Chapter Summaries

Chapter 1: The Foundations of Public Sector Theory

The chapter begins by introducing the normative questions that underlie the three main divisions of public sector economics: public expenditure theory, the theory of taxation, and the theory of fiscal federalism.

1. *Public expenditure theory*: What are the legitimate functions of government? This is the most fundamental normative question in public sector theory. Once the legitimate functions have been determined, what are the appropriate methods for governments to use in carrying out each function?
2. *Tax theory*: What normative criteria should guide the design of the taxes needed to finance the legitimate expenditures of government? That is, what makes a good tax good and a bad tax bad?
3. *Theory of fiscal federalism*: Federalism refers to a tiered structure of governments in which each government has some authority over the governments immediately below it in the fiscal hierarchy. Having determined the legitimate functions of government, which functions should be assigned to each level of government?

The chapter then turns to the question of the legitimate functions of government:

4. There can be no one answer to this question. The answer will vary depending on which economic system society chooses for its economy along the spectrum from decentralized market capitalism to centrally planned socialism.
5. *Humanism*, the philosophical revolution that swept through Europe in the 14th century, made individual development the center of human endeavors and established consumer (producer) sovereignty as the fundamental normative value judgment in Western economic theory: Consumers (producers) are the best judges of their own economic well-being.

6. In addition to favoring decentralized *market capitalism* as the economic system of choice, *consumer (producer) sovereignty* provided the answer to the question of the legitimate functions of government, as well as the goals that the government should pursue when it does become involved, and the appropriate methods for the government to employ.
7. *Market failure*, and only market failure, gives governments legitimacy. Governments can legitimately intervene in the market economy when markets fail completely or perform sufficiently badly to warrant government intervention.
8. *The goals of government policy* are the pursuit of efficiency and equity (fairness), which serve as proxies for the pursuit of individual economic well-being.
9. The *efficiency* goal is Pareto optimality expressed in terms of people: An allocation is efficient if in order to make one person better off, at least one other person must be made worse off. The picture of Pareto optimality is the utility possibilities frontier for two individuals.
10. There is no consensus *equity* goal comparable to the efficiency goal. All one can say is that economists think in terms of end-results and process equity when thinking about equity.
11. End-results equity judges whether economic outcomes are fair. A widely accepted principle is horizontal equity, that equals should be treated equally. Vertical equity refers to how unequals should be treated and here there is a broad range of opinions and much disagreement. The pursuit of vertical equity is commonly referred to as the pursuit of distributive justice.
12. Process equity judges whether the rules of the economic "game" are fair. A widely accepted principle is equal opportunity or equal access – people (firms) should be allowed to do what they are willing and able to do. Societies also appear to desire a high degree of social mobility, meaning the ability of individuals to move through the distribution of income over time. Equal opportunity tends to generate a high degree of social mobility. Also, equal opportunity is linked to horizontal equity in economic affairs, since horizontal equity is the equilibrium condition in the long run when there is equal opportunity to enter or leave a market.
13. The appropriate way for government officials to behave when carrying out the legitimate functions of government is to act strictly as *an agent* for the people. Consumer sovereignty dictates that the preferences of the people should count in making public sector decisions, not the preferences of the elected officials.

    The chapter then discusses *the theory of public choice*, whose founding father is considered to be Nobel laureate James Buchanan. Public choice is the chief competitor to mainstream public sector theory, although it remains in the minority among economists. Buchanan set down the following fundamental principles behind the theory of public choice in his Nobel address.

14. Mainstream theory errs in assuming that people are self-interested in their economic affairs but suddenly when turning to public affairs they become other interested and think about the goals of efficiency and equity. Buchanan believes that people are always self-interested, in their public affairs as well as their economic affairs. They view their interactions with the government as self-serving fiscal exchanges, analogous to market exchanges in their economic affairs.
15. The appropriate definition of efficiency for the public sector is that the government is efficient if self-interested people get what they want from the government. This also establishes the legitimacy of the government in economic affairs.
16. The Swedish economist Knut Wicksell, who followed this line of reasoning, believed that the only way to achieve efficiency or legitimacy is under a one-person, one-vote democracy in which all issues are decided by unanimity. Buchanan, realizing that the unanimity requirement would lead to paralysis, argues instead that unanimity is required only at a nation's constitutional convention: Government procedures are legitimate if they are agreed upon unanimously by the framers of the constitution. As events that the framers could not have foreseen unfold over time, the test of some policy or procedure is always whether people believe the framers of the constitution would have agreed to it by unanimous consent.
17. The main drawback to the theory of public choice is its thin normative base; it lacks a sense of citizenship or common purpose.
18. Its appeal to many economists is that it has a richer political content than the mainstream theory, for which the government-as-agent principle is almost devoid of political content, that its focus is on process whereas the focus in mainstream theory is more often on end results, and that economists are comfortable with the assumption of entirely self-interested behavior.

The chapter concludes with a brief introduction to behavioral economics, which is fast becoming the new frontier in public sector analysis.

19. Behavioral economics is concerned with how people form their preferences; preferences are usually assumed to be a given in mainstream analysis. Behavioral economists have uncovered a number of ways in which people behave differently from the standard assumptions of economic theory. One example is that people do not follow their self-interests in experiments involving a public and a private good.