

The Economics of Public Finance

Essays by

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tion of the population may be assured a subsistence level of living; price supports may provide farmers (or racetrack touts) with protection against excessive competition that would be unavailable without collective action; a program to place a man on the moon by 1970 (or to commit genocide) can be visualized only as a collective program. Each of these problems transcends individual solution and thus gets either collective solution or none at all; but by itself that does not render them legitimate activities of government.

Moreover, the required use of collective action is not only not sufficient to define public activities, but also not strictly necessary. Governments may be asked to provide education, housing, transportation, and recreation even though private alternatives exist. The demand may rest upon considerations of efficiency, but it may also reflect captious preference or even prejudice. What leads to the choice of public provision from among alternative means of meeting particular ends?

Casual observation suggests that the public interest may be served by providing or encouraging provision of a variety of goods or services, and by nonprovision or discouragement of others. The former goods and services may be loosely defined as vested with the public interest, or as public goods.

The Nature of Public Goods

Serving the public interest may take many forms: provision of goods, subsidization of their provision by private means, enactment of laws that impede or prohibit their provision or constrain the form in which they are provided. The focus here will be on policies that involve public expenditures. It should be remembered that choice among alternative available means is always an element in important policy issues.

The goods and services provided by public expenditures or encouraged by public policies can be described and classified in a number of different ways. Though "public goods" are spoken of as a single category, any review of public policies shows great diversity. Some kinds of public goods are provided only publicly because there exists no reasonable private alternative way of providing them. This can happen (as in the case of national parks, national defense, or

space research) because there is no private mechanism to pay for these goods, or it can happen (as in the case of sewage disposal or justice) because compulsory use of the good by all is required to permit its enjoyment by any group. Other public goods, such as public housing or public education, may be functionally similar to available private alternatives, but qualitatively different in ways that society prefers. Still other public goods may differ from private ones only in the distribution of beneficiaries and costs.

If the proper domain of public expenditure policy is public goods, their definition becomes vital. The concept has been defined in many ways, and for diverse purposes, and it is not surprising that definitions motivated by purposes other than understanding the rationale and process of public expenditure policy are not wholly satisfactory.

"A *public good* is any good or service which is *de facto* provided for or subsidized through government budget finance."² This definition is neat but not helpful. It does not name the attributes of a potential good or service which a policy maker should take into account in deciding whether to provide the goods. In this definition "publicness" is wholly a matter of legislative designation, not of any characteristic of the good or service.

In many ways, an intrinsic definition based upon technical characteristics of goods or services would be desirable. The perfect collective consumption good provides such a definition. An impressive array of economists have so defined public goods.³ Dorfman has recently written:

There are certain goods that have the peculiarity that once they are available no one can be precluded from enjoying them whether he contributed to their provision or not. These are the public goods. Law and order is an

² William C. Birdsall, "A Study of the Demand for Public Goods," in Richard A. Musgrave (ed.), *Essays in Fiscal Federalism* (Brookings Institution, 1965), p. 235.

³ These include Paul A. Samuelson, "The Pure Theory of Public Expenditure," *Review of Economics and Statistics*, Vol. 36 (November 1954), pp. 387-89; Robert H. Strotz, "Two Propositions Related to Public Goods," *Review of Economics and Statistics*, Vol. 40 (November 1958), pp. 329-31; Howard R. Bowen, "The Interpretation of Voting in the Allocation of Economic Resources," *Quarterly Journal of Economics*, Vol. 58 (November 1943), pp. 27-48; Albert Breton, "A Theory

example, and there are many others too familiar to make further exemplification worth while. Their essential characteristic is that they are enjoyed but not consumed, [and that their benefits are derived] without any act of appropriation.⁴

This kind of very narrow definition was designed to demonstrate that there may be a type of activity that is socially desirable but that will not be achieved by the private market unaided. It serves well the purpose of showing the existence of public goods. It can prove a hindrance, however, if it leads to the view that goods which conform to it are the only class of goods which government can legitimately provide. In fact, examples are hard to find, and the great bulk of nondefense public expenditures covers goods and services that do not meet the definition. Roads, schools, welfare payments, recreational facilities, housing, public power, and irrigation, among others, are important classes of public expenditures that some can be precluded from enjoying, that can be consumed in whole or in part, and that technically can be made subject to user charges. The concept of the perfect collective consumption good, while sufficient to justify public expenditure, is not necessary nor does it embrace much of what public expenditure policy concerns. It does, however, identify certain characteristics such as nonconsumption, nonappropriation, and the existence of externalities that may give a good its public goods aspect.

