Chapter 14
The Failure of Public Finance

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Introduction

A number of explanations are commonly given as reasons why government intervention in the economy will improve performance. This chapter questions the validity of each of them. They are presented in popular public finance textbooks.[1] If, as we believe, these arguments have not been demonstrated to be correct, much of public finance as presented in typical textbooks is not positive economics but rather relies on rather dubious normative judgments.

The arguments given are merit goods, equity considerations, growth and development, and stabilization. Each of these will be considered in turn. An earlier paper (Block, Kordsmeier, and Horton) considered the arguments of divergence from perfect competition and the supposed problem of externalities.

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[1] A.B. Atkinson and J.E. Stiglitz, Lectures on Public Economics, New York, McGraw- Hill, 1980; A. L. Auld and F.C. Miller, Principles of Public Finance: A Canadian Text (Toronto: Methuen, 1982); J.F. Due, Government Finance: An Economic Analysis, Homewood (Illinois), Irwin, 1963, third edition: Richard A. Musgrave, Peggy B. Musgrave, and Richard M. Bird, Public Finance in Theory and Practice, first Canadian edition (Toronto: McGraw-Hill Ryerson, 1987); Douglas J. McCready, The Canadian Public Sector (Toronto: Butterworths, 1985); C. S. Shoup, Public Finance, Chicago, Aldine, 1969; Charles Wolf, Jr., Markets or Governments: Choosing Between Imperfect Alternatives (Cambridge, MA: MIT Press, 1988).

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Merit Goods

In the case of merit goods, the public finance writers, instead of arguing that the market is deficient because it misallocates resources, maintain that although the free enterprise system does not misallocate resources from the vantage point of consumer sovereignty, government should still be brought in precisely because the market does allocate goods in accord with the wishes of individual consumers!

> What are merit wants? According to Shoup (p. 43), Certain private-sector outlays are deemed so laden with a public purpose that they are stimulated by tax laws or subsidies; philanthropic and religious outlays are examples.
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> Musgrave (p. 13) holds that merit wants are considered so meritorious that their satisfaction is provided for through the public budget, over and above what is provided for through the market and paid for by private buyers…. Public services aimed at the satisfaction of merit wants include such items as publicly furnished school luncheons, subsidized low-cost housing, and free educations. Alternatively, certain wants may be stamped as undesirable, and their satisfaction may be discouraged through penalty taxation, as in the case of liquor…. *The satisfaction of merit wants, by its very nature, involves interference with consumer preferences*, In view of this, does the satisfaction of merit wants have a place in a normative theory of public economy, based upon the premise of individual preference in a democratic society? A position of extreme individualism could demand that all merit wants be disallowed, but this is not a sensible view.
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> Atkison and Stiglitz (p. 8) describe merit wants as, a category of goods where the state makes a judgement that certain goods are "good" or "bad," and attempts to encourage the former (e.g., education) and discourage the latter (e.g., alcohol). *This is different from the arguments concerning externalities and public goods in that with merit wants, the "public" judgement differs from the private evaluation, rejecting a purely individualistic view of society.* (emphasis added)

But these arguments will not do at all. The public finance economists cannot have it both ways. If it was so important not to misallocate resources from the perspective of consumer sovereignty before (e.g., as argued in their analysis of the role of the state, perfect competition and externalities), how can the very opposite now be required, namely, a setting aside of the sovereign consumer's desire for alcohol and a wish to neglect education? Alternatively, if resource allocation in service of the sovereign consumer is so unimportant that it can be set aside in favor of these paternalistic merit wants, why should anyone pay attention to arguments purporting to show that the market misallocates resources by being imperfectly competitive and subject to externalities? The public finance writers cannot both have their cake and eat it. Their merit want concept makes a mockery of their allocational concerns. The two are contradictory. At least one set of arguments must go by the board.

