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Intermediate Public Economics

Jean Hindriks and Gareth D. Myles

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This book is a very welcome entrant in the relatively sparse set of “recent” textbooks in public economics. Aiming an advanced undergraduate student audience, this book therefore fills the gap between the widely used introductory undergraduate textbook of Stiglitz (1999) and the graduate level piece of Myles (1995). The book covers, in its 625 pages and 21 chapters, much of the topics traditionally studied under the heading of Public Economics. It extends quite significantly the list of topics covered in Myles (1995) by adding to it asymmetric information, political economy, rent seeking, local public economics and fiscal federalism.

Chapters are conveniently grouped into eight thematic sections and each of them is completed by a rather long list of exercises (424 in the whole book!). The first section of the book, made of two short chapters, gives a quick presentation of the field of public economics (chapter 1) as well as the canonical Arrow-Debreu model and the two welfare theorems (chapter 2). The second section provides an interesting institutional description of the public sector by means of both historical and cross-country comparisons (chapter 3) and surveys various theories that explain the growth in public sector size which has been observed in all countries in the 20th century (chapter 4). The third section covers the standard “market failures” that are typically invoked to justify public intervention in the economic sphere. These are pure public goods (chapter 5), club goods and local public goods (chapter 6), externalities (chapter 7), imperfect competition (chapter 8) and asymmetric information (chapter 9). The fourth section introduces what one could call the “political economy” perspective to public economics which, instead of looking at the best possible public intervention from the view point of some normative criterion (efficiency, equity, and so on) as would do the “classical approach” to the problem, tries to predict the likely behavior of the public authorities given the incentives faced by the actors of the public sector (essentially politicians and

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bureaucrats). Politicians behavior and elections are treated in chapter 10 while chapter 11 is devoted to rent seeking and lobbying. Section 5 leaves the political economy perspective and addresses the issue of appraising the equity of various policies. It does so in chapter 11 which deals with standard welfarist normative evaluation and in chapter 12 which discusses the issue of income inequality and poverty measurement. Section 6 covers classical taxation issues such as indirect taxation (chapter 13), income taxation (chapter 14) and tax evasion (chapter 15). Section 7 addresses some of the issues that are involved in the coexistence of several jurisdictions. It especially discusses those issues pertaining to the optimal choice of the *number* and the *size* of government levels (chapter 16) and to fiscal competition (chapter 17). Finally the last section deals with the intertemporal dimension of public policies. Are covered in this section the canonical overlapping generation model (chapter 18), the specific issue of the “pension crisis” and the social security debt (chapter 20) as well as the design of growth-enhancing policies (chapter 21, which also discusses the issue of capital taxation).

As can be seen, the choice and range of topics is quite faithful to the common understanding of public economics as the study of the causes and consequences of public intervention in the economic sphere. Yet some topics which have clearly to do with public intervention, like corporate taxation and cost-benefit analysis, are not treated. Furthermore, a large part of the discussions of imperfect competition and asymmetric informations that are conducted in the book do not immediately connect to public intervention and could instead have find their place in a textbook on industrial organization or on information economics. On this last point, I was in particular a bit disappointed by the evasive treatment of information asymmetries that are specific to public intervention. These information asymmetries have been put on the front scene of academic research by the Gibbard-Satterthwaite theorem (not covered in the book) and all the literature on implementation and public decision in incomplete information. While the book does mention on occasion the information asymmetries that limit the scope of public intervention (especially in the chapters of optimal commodity and income taxation and in its discussion of the Clarke-Grove mechanism for public good), it does not provide an integrated treatment of these “public economics specific” information asymmetries. It seems to me that such an integrated treatment could have been provided in chapter 9, even at the cost of leaving the task of presenting the more standard material on moral hazard and adverse selection in insurance to textbooks on information and insurance economics.

But these are rather minor departures from what would have been, in my view, an optimal choice of topics covered by a textbook in public economics. And to this respect, the book is quite close indeed to my ideal point.

With some exceptions, the general approach to the topics and the style of the book is academic, and follows rather closely the relevant recent literature. To

that extent, the book's approach to public economics differs significantly from, say, that of Stiglitz (1999) who adopts a more casual and down-to-earth style based on current public policy issues and who uses academic knowledge to shed light to these issues. Yet the academic style of the book is developed with what I would be tempted to call a rather casual use of mathematics. Assumptions of the models are not always spelled out completely and some of the results, stated sometimes as theorems, are expressed without the assumptions under which they hold. While this casual mathematical style may have the advantage of easing the reader's access to the main intuitive results of the various models presented, it suffers from the flaw that it sometimes obscures the dependency of the results upon the assumptions, and even sometimes the understanding of a property or a condition. I will just take two examples to illustrate this.

