

The Theory of the Public Sector Budget: An Economic Perspective

Merl Hackbart and James R. Ramsey

While federal, state, and local government budgets are driven by policy priorities and make "policy statements," public budgeting theories have tended to focus on the rationale for incremental budget changes (Key, 1940; Simon, 1957; Lindbloom, 1959; Wildavsky, 1964; Rubin, 1990; Davis, 1974; Ippolito, 1993; Berry, 1990). As a consequence, budget theory development, particularly incrementalism, has focused on explaining budget decisions rather than focusing on how budget policy and budget content is determined. An inherent assumption of incremental budget theory is that marginal budget decisions are the "necessary tools for policy change negotiation" as marginal changes are more politically feasible. Therefore, incrementalism has greater value for explaining marginal budget or policy tradeoffs than as a theory that explains what is in public budgets or what goods and services should be provided by the public v. the private sector.

Also, by emphasizing small budget changes, incrementalism has been criticized for its inability to explain large, nonincremental, budget adjustments. Authors such as Caiden raised concerns regarding "time-bombs" (Caiden, 1989), and others have found evidence of large budget changes that pose problems for incremental budget theory (Davis, 1974). Still others determined that while incremental budget changes may predominate, breaks in incremental funding must be accounted for and analyzed (Baumgartner and Jones, 1993).

So while a descriptive budget theory such as incrementalism provides insights into marginal budget and policy adjustments, it is lacking in its ability to explain why nonincremental budget reallocations might occur. Moreover, incrementalism lacks the ability to explain why programs or policies are being executed

through the public expenditure budget. Assuming that the budget is an articulation of policy and policy change, a theory that explains why programs may or may not be in the budget under different circumstances is a valuable addition to budget theory. A corollary to that conceptual question is: In a federalist system which level of government should budget for various expenditures, or how should the costs of the public programs be shared across government levels? This issue is becoming an increasingly important public policy concern.

Decisions as to whether program X or program Y should be in the public budget are often derivatives of broader policy decisions regarding the appropriate role of government in the economy. In any case, policies and policy changes drive the content and adjustments to public budgets. A policy driven theory of public budgeting should provide the basis for developing and interpreting non-incremental budget adjustments.

Researchers regarding nonincremental budget change have postulated that large budget changes are the result of policy adjustments. Researchers have confirmed and analyzed nonincremental budget change. At the forefront of such research are writers who have analyzed punctuated equilibrium (True, 1995; Jones et al., 1996). True found that domestic policy issues drove expenditures and that budgets were driven by policy. He attributed nonincremental budget changes to policy adjustments such as "the Great Society," and the "cold-war build up." Jones et al. found similar effects in policy epochs such as Truman-Eisenhower, Kennedy-Johnson, Nixon-Ford-Carter, and Reagan-Bush-Clinton. Jones et al. focused their work on budget authority, following the suggestion of True (1995) that it most effectively reflects the policy desires and decisions of policy makers. Meanwhile, Jordan determined that nonincremental change is common for local governments in selected functional program areas (Jordan, 1999).

CHAPTER FOCUS

This chapter provides an alternative view of public budgeting by focusing on the what and by whom questions. More specifically, the "what should be in the budget" and a related question of "which public budget should it be in" are considered from an economic public expenditure policy perspective. Historically, the appropriate roles or functions of government in a market economy or, the what question, has been debated by leading economists (Bator, 1960, 1958; Coase, 1960; Thurow, 1971; Samuelson, 1954). While broad agreement regarding the role of government has emerged, active policy debate continues among economists regarding the level of government involvement in these "appropriate government functions." As a consequence, the appropriate level of public expenditures tends to be resolved by marginal reallocations during the budget process (Mikesell, 1999; Bator, 1958).

We consider public expenditure theory as a policy-based theory of public budgeting. In contrast to incrementalism, public expenditure theory considers

which goods and services or programs should or may be provided by government and included in a public budget. Also, public expenditure theory provides insights regarding which budget, federal, state or local, various programs should be in rather than explaining how final budget allocations are resolved. In addition, public expenditure theory-based policies may produce nonincremental budgetary changes as well. Such policy driven budget adjustments may contribute to the nonincremental changes observed by Davis, Baumgartner, Jones, Jordan, and others.