If nothing else, the concept of "merit goods" is a public relations success of vast proportions.[2] Our authors could have characterized those items for which they wanted to promote subsidies or special protections as "our favorite goods." Had

[2] For a group of people who purport to dislike advertising, the public finance economists do very well in this regard.

they done so, no one would have paid them much mind, dismissing the idea as that of yet another special interest group – not a financially motivated one, but rather one that acts out of ideological purposes.[3] Instead, they hit upon a brilliant ploy: they called their pet projects and favorite commodities "merit goods," thus effusing them with a spurious objectivity. At least in the upper reaches of the halls of academia, this justification for government intervention is actually seriously deliberated upon by otherwise thoughtful scholars.

How does the doctrine of merit wants relate to the issue of democracy? At first glance, there would appear to be a downright contradiction between the two. If people are smart enough to pick their leaders, how can they not be able to spend their families' budgets without "help" from their political masters? MM&B (p. 71) give some evidence of concern:

> The concept of communal needs (which underlies the doctrine of merit goods)…carries the frightening implications of dictatorial abuse. But this does not go far enough. It is not just dictators we need to worry about. There is also the totalitarianism of the majority, dictating minute choices over our everyday lives.

In any case, Musgrave (1959, p. 14) was far less worried about this problem:

> While consumer sovereignty is the general rule, situations might arise, within the context of a democratic community, where an informed group is justified in imposing its decisions upon others.

In conclusion, it is difficult to see how any economist who sees value freedom as an important part of the methodology of the profession can embrace the concept of merit goods.

Equity

The public finance writers often argue for government intervention to redistribute income to enhance equity. A&M state (p. 3):

> Without government intervention, the distribution of income would depend upon who owns the various factors of production and the price they command in the market. There is nothing to say that this distribution, even if determined by perfect competition in product and factor markets, is the most socially desirable distribution. Governments must attempt to determine the consensus of the population as to whether there should be more assistance to the lower-income groups, and if so, who should bear the burden of higher taxation to provide this assistance in a situation where there is an unequal pattern of income distribution.

A&M's argument is fraught with difficulties. First we are given no independent measure of "socially desirable distribution." Yet, without it, there would appear to be no way to unambiguously determine whether the income distribution that arises

[3] The near universal inclusion of education among merit goods by college professors might, however, give one pause about possible financial interest.

from market activity is "desirable" or not. The government is to determine a consensus of the population. How this is to be done is not specified. However, Arrow's impossibility theorem tells us that there is no way of aggregating individual preferences to provide decisions that are consistent and rational as we would expect them to be for individuals (Arrow, 1963). Second, even if we were given this independent measure, it would appear difficult to reconcile this with positive economics. How does one deduce what should be from what is? Third, why resort to a "consensus of the population"? Even the public finance writers admit that democratically derived consensuses fail to be efficient due to problems inherent in majority rule such as logrolling, etc. Fourth, there is the conflation of equity and equality by these authors. According to A&M:

> Governments must attempt to determine the consensus of the population as to whether there should be more assistance to the lower-income groups.

Contrary to A&M's implicit presumption that such assistance enhances equity, it is not clear that more equal incomes are indeed more equitable. The implicit premise in A&M is that the two concepts are indistinguishable.

McCready (p. 5) also addresses the issue of equity:

> …there are always some persons unable to exist in the market structure, either through disabilities of one sort or another, or because they lack advantages in education, upbringing, and the like. In earlier times, the accepted method of dealing with these persons was by way of religious and charitable organizations of one sort or another. It is now generally accepted that government must play some role in distributing income and wealth to coincide with the humanitarian values of our society.

There are grave difficulties with McCready's argument as well. Charity, whatever its drawbacks, and none are mentioned here, is part and parcel of the system of laissez faire capitalism (Hughes, 1992). It is a commercial interaction, after all, between consenting adults. These "earlier times" have certainly given way to modern times. Nowadays, our welfare system creates dependency, promotes crime, fosters illegitimacy, and family breakup (Murray, 1984, 1988). Wolf (p. 41) scathingly points to the

> …failure to realize that expanded welfare programs, such as Aid for Families with Dependent Children, although intended to provide help for poor families, might have the subsequent effect of seriously weakening the structure of the family.