First, there is a small part of chapter 7 that deals with non-convexities and the well-known problems that their existence pose for the functioning of competitive markets. Yet nowhere is a definition of convexity, along with an explanation of the problems that its violation poses for competitive markets, provided. As a second example, the informal statement of the property of Independence of Irrelevant Alternatives (IIA) in the presentation of Arrow's theorem in chapter 10 (p. 273) is vague, and, literally, incorrect. The authors indeed define IIA as the requirement for the social ranking to be invariant with respect to the addition of new alternatives to the agenda ("adding new options should not affect the initial ranking of the old options"). Yet, the usual IIA in social choice theory is the requirement for the social ranking between two alternatives to depend only upon the individual rankings of these two alternatives. It is therefore a condition that restricts the sensitivity of the social ranking to certain changes in the individual preferences, and not a condition that restricts the sensitivity of the social ranking to changes in the menu of available alternatives. While this particular "error" is not dramatic (there are actually ways to formulate the original IIA that are closer to what the authors refer to in their vague definition), I do think that it may introduce some confusion in the reader's mind, especially if this reader is an unexperienced "advanced" undergraduate student who may have hard time in connecting the author's statement of IIA with the more conventional and precise one that can be found in most textbooks that discuss Arrow's theorem (see for instance Roemer, 1996, p. 22; Laffont, 1988, p. 98; Myles, 1995, p. 54 and, at the undergraduate level, Feldman, 1980 p. 182-183).

It is always difficult to find the right balance between the requirement of analytical rigor and that of introductory pedagogy. This is especially true of a textbook that is precisely targeting an intermediate level audience. Yet, in my view, and given the overall academic style that it has adopted, the book would have gained somehow in being a bit more cautious with the handling of mathematics.

A strong point of the book is the good balance that it maintains throughout

between two prevalent, but, until recently, quite isolated from each other, approaches to public economics: the “classical” approach and the “political economy” one. I mentioned earlier what I view as the main difference between the two approaches. The classical approach considers public interventions as optimal, from the viewpoint of some normative objective, corrective measures to specific deficiencies associated with the functioning of the economy. It does not address the issue of whether the individual actors (politicians, bureaucrats) who are involved in the intervention have the incentive to perform the intervention, given their own personal objective. By contrast, the “political economy” approach tries to predict the type of public intervention that can be expected from the behavior of individual actors involved in the public sector, given what can be assumed of their objective, and of the institutional setting in which they operate. Both perspectives are clearly important, and complementary.

It is unfortunate that the two approaches have developed until recently in relative isolation from each other. Much is therefore to be expected from the recent cross-fertilization of these two approaches that the recent trends in research have initiated, and one can hope that textbooks like this one would contribute to this.

It is also unfortunate that these two approaches have sometimes served as scientific caution to some non-scientific preconceived ideas about the merit of public intervention and the optimal size of the state. As is well known to this readership, the “political economy” approach has been very often associated with a significant, and sometimes extreme, skepticism with respect to public intervention. And it is true that the depiction of the public sector as a collection of budget-size maximizing bureaucrats, re-election seeking politicians and rent-seeking lobbyists that this approach provides does not contribute much to making one optimistic about public intervention. At the other extreme, the naïvely simplistic vision of the public sector as a benevolent agency in charge of maximizing some function of the citizens’ well-beings that is provided by the classical approach bears some responsibility for having made others overly optimistic about public intervention, or for having given arguments to ideologically inclined “state interventionists”.

Yet, despite the obvious relevance of scientific knowledge for feeding ideological attitudes in the political debate, and the somewhat reciprocal fact that ideological opinions may be a serious source of motivations for doing scientific research, especially in the fields of public economics, it is I think important to leave outside the strict domain of science ideological beliefs and statements. Textbooks should be exemplary to that respect, because their primary aim is to provide training to future scientists. While this book stands overall rather well on this issue, it is not entirely faultless. On various occasions, one finds rather strong statements of ideological nature. Two examples come to my mind.

First, in their brief discussion of public ownership of natural monopolies in a

section of chapter 12 as a possible regulation devise, the authors write:

“Public ownership was practiced extensively in the UK and elsewhere in Europe. All the major utilities including gas, telephones, electricity, water and trains were taken into public ownership. This policy was eventually undermined by the problems of lack of incentives to innovate, invest or limit costs. Together these produced very poor outcome with the lack of market forces producing industries that were over-manned and inefficient. As a consequence, the UK has undertaken a privatization program that has returned all these industries to the private sector.” (p. 212)

This amalgamation of all the mentioned utility companies (whose cost structure are very different, and who for this reason qualify quite differently for the status of natural monopoly) is somewhat too crude. And as a matter of fact, many countries have maintained public ownership on electricity (France and Canada), water (Canada and US) and trains (almost all continental Europe) and the privatization of electricity in the US has been the object of several controversies. There is still much scientific debate about the *pro* and *cons* of privatization of utility companies and I do not think that economic theory as it now stands provides us with such a firm conclusion on this matter as that which would back this claim that gas, telephones, electricity, water and trains should all be privatized.

Second, the authors start their section on “equity and distribution” by the following rather provocative preamble:

“On 17 April 1975, the Khmer Rouge seized power in Cambodia. Pol Pot began to implement his vision of Year Zero in which all inequalities – of class, money, education, religion – would be eliminated. Driven by their desire to achieve what they perceived as the social optimum the Khmer Rouge attempted to engineer a return to a peasant economy. In the process, they slaughtered an estimated two million people, approximately one quarter of Cambodia’s population. The actions of the Khmer Rouge are an extreme example of the pursuit of equality and an immense reduction in economic output in order to achieve it.” (p. 331)

While I leave to the reader the task of appreciating the relevance of the Khmer Rouge genocide as the genuine example of what an egalitarian concern can be, at least the example is telling of the type of feelings that this egalitarian concern is inspiring to the authors.