

**Instructor's Manual to accompany
Public Finance, Tenth Edition, by Harvey S. Rosen and Ted Gayer**

Chapter 1 – Introduction

Brief Outline

1. Public Finance and Ideology
 - a. The Organic View of Government
 - b. The Mechanistic View of Government
 - c. The Viewpoint of This Book
2. Government at a Glance
 - a. Legal Framework
 - i. Federal Government
 - ii. State and Local Governments
 - b. Size of Government
 - c. Expenditures
 - d. Revenues
 - e. Our Agenda

Suggested Answers to End-of-Chapter Discussion Questions

1.
 - a. McCain's statement is consistent with an organic conception of government. Individuals and their goals are less important than the state.
 - b. Locke makes a clear statement of the mechanistic view of the state in which individual liberty is of paramount importance.
 - c. Chavez's statement is consistent with an organic view of government. The individual has significance only as part of society as a whole.
2. Libertarians believe in a very limited government and are skeptical about the ability of government to improve social welfare. Social democrats believe that substantial government intervention is required for the good of individuals. Someone with an organic conception of the state believes that the goals of society are set by the state and individuals are valued only by their contribution to the realization of social goals.
 - a. A law prohibiting receiving compensation for organ donation would be opposed by libertarians, as they would want the market to decide who buys and who sells organs and at what price the organs would be sold. Social democrats also might oppose the law if they consider that such a law would prevent organ donation from happening as frequently. However, they are likely to support the law on the grounds that paying for organ donation would coerce financially desperate people to sell their organs. The law would protect the individual from making a poor

decision. The organic view might also oppose the law because the society might become healthier if more individuals received transplants, although they would believe that individuals should donate for the good of society, rather than for compensation.

- b. Libertarians oppose the law mandating helmet use for motorcyclists, arguing that individuals can best decide whether or not to use helmets without government coercion. Social democrats take the position that the mandate saves lives and ultimately benefits individuals. The organic view would probably lead to favoring the mandate on the grounds that reduced health care costs caused by fewer injuries benefit society.
 - c. Libertarians oppose the law mandating child safety seats, arguing that individuals can best decide whether or not to use child safety seats without government coercion. Social democrats take the position that the mandate saves lives and ultimately benefits individuals. The organic view would probably lead to favoring the mandate on the grounds that reduced health care costs caused by fewer accidents benefit society.
 - d. Libertarians would probably oppose a law prohibiting prostitution, while social democrats would likely favor such a law. The organic view depends on the type of society policymakers are attempting to achieve. The law would probably be favored on moral grounds.
 - e. Libertarians would probably oppose a law prohibiting polygamy, while social democrats would likely favor such a law. The organic view depends on the type of society policymakers are attempting to achieve. The law would probably be favored on moral grounds.
 - f. Libertarians would likely oppose the ban on trans fats in restaurants, believing that consumers will demand restaurants remove trans fats if they believe that is important. Social democrats would probably support the ban because consumers might not understand how bad trans fats are for their health. Those with an organic view would probably favor the ban because the scientific literature suggests that people who avoid trans fats are healthier, therefore the ban would reduce health care costs.
3. The mechanistic view of government says that the government is a contrivance created by individuals to better achieve their individual goals. Within the mechanistic tradition, people could disagree on the tax on saturated fats to reduce obesity. Libertarians would say that people can decide what is best for themselves - whether to consume saturated fats - and do not need prodding from the government. In contrast, social democrats might argue that people are too short sighted to know what is good for them, so that government-provided inducements are appropriate.

4.
 - a. If the size of government is measured by direct expenditures, the mandate does not directly increase it. Costs of compliance, however, may be high and would appear as an increase in a “regulatory budget.”
 - b. This ban would not increase government expenditures, but the high costs of compliance would increase the regulatory budget.
 - c. It’s hard to say whether this represents an increase or decrease in the size of government. One possibility is that GDP stayed the same, and government purchases of goods and services fell. Another is that government purchases of goods and services grew, but at a slower rate than the GDP. One must also consider coincident federal credit and regulatory activities and state and local budgets.
 - d. The federal budget would decrease if grants-in-aid were reduced. However, if state and local governments offset this by increasing taxes, the size of the government sector as a whole would not go down as much as one would have guessed.
5. The inflation erodes the real value of the debt by $0.036 \times £904$ billion or £32.54 billion. The fact that inflation reduces the real debt obligation means that this figure should be included as revenue to the government.
6. If you consider the size of government as the extent to which society’s resources are subject to control by the government, the both Policy 1 and Policy 2 would increase the size of government by the same amount. While it seems Policy 1 has no effect of the size of the government because it only mandates private spending, it causes resources to be under the control of the government. Policy 2 seems to affect the size of the government because it changes revenues and transfers, but the cost to each household is the same as in Policy 1, a \$5000 expenditure on health insurance or in additional taxes.
7. Relative to GDP, defense spending grew from 5.0 percent of GDP in 1981 to 6.0 percent of GDP in 1985 and then grew from 3.9 percent of GDP in 2007 to 4.7 percent of GDP in 2011. The increase from 2007 to 2011 was proportionally larger, but both increases were the same in terms of the percentage point increase.
8.
 - a. For the years 1997 to 2001, the absolute change in federal expenditures was \$261.7 billion [$\$1862.8 - \$1,601.2$ billion],