Why is the substitution of public for private charity an improvement, given that family breakup leads to crime, poverty, and other indices of social disarray? Indeed in 1997, the US government, explicitly recognizing the problems inherent in the AFDC program, abandoned it. Unfortunately, AFDC was replaced by a new federal program, Temporary Assistance for Needy Families (TANF). While the new stopgap welfare program may be less offensive than its predecessor, it still perpetuates public charity as a substitute for the voluntary exchanges that characterize private charity.

McCready continues (pp. 7–8):

> Initially, the state of distribution depends on the distribution of factor endowments. Factors are priced in the marketplace depending on competitive circumstances and the value of the marginal products. This determines the distribution of income. Hence an individual's income depends on factor supplies and factor demands, plus in some cases inherited wealth.
>
> The resulting distribution may or may not be in line with society's desires. Influenced by social philosophers and value judgments, society must somehow determine the "just" state of distribution…
>
> Economists include distribution as an important aspect of public policy. Adequacy of income at the lower end of the income scale appears to have become a widespread concern, which is in contrast with earlier concern about relative income positions or about excessive incomes at the top of the scale. Current discussion rather involves trying to determine a tolerable minimum level of income.

McCready is clearly unhappy with the state of distribution in Canadian and other modern societies. He correctly acknowledges, however, that it "depends" upon factor endowments. This leads to an interesting speculation. Suppose that we did not have it within our power to change the distribution of wealth, but only to alter the pattern of initial endowments. That is, while we could not redistribute purchasing power, we could do so for IQ, beauty, endurance, persistence, charm, musical, and athletic talent, and all of the other human attributes that together determine the variance of income. Would we do so? The result would be a situation that would make the one depicted in Brave New World look like a Libertarian Nirvana, but based on McCready's comments, he would appear to be logically committed to welcoming such a spectre. The public education system in the USA is a program that seeks to equalize intelligence, learning, and skills among our youth. Instead of nurturing exceptionally good students, it generally pulls all students down to the lowest common denominator. It is just such a spectre that frightens market devotees.

How, then, does McCready's argument represent an improvement over that of A&M? In two regards. First, McCready clearly concedes that "value judgments" play a critical part in the determination of equity. Unfortunately, he does not conclude from this that the economist, qua economist, has absolutely *no* role to play in this determination. Second, McCready's discussion of income distribution has the virtue of depicting it accurately along the lines of concern over style changes in hemline lengths: initially, focus on the adequacy of income at the lower end of the income scale; then, on relative income positions; after that, on excessive incomes at the top of the scale; finally, try to determine a tolerable minimum level of income, but do not take it as a serious scientific endeavor.

And what has Wolf to add to our deliberations? There is one aspect of his analysis that is vastly preferable to that of A&M and McCready: his willingness to consider the merits and demerits of imperfect markets and imperfect governmental institutions vis-a-vis one another. This is a distinct advantage over the

other commentators, who all too often compare perfectly functioning benevolent state organizations with what they are pleased to see as highly imperfect markets.

Wolf's contribution to the discussion of equity focuses, reasonably enough, on the role of private charity.[4] Unfortunately, he categorizes such efforts under the rubric of nonmarket activity, alongside those of government (p. 6):

> Although government is the largest member of the nonmarket sector, the others (foundations, universities, and nonproprietary hospitals) are numerous, vast, and growing. The behavior and deficiencies of those other nonmarket organizations should be included in a comprehensive theory of nonmarket failure that can highlight similarities and differences among them, as well as permit suitable comparisons to be made between the market sector and the nonmarket sector.[5]

There is a certain amount of truth to the Wolf position. After all, neither governmental nor private charitable activities are market driven. Neither relies upon prices, profits, buying, and selling. However, in lumping them together, Wolf makes it awkward to evaluate the benefits of the laissez faire capitalist system, which very much includes philanthropy, but not the state. Charity, it must be repeated, is part and parcel of the complex of voluntary interactions; governments, and taxes and regulations, hardly qualify.