ECONOMIC POLICY FUNCTIONS AND THE PUBLIC BUDGET

It is generally agreed among economists that there are basic responsibilities and functions of government in a free market economy. These functions are:

- The allocation function
- The distribution function
- The stabilization function

We begin with a brief discussion of market failure and its implications for determining which allocation functions are appropriate for the public sector through the budget process. The budget process of the federal, state, and local governments is, of course, the vehicle by which allocation policy decisions are established. While market failure analysis may provide guidance regarding which goods and services or "programs" should be provided by the public sector, decisions regarding which goods and services will be provided by government involves policy decisions. The distribution function of government has grown both as an absolute and as a relative percentage of the federal budget (Mikesell, 1999). Policy makers use the expenditure budget, the "tax expenditure" budget, and revenue policy to achieve redistribution policy goals (Rosen, 1985: 353–355). Again, policy decisions will dictate the nature and level of redistribution expenditures in public budgets. The final function of government, in a free market economy, is the stabilization function or the achievement of defined macroeconomic goals through budget policy including both expenditure and revenue initiatives.

After considering the functions of government, discussion in this chapter considers theoretical policy issues surrounding the determination of the appropriate level of government for the allocation of resources, the redistribution of income, and economic stabilization policy. The simultaneous pursuit of multiple policy goals in an intergovernmental administrative environment is a complex policy challenge. However, budget theory guidance for the rationalization of these decisions can be adapted from public finance expenditure theory.

Allocation Function

The marketplace, through the interaction of supply and demand, determines the “optimal” provision and allocation of most goods—those produced in a perfectly competitive market. In addition, the marketplace automatically answers the three basic economic questions that must be answered in every economic system: (1) what is produced; (2) how are goods produced; and (3) how are the goods produced distributed? However, if the assumptions of the competitive model are not satisfied “Pareto optimality,” or maximum social welfare, may not be obtained through the marketplace and a case may exist for the public sector to “allocate” resources through the political process.

Four situations that can occur may cause the marketplace to fail to optimally provide for a good or service:

1. the existence of public or collective consumption goods or services,
2. the existence of externalities,
3. the existence of natural monopolies or imperfect competition, and
4. the existence of consumer ignorance.

Each of these situations and their relevance to determining what will be in a public budget is briefly discussed in sections which follow.

The Case of Public Goods

Public goods are defined by two basic characteristics: nonexcludability and nonrivalry of consumption. Nonexcludability exists when a good is equally available to all consumers; e.g., a fireworks display. One person's consumption of a fireworks display does not preclude someone else consuming the fireworks. It is impossible, or at least extremely expensive, to exclude anyone from the consumption of a public good, since these goods cannot be packaged and distributed separately to individuals. Hence, the characteristic of nonexcludability. Nonrivalry of consumption means that individuals are not rivals over the consumption of the same good. Nonrivalry exists when the marginal cost of each additional consumer is zero. For example, take the case of a lighthouse—the marginal example cost of one additional boat using the light from a lighthouse is zero. Boats are not rivals for the consumption of the light of the lighthouse.

Goods that have these two characteristics are defined to be pure public goods. (It is possible to have a situation where the characteristic of nonexcludability is present but nonrivalry is not, or vice versa—such a good is an impure or quasipublic good.) It is recognized that in many cases, public goods, or quasipublic goods can, and will, be provided by the private marketplace. However, generally, public goods will *not* be provided through the marketplace, since no one can be excluded from the consumption of a public good. Individuals can consume a public good without having to pay for the good. Each consumer will

have a tendency to "mask" or understate his preference for the good, thereby avoiding having to pay for the good. Consumers attempt to become "free riders"—consume the good without paying for it. If all consumers of public goods act in this manner, there will appear to be no demand for the good, hence it will not be provided via the market.

Let's take a simple example to illustrate. Suppose that Mr. Smith and nine of his friends buy ten acres of land in the country and plan to build houses on one-acre lots. Now assume further that this land is really in an isolated area and does not have roads or highways. Furthermore, the state has no plans to build a road leading to the property. It may be that the only access to Mr. Smith's property from the closest highway is a dirt path made by the construction company that built his home and those of his friends. What happens when winter sets in the first year Mr. Smith is living in his new home? In all likelihood, the rain and snow will turn the dirt path, which is used by Mr. Smith and his neighbors to get to the highway, into mud and, in fact, the path may become impassible.

