclusive goods that, he argued, met the dual requirements of paying for the goods on the basis of each person's marginal benefit received along with the British ability-to-pay doctrine. The latter applied because the marginal benefits were directly related to people's incomes. Lindahl's pricing scheme is discussed in Chapter 8. Unfortunately his method cannot be implemented because people have an incentive to hide their preferences for these goods and try to free ride on others. Nonetheless, Lindahl's theory was the closest that the 19^{th} and early 20^{th} century European economists came to the modern mainstream public sector theory, which was first formalized by MIT's Paul Samuelson's in a series of articles published in the 1950s. The structure of Samuelson's model is described in Chapters 3 and 4.