Notwithstanding the above, when it comes time for Wolf to criticize the institution of private charity, he does so from a perspective that sees this as market, not nonmarket, failure (pp. 28, 29):

> … it is theoretically correct to consider distributional *in*equity as an example of market failure. From this perspective, income distribution is a particular type of public good. An "equitable" redistribution does not result from freely functioning markets because philanthropy and charity yield benefits that are external to, and not appropriable by, the donors, but are instead realized by society as a whole. Left to its own devices, the market will

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[4] It is marred, however, by the simplistic identification of equity with equality: "Even when the central importance of distributional equity is acknowledged, the question remains, What standard should be used to evaluate it? The answer will be very different, and often ambiguous, depending on whether equity is interpreted in the sense of equality of outcome or equality of opportunity (p. 19). That's it? That is how far equity can stretch? Between one or another type of *equality*? Nonsense. Equity means justice, or fairness, and need have nothing whatever to do with equality. An equitable division of the points between two football teams is whatever points they have *earned*, not a tie score; an equitable division of the haul in a fishing expedition is whatever had been agreed upon beforehand, not necessarily equal shares.

[5] Later on in his analysis, Wolf sees this relationship as "complex. . .difficult and ambiguous" (pp. 87–91).

> therefore produce less redistribution than is "efficient" (that is, socially desirable), because of the usual "free rider" problem associated with externalities, public goods, and incomplete markets.[6]

But this externalities defense of the welfare state is open to several telling criticisms.

Let us grant this unproven and logically unprovable contention in any case, just for the sake of discussion. Why does the argument lead to the conclusion that poverty must be alleviated? If it is a negative externality, perhaps it should instead be *prohibited*. Instead of seeing *helping* the poor as an external economy to be encouraged, we could with equal logical rigor interpret *being* poor as an external diseconomy to be *punished* (this, after all, is the message of Coase, 1960). There is ample historical precedent for such a policy, including laws against vagrancy. Frederick William I, father of Frederick the Great, instituted the first War on Poverty. He drove around Prussia in his carriage, and every time he spotted a beggar he would leap out of the carriage and beat the tar out of him with his cane. This did wonders to diminish the number of beggars in Prussia. It is not clear if it actually reduced poverty, but no doubt it reduced the supposed negative visual externality of poverty.

But there are still other difficulties with this argument. One man's meat is another man's poison, as we have seen. Some people may be distressed by the sight of poverty, but others might relish this state of affairs, perhaps as a means of lording it over others. Giving welfare to the poor, then, might promote the welfare of the men of good will, but it will reduce that of the misanthropes among us. Since there is not and cannot be any scientific method of making interpersonal utility comparisons, we cannot rigorously conclude that welfare programs unequivocally improve the well being of society as a whole.

Then, too, with this perspective, there is a great difficulty of accounting for the generous amount of charity that does indeed take place, given governmental efforts in this regard. For, according to the theory, we are all going to refuse to help the poor unless everyone does so. Why, then, in a society where government gives a historically unprecedented amount of money to the poor, are people still making charitable contributions? There should be little or none according to the externalities argument, but on the contrary there is much private giving.

[6] Wolf continues: "Another perspective for viewing distributional equity is quite unrelated to market failure in the strict sense. From this perspective, the equilibrium redistribution previously referred to may be quite inequitable in terms of one or another ethical norm. Even if the market could surmount the narrow type of 'finance' discussed above, its distributional outcome might still be socially and ethically unacceptable from the standpoint of one or more such norms. On these groups, the distributional outcomes of even perfectly functioning markets can be justifiably criticized." Much as it pains the present authors to appear to defend "perfectly functioning markets" (We maintain there is no such thing, and that the perfectly competitive model is a vast red herring), this last statement of Wolf's does not logically follow the foregoing. The distribution arising from market interaction can only be justifiably criticized if the ethical norms to which Wolf refers are themselves valid. But no such proof has been even considered, much less offered. In any case, to do so would be to take us very far afield indeed from the realm of (positive) economics.

Indeed, one of the problems with this argument is that government action or even the argument itself may reduce voluntary charitable giving. News reports in 1997 told that Vice President Al Gore contributed only $353 to charity. This may well indicate the amount to be expected from a person who genuinely cares for others but who believes that it is the responsibility of government, rather than voluntary giving, to aid them. The externality argument, to be extent that it is widely believed, may have the effect not only of encouraging acceptance of government programs that trap the poor but of lessening support for voluntary programs, thus diminishing freedom as well.