Given that this is the case, one of his neighbors may investigate and find out that it would cost only \$1,000 to pave the path; a cost of \$100 per family living in the area. Suppose further that this neighbor begins collecting this \$100 from everyone living in the area, and he has been successful until he reaches Mr. Smith. Really, Mr. Smith would like the path paved, but suppose that Mr. Smith decided to "mask" his preferences to become, in every sense of the word, a free rider. He tells his neighbor who is collecting the \$100 that he has a four-wheel-drive jeep, or that he doesn't really mind getting stuck in the mud occasionally. He reasons that if the path is paved, he will be able to use it since it would be impossible to exclude him from it. Mr. Smith might be able to save money and drive on the newly paved road only if all of his neighbors do not decide to mask their preferences; if they do, no road would be built.

Therefore, when we have public goods, individual preferences for public goods can only be revealed through a political process or by a voting system whereby each individual realizes that they must live with the choices that are collectively made, and collective preferences will be revealed through the budget process. In other words, when public support is sufficient, public goods will be provided through the budget process to deal with the special characteristics of public goods. Moreover, when the political process determines that new goods and/or services should be provided, new programs will be established and non-incremental budget changes may occur. In like manner, when the policy decision process fosters major increases for programs such as education or national defense, budget adjustments may be anticipated.

The Case of Externalities

When externalities exist, goods will be provided through the market process (unlike the case with public goods), but these goods will either be under- or overprovided by the market. Therefore, governmental intervention is required to

guarantee that the output of these goods is "optimal." It should be noted again that this intervention need not require actual government provision.

Externalities are activities the production and/or consumption of which gives rise to benefits or costs to persons other than those individuals producing and/or consuming the goods. Goods that give rise to externalities are separable and divisible and can be exchanged via the market process, yet the market still is not optimal. To better understand this, we will think of both consumption and production externalities.

Suppose that we have two individuals, Mr. X and Mr. Y, and that their utility functions are represented as:

$$\begin{aligned} U^X &= U(X^A, X^B) \\ U^Y &= U(Y^A, Y^B, X^A) \end{aligned}$$

We see, on the one hand, that Mr. X receives utility or satisfaction from his own personal consumption of goods A and B. Mr. Y, on the other hand, receives utility or satisfaction from his own personal consumption of goods A and B, but he also receives utility (or perhaps disutility) from Mr. X's consumption of good A. That is, Mr. X's consumption of good A enters into his utility function as well as that of Mr. Y. This is a consumption externality. Furthermore, we can say that if, in fact, Mr. X's consumption of good A increased Mr. Y's utility, or

$$\frac{\Delta U^Y}{\Delta A^X} > 0$$

we have a positive externality or an external economy. If Mr. X's consumption of good A decreases, Mr. Y's utility, or

$$\frac{\Delta U^Y}{\Delta A^X} < 0$$

then we have a negative externality, or external diseconomy.

Let's take an example. Suppose Mr. X and Mr. Y have homes located next to each other and Mr. X likes to party: loud music and the works. If Mr. Y happens to like parties and loud music, Mr. X's partying may increase his utility and thus a positive externality exists. If, instead, Mr. Y is not a partier, Mr. X's consumption of parties decreases Mr. Y's utility and, thus, a negative externality exists.

Other more meaningful examples of consumption externalities exist such as the case of education. When one person consumes education, it enhances their utility (it increases their productivity and, hence, lifetime earning potential). But at the same time, consumption of education by one individual increases the utility of the rest of society since they will earn more income, pay more taxes,

be better citizens, and so on. In fact, it is because the rest of society also benefits from one individual's consumption of education that, collectively, we are willing to subsidize a person's consumption of education and absorb part of the cost.