the change in federal expenditures in real terms (2001 dollars) was \$146.26 billion [$\text{inflation rate} = (90.727 - 84.628) / 84.628 = 7.21\%$, $\$1,862 \text{ billion} - \$1,601(1 + 0.0721) = \$146.26 \text{ billion}$],

the change in real government expenditures per capita was \$241.26 [$\text{real government expenditures per capita in 1997 (2001 dollars): } \$1,601.1 * (1 + 1.0721) / 0.227912 = \$6,289.72$; $\text{real government expenditures per}$

capita in 2001 (2001 dollars): $\$1862.8/0.285225 \text{ billion} = \$6,530.98$; $\$6,530.98 - \$6,289.72 = \$241.26$],

and the change in expenditures per GDP is $-\$0.01106 \text{ billion}$ [$\$601.1/\$8,332.4 - \$1,862.8/\$10,286.2$].

For the years 2007 to 2011, the absolute change in federal expenditures was $\$874.4 \text{ billion}$ [$\$3,603.1 \text{ billion} - \$2,728.7 \text{ billion}$],

the change in federal expenditures in real terms (2011 dollars) was $\$691.9 \text{ billion}$ [*inflation rate* = $(113.338 - 106.231)/106.231 = 6.69\%$, $\$3,603.1 \text{ billion} - \$2728.7(1 + 0.10669) = \$691.9 \text{ billion}$],

the change in real government expenditures per capita was $\$1,899.78$ [*real government expenditures per capita in 2007 (2011 dollars): $\$2,728 * (1 + 1.10669)/0.3017 = \$9,647.14$* ;

real government expenditures per capita in 2011 (2011 dollars): $[\$3,603/0.3120 \text{ billion} = \$11,546.92$; $\$11,546.92 - \$9,647.14 = \$1,899.78$],

and the change in expenditures per GDP is $-\$0.0442 \text{ billion}$ [$\$2,728.7 / \$14,028 - \$3,603.1 / \$15,094$].

- b. The health spending and “other” categories had the largest relative increases changes from 1997 to 2001 and 2007 to 2011. Net interest had the only decrease in spending.

	1997	2001	relative change from 1997 to 2001	2007	2011	relative change from 2007 to 2011
Defense	285.7	321.2	12.426%	579.8	751.3	29.579%
Health	123.8	172.2	39.095%	266.4	372.5	39.827%
Medicare	190.0	217.4	14.421%	375.4	485.7	29.382%
Income security	235.0	269.8	14.809%	366.0	597.4	63.224%
Social Security	365.3	433.0	18.533%	586.2	730.8	24.667%
Net Interest	244.0	206.2	-15.492%	237.1	230.0	-2.995%
Other	157.3	243.1	54.545%	317.9	435.5	36.993%

9.

- a. The 1997 to 2001 absolute change in federal tax revenues was $\$411.9 \text{ billion}$ ($= \$1991.1 - \1579.5), while from 2007 to 2011 the same change was $-\$264.5 \text{ billion}$ ($= \$2303.5 - \2568.0).

In real terms, the 1997 to 2001 change in federal tax revenues was $\$298.04$ (*inflation over period 7.21%, real change* = $\$1991.1 - (\$1579.2 * 1.0721)$). For 2007

to 2011, the change in federal tax revenues was \$-436.30 (*inflation over period 6.69%, real change = \$2303.5-\$2568.0*1.0669*).

The change in real tax revenues per capita for 1997 to 2001 was \$778.16 ($= (\$1991.1 / .285225 - \$1579.2 * (1.0721) / 0.272958)$) and for 2007 to 2011 was \$-1699.26 ($= (\$2303.5 / .312040 - \$2568.0 * (1.0669) / 0.301696)$).

The change in the tax revenues per GDP from 1997 to 2001 was 0.004 ($= (\$1991.1 / 10286.2 - \$1579.5 / 8332.4)$) and from 2007 to 2011 was 0.0530 ($= (\$2303.5 / 15094 - \$2568.0 / 14028)$).

- b. From 1997 to 2001, social insurance taxes had the largest relative increase. From 2007 to 2011, the excise tax had the largest relative increase. From 1997 to 2001 and 2007 to 2011, social corporate taxes revenue had the largest relative decrease.

	1997	2001	relative change from 1997 to 2001	2007	2011	relative change from 2007 to 2011
Individual Income Tax	737.5	994.3	34.820%	1163.5	1091.5	-6.188%
Corporate Tax	182.3	151.1	-17.115%	370.2	181.1	-51.080%
Social Insurance	539.4	694.0	28.661%	869.6	818.8	-5.842%
Excise Tax	120.1	151.7	26.311%	164.7	212.1	28.780%