Then there is also the difficulty of explaining the level of private charitable contributions made before government began its activity in this field. According to Wolf's theory, donations should have then been virtually nonexistent, as we each all wanted to contribute, but were waiting for someone else to do it so that we could free ride on their efforts, or would only do so if given an assurance that everyone else would do so, too. The point is, we have overwhelming evidence suggesting that people do not wait for the assurances that others will give before doing so themselves. On the contrary, they give in any case, and they give generously, even when they know that others will *not* give as generously, or indeed, give at all.

One way to comprehend this state of affairs is to realize that externalities, should they exist,[7] can be internalized through the operation of a free society. This is done in many different ways. People are given buttons to denote their contributions. Those without them are looked down upon. High society patrons hold charity balls. It is of great importance, in some circles, to be invited. But guest lists are highly correlated with charitable giving. Making a contribution, especially a highly public one, is good advertising for businessmen. This must be a large part of the explanation of the endeavors, not to say the very existence of, groups such as the Rotary, the Elks, the Moose, and similar institutions. People of a religious persuasion are convinced that helping the poor in this vale of tears can help square their accounts in the world to come. These motivations are hardly compatible with the Wolfian account we are contemplating.

Even if all of these objections were somehow countered, the argument does not suffice to establish anything like the welfare state now in existence. It is vulnerable to all sorts of reductio ad absurdum. For example, this argument applies as much to foreigners as to domestic citizens. Are we more distressed by the abject poverty of Americans than we are by that of Ethiopians or Bangladeshians? In some sense, there really *are* no poor people in America, at least not as this phrase is used in the latter two countries. So if our distress is correlated with the degree of immiseration, virtually all of our tax money devoted to fighting poverty will be used up for foreigners; none will be left over for our fellow countrymen. And yet our welfare system most certainly does not include the poorest people in the world. On the contrary, it focuses almost entirely on the relatively well off "poor" people in the USA. This can hardly be explained on the grounds that we are distressed by poverty.

[7] Until they are one day proven to exist, we can now only accept them on the basis of faith.

Another reductio ad absurdum concerns the level of welfare payments. Some people, perhaps not Wolf, are distressed not merely by the sight of poverty, but by the sight of inequality of income or wealth. In their view, anything less than absolute egalitarianism is "distressful." If these arguments justify coercive taxation in order to "help" the poor, then they also justify anything that anyone else finds distressful, such as the absence of egalitarianism. But why stop here? Why just equality of money income or physical wealth? Why not equality of some rather more important things, such as intelligence, beauty, musical talent, etc., on the assumption, of course, that it were physically possible to redistribute such things. There is simply no stopping point to the argument of redressing the absence of absolute equality of some characteristic about which someone, somewhere, is distressed. So much for Wolf.

What can MM&B[8] contribute to the equity argument? Starting out on a high note, they concede that Pareto optimality can play no role (p. 10):

> This criterion… cannot be applied to a redistributional measure which by definition improves A's position at the expense of B's and C's" (p. 10). As well, they admit that "the answer to the question of fair distribution involves considerations of social philosophy and value judgement".

Most important, MM&B recognize that interpersonal utility comparisons are fraught with logical dangers (p. 11):

> …it is … impossible to compare the levels of utility which various individuals derive from their income.

With a base as sound as this, it is hard to believe that their argument would come to grief. Nevertheless, this is precisely what occurs. For in almost their next mention of the topic they are busily drawing two-person utility frontiers and social indifference curves (p. 53). So quickly did the "impossibility of comparing the levels of utility which various individuals derive from their income" vanish from memory.

Their other contribution to the equity argument consists of a defense of the principles of benefits received and ability to pay, for determining "equitable" taxation.[9] A moment's reflection will convince us that both are iniquitous and do not promote equity at all. This can be shown by applying the two precepts to any other area of life besides the relationship between the citizen and the state.

First, let us ponder about the benefits received principle (p. 209):

> … each taxpayer contributes in line with the benefits which he or she receives from public services.

But according to the theory adumbrated by MM&B, there is no way to be sure that taxpayers – any one of them, let alone all of them – actually benefit from so-called public services at all.