The case of a negative consumption externality is the converse of this. In this case, an individual consumer considers only his or her costs and benefits, but additional costs may be imposed on society. Since an individual does not consider the total costs to society, only his or her own costs as an individual, the private marketplace results in an overconsumption of the good. Thus, government intervention, for example, in the form of taxes, is required to increase the cost to the individual and, thus, cause his or her consumption to decrease. (It is noted that with small groups, bargaining may take place. For example, depending upon the establishment of property rights, one person may pay another person for the opportunity to party.) We also note that the external diseconomy may not be completely eliminated, rather, it is reduced in an efficiency level, or the level where marginal social benefits are equal to marginal social costs.

As indicated, the existence of externalities, such as positive externalities associated with education, may establish the case for public provision of goods and services by the public sector through the budget process. In other cases, such as when negative externalities are produced, the case may be made for the creation of public regulatory agencies which, in turn, are funded through the budget process. In such case, the budget allocation issues involve decisions regarding the size and capacity of the regulatory activity compared to other budget choices. The creation of new agencies and/or programs can generate nonincremental budgetary changes as well.

The Case of Natural Monopolies and Imperfect Competition

The marketplace may also fail to allocate economic activities efficiently because the conditions of perfect competition are not met: a producer may have a sufficient share of the market such that he is able to affect the price of the product by changing his output level (i.e., he is not a price-taker.) As a result, his profit-maximizing price will not be equal to marginal cost, as is the case with perfect competition.

This situation can actually occur for several reasons: (1) The efficient size of the firm may be so large relative to the size of the market that it forms a natural monopoly; (2) the market (for a variety of reasons) may be characterized by oligopoly (e.g., the automotive industry), in which just a few firms dominate the market; or, (3) there may be a large number of firms, but each has sufficient market power that it faces a sloping, rather than a horizontal demand curve.

Economics of scale occur in production when, as the inputs into the production process increase, the output of that production process increases by proportionally greater amounts. For example, if the inputs into the production process are doubled, output will increase by more than twofold, and as a result, the average cost of production will continually decline with expansions in output. In such a situation, only one or maybe just a few firms can survive in the

market, given the limited demand that exists for the product. That's why we say that such markets will be natural monopolies—one firm will generally be able to continually expand output at lower average costs and, by so doing, drive his competitor out of the market.

As already stated, when monopoly power is present, price exceeds marginal cost, and it can be shown that Pareto-optimality will not be attained. Output is lower and price is higher than would be the case in a perfectly competitive situation. Accordingly, when monopoly power exists, governmental intervention is desirable to increase efficiency in the utilization of resources. There are various forms this intervention has taken over time: (1) antitrust legislation (for example, as the Sherman and Clayton Antitrust Acts); (2) governmental regulation of the prices charged by the firm; or, (3) since the product is excludible and rival, government may actually provide the good and charge a price for the good, as would be the case with the private market.

With the case of imperfect competition, firms set prices above marginal costs, resulting in suboptimal resource allocation. However, government intervention may not result in improved resource allocation. In fact, if government intervention results in setting prices equal to marginal costs, a decrease in welfare may result. For example, the Organization of Petroleum Exporting Countries may set a policy resulting in increased oil prices. At the same time, if it is believed that electricity provided in a noncompetitive market is "overpriced" and the government attempts to set electricity prices equal to marginal costs (MC), an excessive use of electricity may result, vis-à-vis oil products. Thus, the theory of "second best" applies to industries and sectors of the economy that are interdependent. This often places policy makers in an unfortunate position of often being forced to accept some point of inefficiency.

Relative to the budget, this form of market failure also suggests reasons for funding of public sector action. Goods and services from an industry with natural monopoly characteristics could be provided by the public sector. Alternatively, like the case of externalities, industries with monopoly tendencies can be subjected to public regulation with funding provided by the budget process.

The Existence of Consumer Ignorance

The final case that results in the failure of the marketplace occurs when consumers are ignorant, or do not have complete and perfect information. In such a case, consumers are not aware of all of the benefits and costs associated with the consumption of a particular good. Therefore, the consumer is not in a position to make a "rational" decision with regard to how much or how little of the good to consume. Consider the case of education. Education gives rise to externalities or benefits to individuals other than the direct consumer of the education. In addition, it is often likely that the individual consumer of education is not aware of all the benefits that accrue to him because of his consuming education. That is, many of the benefits of education are of a consumption nature—they accrue at the time of consumption. But many of the benefits of

education are of an investment nature in that they do not accrue except at some period in the future. A student attending school may consider only the present cost and benefits in deciding whether or not to consider additional education. Since so many of the costs are incurred today (out of pocket expenses, forgoing income, unpleasantness of study, boring teachers) and so many of the benefits accrue in the future, it may appear that costs exceed benefits and, therefore, a rational economic decision is to not consume more education. In this case, since the consumer is ignorant of the future benefits of education, the government requires the individual to attend school through age sixteen, or the government subsidizes one's education to reduce the cost part of the cost-benefit calculation.