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[8] These authors, unfortunately, ascribe fully to the version of the externalities theory we have been attributing to Wolf. (See p. 91).

[9] The ability to pay principle is deeply flawed. For discussions of this point, see McGee (1998a, b, c).

In their view (p. 6):

> But where the benefits are available to all, consumers will not voluntarily offer payments to the suppliers of social goods. I will benefit as much from the consumption of others as from my own, and with thousands or millions of other consumers present, my payment is only an insignificant part of the total. Hence, no voluntary payment is made….

And again (pp. 48, 49):

> … the crucial fact (is) that social goods are provided without exclusion. Because of this, consumer preferences for such goods (the value which they assign to successive marginal units of consumption) will not be revealed voluntarily.

MM&B simply *assume,* without any proof whatsoever, that consumers gain from social goods. But what kind of grounding for the economic science of public finance is that? An unsupported assumption, hanging in the air, with no foundation. As we have seen, there is reason to believe that at least some members of the public (pacifists) might well *be hurt* by some "public" goods (defense). MM&B concede that there is no way, as in the private sector, for consumers to reveal, or demonstrate, their positive preferences for these so-called "public goods." In the absence of any evidence, the only rational conclusion is a healthy skepticism.

But doesn't the government provide services? Even though people will not reveal their preferences for these goods, don't we know "in our hearts" that they do indeed provide benefits? The obvious objection to this scenario is that it is not enough to give out "benefits," even if we stipulate that everyone recognizes them as "good." It is also necessary that people value the item they are given more highly than the money they give up in order to get it. People must agree to the transaction, else how on earth can we ever tell that they valued the item more than the money taken from them? Thus, the MM&B theory cannot be maintained. What is missing is the *acquiescence* on the part of the victim/taxpayer.[10]

Now, let us appraise the ability to pay principle (p. 210):

> … each taxpayer is asked to contribute in line with his or her ability to pay.

How would this principle work in the area of consumer purchases? Currently, when Rockefeller and a poor man buy a loaf of bread, they pay the identical price.[11] In a fiscal context, this would appear as a very severe regressive "tax." In contrast, on the assumption that Rockefeller is one million times richer than the poor man, if the latter paid $1 for the loaf, Rockefeller would pay $1 million under the ability to pay assumption. The problem with this scenario, at the very least, is that if it were carried out consistently over all people and all goods and services in the economy, our economy would have been reduced to one of absolute income equality.

[10] Those who maintain that paying taxes, or voting, or living in the country, or swearing allegiance, or singing the national anthem, or maintaining citizenship is sufficient to establish willingness to pay taxes are invited to peruse Spooner (1870) 1966.

[11] We abstract from such irrelevancies as quality, associated services (e.g., delivery), location of the vendor, etc.

Rockefeller's budget would enable him to buy no more cars, bicycles, fishes, or loaves of bread than would that of the poor man. All people would have identical standards of living. Apart from the pragmatic difficulty (what would be the point of trying to become rich?), this result would only be satisfactory to those whose concept of equity meant strict equality.

Take another example. Suppose a thief (Robin Hood) robs from people in proportion to their wealth; he takes much from the rich, and little from the poor. Or, to make him even more palatable, he steals only from the rich, in proportion to their wealth. Say what you will about such a robber, but it is difficult to see why his actions could best be characterized as "equitable." This is theft, pure, and simple. The only reason Robin Hood can be successfully depicted as being on the side of the angels is *not* because he plunders the rich, but because he does so to people who were thieves themselves. If a modern day Robin Hood burglarized Jane Fonda, Bjorn Borg, Madonna, Magic Johnson, Mike Tyson, Steven Spielberg, Woody Allen, and Arsenio Hall – all exceedingly rich people – he would not be seen in a positive light at all.

Growth and Development

The market is also said to misallocate resources between present and future consumption, i.e., it is charged that the rate of growth is not optimal under free enterprise, and that this, too, is a justification for government taxation and expenditure policy. In the view of Musgrave (p. 7):

> Other discrepancies may arise from differences between public and private…time preferences.