As another example, take the case of drug consumption. Many of us are unaware of the full range of costs of consuming certain drugs. Thus, the federal government has established the Food and Drug Administration to regulate drug production and distribution. In fact, certain drugs are illegal and cannot be distributed at all. Again, we might note that while there exists a need for government intervention, this intervention does not imply actual government provision. Intervention again could involve the creation of a policy or program activated by the budget process.

Thus, to sum up, the interaction of supply and demand determines the optimal provision and allocation of a good produced in a perfectly competitive market. However, the perfectly competitive market fails to properly provide and allocate goods when there exists goods with public good characteristics or which give rise to externalities, when we have industries characterized by increasing returns to scale, or imperfect competition and consumer ignorance. Thus, an economic rationale for government provision exists, and the public sector budget becomes the policy tool for government involvement in the marketplace.

Distributive Function

As noted above, given the absence of externalities, public goods, and consumer ignorance, perfectly competitive markets ensure that society reaches this mystical point known as Pareto-optimality, or the point whereby the welfare of no one individual can be increased without causing a reduction in the utility of at least one other individual. But it is unlikely that existing factor endowments (the distribution of land, labor, and capital), society's tastes and preferences, and technologies, will be such that the resulting distribution of income is acceptable to society. It is generally agreed then that government redistributes resources through both revenue and expenditure measures to ensure that society achieves an ethically acceptable income distribution.

What is it that determines the existing patterns of income distribution; i.e., why are some people better off than others in terms of income? The answer to this question can be partially found in the economist's marginal productivity theories that tell us that an individual's wages are equal to his marginal product. If some people have less income than others, the policy prescription is quite

the productivity of those with lower incomes (by means of health care, job training, and more). In addition, due to market public employment programs, wage subsidy programs, and enforcement of antidiscrimination laws have been implemented to effectiveness of programs designed to improve worker productivity. At the same time, it is also recognized that productivity levels of individuals are a function of many variables in addition to education and investment in human capital. For example, some individuals are born into families with wealth and family business that guarantees the individual a high income level. Some individuals are born with extremely high IQ levels; some people are born with athletic ability and the ability to play basketball; and some people are born with good looks, appearances and pretty voices. In all of these cases, individuals are not able to be born with some special characteristic that will allow them to earn a high income. Thus, the point is that the present distribution of income is not determined by one's productivity, but it is also determined in part by luck.

Poverty in the United States is both an absolute and a relative concept, and we must admit that poverty does exist in this country. The question now is what can the government do about the existing pattern of income distribution. The government can, through the budget process, affect the income distribution, both absolute and relative, in various ways: through its tax structure, its social expenditure programs, and through its macroeconomic policies aimed at growth and full employment. Policies initiated to affect income distribution may influence the traditional, incremental adjustments to production, such as much like the adjustments resulting from policy changes relative to government spending, externalities and natural monopolies.

Function

The production and distributive functions of government are concerned primarily with the basic microeconomic questions of what is produced, how it is produced, and to whom goods are distributed. The stabilization function, however, is concerned with the macroeconomic problems of unemployment, inflation, and economic growth. The Full Employment Act of 1946 made official a policy of promoting an economy with full employment, price stability, and a desirable rate of economic growth. This was the first statement of government policy in our economic history. Prior to this time, we did not worry much about macroeconomic problems. In fact, much of our economic theory assumed that unemployment could not exist, at least for long periods, because workers who were laid off would begin to bid the wage rate down by offering to work for less, in hopes of resecuring employment. This bidding-down process would continue until the labor market could be restored to equilibrium. Thus, the Full Employment Act ensures that the economy will always be restored to equilibrium after a shock.