Shoup maintains (pp. 38, 39) that:

> …the rate at which income per head will grow under full employment can be increased by public finance measures that restrain certain types of consumption, thus freeing resources for investment in the broadest sense, including education, medical care, and improvements in the pattern and level of nutrition for children and working age adults that increase their productive capacity, present or future, by more than the cost of these improvements (all discounted to a given date). Some of those whose consumption is restricted for this purpose will object, not agreeing that the present sacrifice is worth the gain, present and future, even if that gain materializes in time to be enjoyed by them rather than only by a future generation.

According to McCready (p. 5):

> There is an argument that government should be involved in the economy because public valuations of future (relative to present) consumption will differ from private values. Typically, the time horizon perceived by an individual is extremely short, with the resultant rate of discount being relatively high. A reasonable case can be made for government valuing the future at a higher rate than individuals would, and therefore, the discount rate used in valuing consumption of goods and services would have to be lessened (p. 5).

MM&B agree with these assessments (p. 169):

> Individuals are said to suffer from "myopia," so that, in arranging their private affairs, they underestimate the importance of saving and overestimate that of present consumption. Hence, the consumers' time discount is too high and government should correct this error by applying a lower rate.

Unfortunately, there is much about which one can object within these short statements. Note, first, that none of the authors come right out and claims that private time preference rates *are* too high. Each maintains this position in the passive voice: "There is an argument that…" "Individuals are said to suffer from 'myopia'…" Perhaps this is because a more forthright statement of the view would open them up to questions of proof or evidence. In plain point of fact, there are no criteria put forth to determine the truth of these assertions. The rate of time preference, the choice between saving and investment, is subjective. None of the veneer of objectivity mentioned by these public finance writers is able to undermine this cold hard fact. Further, even if it can somehow be shown that the market's desire for present consumption is intemperate, it by no means follows, as we have seen, that government can or "should correct this error."

If anything, public finance theorists have got things exactly backwards; if there is any difference between government and the market system with regard to the rate of time preference, it is not that the latter is too present oriented. It is the very opposite: the time horizon of the politician rarely stretches past the next election, in a few years time. When the bill comes in for capital improvements, he will likely be retired, or in jail, or in higher office; so, why worry about these things now? In contrast to the politician, the manager of the modern corporation may have a very long-term view. The typical financial management text presents the role of the manager as maximizing stockholder wealth (Block and Hirt, pp. 11, 12). The value of stock depends upon the earnings of the firm out to infinity. There is no cut-off point such as the next election. Thus, the value of investments to people yet unborn is, at least in principle, considered in corporate decisions. There is no similar assurance of considerations of future generations, even in principle, in decisions made by politicians.

Let us follow up in some detail on MM&B, since they are the most thorough in their analysis of social discount rates (p. 169):

> Next come several arguments related to the welfare of future generations. One argument is that people are too greedy and do not care sufficiently about the welfare of those who follow them. If they did, they would save more so as to leave future generations with a larger capital stock and hence higher level of income. The government, as guardian of future generations, can offset this by using a lower rate of discount and investing more. Saving is viewed as a merit good. This may be a decision faced by the planning board of a developing country, which must choose between more rapid development and an early increase in the level of consumption.

Again, no objective criterion is proffered to determine the "proper" level of greed[12]; nor is it possible to do so. What is the evidence for the declaration "government (I)s the guardian of future generations"? No one in any future generation ever elected any member of any present parliament. If the government represents anyone[13] it is surely the *present* generation, the one that elected it. We have already seen the fallacy of "merit goods," but "the planning board of a developing country," is a contradiction in terms. To the extent that a nation really is developing economically (Hong Kong, Singapore, South Korea) this is precisely the extent to which it has eschewed "planning boards." And to the extent that a nation really has a planning board – for example, many of the nations of Africa and South America, The "People's" Republic of China, North Korea, Vietnam, Cuba, the former USSR. and Eastern Europe until a few years ago, this is precisely the extent to which it is *not* developing economically. This is the extent to which, and precisely why, it is on the way to becoming an economic basket case. It is perhaps easy to see this now, from the vantage point of late 1998, from which we have seen the move of socialism toward the dustbin of history.

Stabilization

A recurring claim all throughout the public finance literature is that the unencumbered market is subject to sudden bouts of depression and that government intervention is thus needed to keep the economy on an even keel. Musgrave's statement (p. 22) is symptomatic of the genre:

> A free economy, if uncontrolled, tends towards more or less drastic fluctuations in prices and employment; and apart from relatively short-term swings, maladjustments of a secular sort may arise towards unemployment or inflation. Public policy must assume a stabilizing function in order to hold within tolerable limits departures from high employment and price stability.

This view amounts to the reiteration of the old familiar standby, "market failure." But here, as in all other cases where this charge is made, it is "government failure" that is really responsible for the flaw mistakenly ascribed to the market.

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[12] To be fair to MM&B, they do note that "with technical progress raising future productivity, the capital stock needed to sustain the consumption standard may fall, calling for a higher discount rate" (p. 169). But this admission is marred in two ways. First, they base their conclusion on the discredited notion of (intergenerational) equity. Second, they still call for government intervention into the economy. This is problematic because they do so if the present generation is "too greedy," and they *also* do so if the present generation is not greedy enough (due to the fact that future generations will be richer than they because of improved technology). In other words, the verdict is in: market failure, the need for government intervention; the only open question is whether there is too much or too little greed. Talk about angels dancing on the tip of a pin.

[13] There are serious arguments to the effect that it does not. See Rothbard (1970, 1973, 1982), Friedman (1989), Spooner (1870) 1966.

Unemployment, for example, is not intrinsic to the capitalist order. On the contrary, it is brought about through all sorts of unwise and mischievous government interventions: minimum wage legislation; legal support for unions to raise wage rates above productivity levels; the Davis-Bacon Act; occupational licensure; and excessive taxation.

Similarly, Musgrave to the contrary notwithstanding, inflation is always a strictly governmental phenomenon (Rothbard, 1983; Mises, 1971; Friedman and Schwartz, 1963). Price inflation depends crucially upon excessive monetary creation, and in the modern era of central banking, this is solely a prerogative of the state. It can only be alleged that the market is responsible for inflation from a perspective that is innocent of basic economics.

The 1929 depression is commonly thought to be a product of the unhampered market place. This is perhaps "exhibit A" of the public finance point of view on this matter. But even here, despite widely accepted man-in-the-street opinion, there is strong evidence to indicate that far from being a result of the working of the free economy, the great depression, too, came about because of unwise government policies: the collapse of the money supply (Friedman and Schwartz, 1963), the Smoot–Hawley tariff, wage-price controls that kept them inflexible in a downward direction; and the previous bout of inflation during the 1920s, which artificially encouraged and overstimulated basic industries and round about methods of production (see Rothbard, 1975; 1933).

Conclusion

We have considered the common normative justifications for government action given in popular public finance texts. We have found each of them to be wanting, often demonstrating nothing more than a desire to use government force to impose personal preferences on others. The most obvious case is merit goods, which are merely the favorite goods of those who advocate them. Equity is taken to mean equality in income or at least more equality, again with no positive justification for imposing this preference on unwilling people. Voluntary charitable actions tend to be ignored or belittled. The call for the government to find a consensus ignores the Arrow impossibility theorem. The demand that government act to increase economic growth relies upon the undemonstrated positive conclusion that it is capable of doing so as well as the value judgment that it should. In fact, there is reason to believe that corporate managers seeking to maximize the wealth of stockholders will be more concerned about the more distant future than will politicians concerned about the next election. Likewise, the claim that government should act to stabilize the economy depends upon the positive conclusion that the government is capable of making the economy more, rather than less, stable. Yet the evidence is that both unemployment and inflation are government caused phenomena. Given this evidence, the normative claims that greater stability than free markets provide is desirable and should be imposed by government does not even require consideration.

Thus, we find that the common normative justifications for government interference with free markets lack a basis in positive economics or consist merely of the preferences of those writing on public finance. Public finance would be strengthened as an intellectual endeavor if it gave up these supposed reasons supporting government as a means of correcting defects in the market.

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