During the Great Depression of 1929–1939, it became obvious that the labor market would not always automatically adjust to a level of full employment, and we began to look to government to help stabilize our economy through a combination of the use of monetary and fiscal policies. The fiscal policy impacts of stabilization policy initiatives have, periodically, resulted in large or nonincremental budget adjustments. Such adjustments realized as large increases in jobs programs, highway construction, and other jobs creating infrastructure programs and projects may produce punctuations in historical budgetary patterns.

Economic Policy Functions and the Budget: A Summary

The budget is a reflection of and the means by which the basic goals of government and society are achieved. The budgetary process is complicated by the fact that we often try to achieve separate policy goals through the use of one policy instrument: the budget. The functions of government may be in conflict with each other. Ideally, it would be nice if we could have three separate budgets or sub-budgets, each of which could be targeted to a specific function of government. For example, we might like to have a distribution budget, for which its manager would design a tax-transfer program reflective of society's social welfare function. In turn, we would like to be able to have an allocative budget with its manager responsible for determining when the marketplace fails to optimally provide certain goods and then developing a budget that would include these goods. Finally, we would like to be able to have a stabilization budget, the manager of which would be responsible for developing the proper fiscal policies and monetary policies to guarantee a fully employed economy.

In reality, we do not have three separate and distinct budgets, and budget planning does not permit evaluation of each objective of government on its own merits. Rather, most often the achievement of one objective can be accomplished only at the cost of another. Thus, conflicts between the three functions of government may exist.

THE BUDGET AND FISCAL FEDERALISM

Thus far we have spoken of government as if there were only one government unit in our economy. In fact, we know our system is federalistic, which involves the interaction of the federal government with state governments and local governments. Government has three goals to accomplish through the budget process, so a next question is, what level of government should do what?

It is normally believed that the stabilization function of government must be performed centrally by the federal government. The reasons are twofold. First, there must exist a central agency to control the size of the money supply; if each level of government was able to create and destroy money, there would exist an irresistible incentive to rapidly expand the money supply. The second problem with decentralized stabilization would be that the effectiveness of state

and local fiscal policies would also be rather limited. Spending leakages from a decentralized economy and the inability of state and local governments to use fiscal deficits would restrict the effectiveness of fiscal policy. So it is normally accepted that stabilization is a function best performed by the federal government.

While a conceptual argument can be made that the stabilization of the government is best performed centrally, for many years state and local governments have been actively involved, from a public policy perspective, in efforts to create jobs and capital formation. Some southern states have begun to use tools such as industrial revenue bonds, tax credits, tax abatements, among others, approximately seventy-five years ago, in an effort to bring economic development to a region of the country that was not prospering to the degree that other regions were. Today, economic development is a major public policy objective of nearly all state and local governments. Both budget expenditures and revenue tax expenditures are utilized to attract business and industry to grow the local economy. This is in part due to the fact that central monetary and fiscal policy have not always been successful in achieving our macroeconomic goals: the existence of recessions of varying degrees of magnitude.

In addition, the tools of central stabilization policy are, by their nature, macro in their application. Various regions of the economy experience differing levels of economic prosperity, even when the national economy is at full employment with price stability. Over the last twenty years, state and local policy makers have realized the concept of "rolling recessions." That is, while the national economy in total is growing, various regions of the economy may be experiencing economic slowdowns and high levels of unemployment. This was particularly true in the early 1990s when the finance, insurance, and real estate sections of the economy were going through a significant shakeout, which impacted the economies of many of the states along the East Coast and the West Coast. While the national economy and regions within the national economy did well, there was a bicoastal recession that was often masked in the national economic statistics and, therefore, was not a focus of central stabilization policy.

In many cases, state and local governments are attempting to bring new capital investment into the U.S. economy as they recruit direct foreign investment. In other cases, the economic development policies of state and local governments are a zero sum game, in that state and local governments are competing with each other for the same business and industry expansion. There is a great deal of economic literature on economic incentives and their role in the corporate decision-making process. This prior economic research tends to suggest that specific incentives offered by state and local governments for economic growth are important only at the margin: when all other decision variables are equal. Yet competition among state and local governments for new jobs and equipment has been so intense in recent years, due to unevenness of economic growth throughout the country, that today, state and local economic development policies are a routine part of public policy decision making.

A conceptual argument can be made that the distributive function can best be achieved centrally. Within a highly decentralized fiscal system, state and local governments working independently to achieve differing redistribution objectives are likely to run into trouble because of migration and the "free-rider" problem. Consider the two communities depicted below. Suppose Community X places a greater importance on income equality; its residents take an egalitarian point of view. In Community Y the attitude may be more one of *laissez-faire*. Now what could we expect to happen in this case? The low-income people living in Community Y will tend to migrate to Community X because of its highly developed welfare system. As this welfare system becomes more expensive to the wealthy living in Community X, they will have a tendency to move to Community Y, since they will not be required to make payments to a welfare system there. If carried to an extreme, we could end up with all the low-income families living in Community X (with nothing to redistribute) and all the high-income families living in Community Y. Thus, uniformity and equity dictate that a policy of income redistribution has a much greater probability of success if carried out by the national government.

It should also be recognized that, while the distribution function of government is ideally best performed centrally, state and local government, again, have been active, primarily through budget expenditures, in attempting to achieve this function of government. State and local involvement is, in fact, a function in large measure, of federal policy that is delegated to management and administration of many of our income maintenance programs to state and local governments. While many of these programs are primarily funded from the federal government, these programs are often of a matching nature, requiring states to co-fund public assistance programs such as Medicaid, temporary assistance for needy families, and others. While federal matching requirements and program guidelines diminish interstate differences in public assistance programs, differences do exist, and the potential for the Tiebout effect, "voting with one's feet," exists as well (Tiebout, 1956).

The concept of externalities (now in the form of community spillovers) would suggest that the allocative function be performed centrally. Consider the good education. We know that education gives rise to externalities, that is, individuals other than the individual consumer benefit from the consumption of good. Now it may be that some of these individuals live in communities other than the one providing the education. For example, primary and secondary education are goods that historically have been provided locally, say, by a county. However, not everyone who receives his education in one county will live and work in that county. Thus, when these individuals move, this represents a spillover to the county to which they move, since this county will be receiving a good it did not pay for. Now communities and counties act just as individuals do when making consumption decisions—they consider only the costs and benefits that accrue to other communities. This thinking on the part of communities, just as in the case of individuals, can lead to over- and underprovision of the goods in

question. The only way to guarantee the optimal provision of these goods is to expand the decision-making horizon, which in this case, would suggest the goods be provided, or allocated, by the federal government, vis-à-vis state and local governments.

However, there are several arguments that suggest the allocative function be performed at the state and local level. First, it is often argued that a basic shortcoming of a unitary form of government is its insensitivity to varying preferences among the residents of the different communities. If all public goods are supplied by a central government, one may expect uniformity across all communities. This may well be inefficient, because the people of New Orleans do not need snowplows (or hope that they don't), and the people of Buffalo do not need hurricane protection systems.

Second, it may be that possibilities for welfare gains through decentralization are enhanced by consumer mobility. As noted by Charles Tiebout, in a system of decentralized government, a consumer can select as his place of residence a community that provides a fiscal package (taxes and public services) well suited to his preferences. This is known as "voting with one's feet" or the Tiebout effect, as stated earlier and such individual preferences cannot be expressed when all goods are all uniformly provided by the central government.

It is often also argued that decentralization of the allocative function may result in greater experimentation and innovation in the production of public goods. And finally, there is reason to believe that decentralization may lead to efficiency, because expenditure decisions are tied more closely to resource costs; that is, the taxpayer has a better opportunity to see what he is getting with his or her money.

The optimal government organization for achieving the allocative function would be one whereby goods are allocated by that level of government that best represents the beneficiaries of the consumption of the good. National defense clearly benefits everyone nationwide, therefore, it should be provided centrally. Street lights in a local neighborhood benefit primarily only the people of that neighborhood. Thus, it should be provided locally. Certainly, many gray areas arise, but basically, the allocative function is being performed by a multiplicity of government levels, each responsible for providing the efficient level of output of the good consumed collectively by the residents of its jurisdiction. Thus, the allocative function is to be performed at all levels of government: federal, state, and local.

PUTTING IT ALL TOGETHER

The adaptation of economic expenditure theory as a "policy-based" theory of public budgeting has been the focus of this chapter as a means of explaining: (1) why programs or activities are included in the public sector budget; and (2) which level of government should be responsible for or budget for certain public programs. The theory of public expenditures provides a useful framework for

understanding why governments select certain products and services for public provision and inclusion in public budgets. As such, it adds to the incremental theory that focuses on budget changes, once the set of publicly provided goods and services is determined. The reallocations, incremental or nonincremental, involved in budget processes, from a public expenditure theory perspective presumes a change in preferences among public goods, attitudes regarding how best to manage the problem of externalities, policy-wise, and public attitudes regarding income redistribution. Therefore, economic theories of public expenditures expand the understanding of the budgetary choices among "X" and "Y."

Likewise, extensions of the theory of public expenditures into the intergovernmental arena provides guidance for the management of intergovernmental budgetary issues. While funding for public programs are often shared across levels of government, the rationale for divisions of responsibility benefit from theoretical constructs of responsibility and administrative appropriateness. Such contributions have been summarized in this discussion.

REFERENCES

- Bator, Francis M. "The Anatomy of Market Failure." *Quarterly Journal of Economics*, 72 (August 1958):351.
- Bator, Francis M. *The Questions of Government Spending*. New York: Harper Bros., 1960: 100.
- Baumgartner, Frank R., and Jones, Bryan D. *Agendas and Instability in American Politics*. Chicago: University of Chicago Press, 1993.
- Berry, William D. "The Confusing Case of Budgetary Incrementalism: Too Many Meanings for a Single Concept." *Journal of Politics*, 52 (1, 1990): 167-196.
- Caiden, Naomi. "Budgeting for Time-Bombs: Recent General Accounting Office Reports on the Crisis of the Nuclear Weapons Complex and the Savings and Loan Industry." *Public Budgeting and Finance*, 9 (4, 1989): 83-93.
- Coase, Ronald. "The Problem of Social Cost." *Journal of Law and Economics*, 3 (October 1960): 1-44.
- Davis, Otto A. "Towards a Predictive Theory of Government Expenditures: US Domestic Appropriations." *British Journal of Political Science* (4, 1974): 419-452.
- Ippolito, Dennis. "The Budget Process and Budget Policy: Resolving the Mismatch." *Public Administration Review*, 53 (1993): 9-13.
- Jones, Bryan D.; Baumgartner, Frank R.; and True, James. "The Shape of Change: Punctuations and Stability in U.S. Budgeting, 1947-1994." Paper presented at the Midwest Political Science Association, Chicago, IL, 1996.
- Jordan, Meagan. "Punctuated Equilibrium as a Comprehensive Theory of Local Governmental Budgeting: The Proof Is in the Tails." Unpublished Ph.D. diss. University of Kentucky, 1999.
- Key, V.O. "The Lack of a Budgetary Theory." *American Political Science Review*, 34: (1940): 1137-1144.
- Lindblom, Charles E. "The Science of Muddling Through." *Public Administration Review*, 19 (1959): 79-88.

- Mikesell, John. *Fiscal Administration: Analysis and Applications for the Public Sector*. Fort Worth: Harcourt Brace & Co., 1999: 1–10.
- Rosen, Harvey S. *Public Finance*. Homewood, IL: Irwin, 1985.
- Rubin, Irene. "Budget Theory and Practice: How Good the Fit?" *Public Administration Review*, 50 (1990): 179–189.
- Samuelson, Paul A. "The Pure Theory of Public Expenditure." *Review of Economics and Statistics*, 36 (1954): 387–389.
- Simon, Herbert A. *Models of Man*. New York: John Wiley, 1957.
- Thurrow, Lester C. "The Income Distribution as a Pure Public Good." *Quarterly Journal of Economics* (May 1971): 327–336.
- Tiebout, Charles. "A Pure Theory of Local Expenditures." *Journal of Political Economy*, 64 (1956): 416–424.
- Tresch, Richard W. *Public Finance: A Normative Theory*. Plano, TX: Business Publications, 1981.
- True, James. "Is the National Budget Controllable." *Public Budgeting and Finance*, 15 (2, 1995): 18–32.
- Wildavsky, Aaron. *The Politics of the Budgetary Process*. Boston: Little Brown, 1964.