Externalities are very important, as has been recognized for a long time. Knut Wicksell (himself citing earlier authority) put it eloquently in 1896:

If the community or at any rate a sizeable part of it has an interest in a particular utility accruing to an individual, then it would clearly be unreasonable to allow the creation of that more general utility to depend solely upon that individual: he might not value the state activity highly enough to make the sacrifice of paying the required fee or charge, or else ignorance may cause him or poverty force him to do without the service.

of the Demand for Public Goods," *Canadian Journal of Economics and Political Science*, Vol. 32 (November 1966), pp. 455-67; and R. Dorfman, "General Equilibrium with Public Goods," in J. Margolis and H. Guitton (eds.), *Public Economics: An Analysis of Public Production and Consumption and their Relations to the Private Sectors* (Macmillan, 1969).

⁴ Ibid.

Herein lies the chief justification of the modern demands for free or very cheap process of law, elementary education, medical care, certain public health measures, etc.⁵

While they are important, it would be easy to follow externalities too far. Does any good which produces an externality become a public good no matter how incidental the externality? Few goods do not meet this test and thus this definition fails to provide guidance as to which goods ought to be candidates for public provision, just as it fails to explain which goods are publicly provided.

Since standard definitions are not fully satisfactory, let me try a new one: *Any publicly induced or provided collective good is a public good.* A collective good in this definition is not necessarily a collective consumption good. Collective goods arise whenever some segment of the public collectively wants and is prepared to pay for a bundle of goods and services other than what the unhampered market will produce. A collective good thus requires that there be (1) an appreciable difference in either quantity or quality between it and the alternative the private market would produce, and (2) a viable demand for the difference.

Collective goods may be privately or publicly provided. Cooperatives, unions, vigilante organizations, country clubs, car pools, and trade associations are all examples of private organizations that arise in response to collective demands for private collective goods or services. When the coordinating mechanisms for providing a collective good invoke the powers of the state, it is here defined as a public good. This definition requires that a public good meet the tests of a collective good. Notice that public provision by itself does not create public goods. This definition is virtually implicit in the discussions of Head, Musgrave, Olson, Weisbrod, and Margolis.⁶ It provides an

⁵ Knut Wicksell, "A New Principle of Just Taxation," reprinted in Richard A. Musgrave and Alan T. Peacock (eds.), *Classics in the Theory of Public Finance* (Macmillan, 1958), p. 98; translated from *Finanztheoretische Untersuchungen* (Jena: Gustav Fischer, 1896).

⁶ John Graeme Head, "Public Goods and Public Policy," *Public Finance*, Vol. 17, No. 3 (1962), pp. 197-219; Musgrave, *Theory of Public Finance*; Mancur Olson, Jr., *The Logic of Collective Action* (Harvard University Press, 1965); Burton A. Weisbrod, "Collective-Consumption Services of Individual-Consumption Goods," *Quarterly Journal of Economics*, Vol. 78 (August 1964), pp. 471-77; and Julius Margolis, "Secondary Benefits, External Economies, and the Justification of Public Investment," *Review of Economics and Statistics*, Vol. 39 (August 1957), pp. 284-91.

analytic framework for considering the various sources of public goods.

A most important aspect of this definition is that it makes publicness not an all-or-nothing attribute, but one that may apply merely to particular aspects of a good. While there are cases (for example, national defense) in which the choice is between public provision and no provision, and it is thus argued that the good is entirely a public good, the more common situation is for goods to comprise a variety of services, only some of which have the attributes of collective goods. Given sufficient importance, these aspects of collective interest may lead to public provision of either these aspects or the entire good, including its noncollective aspects. Thus provision of smog control or river purification attacks a particular externality of private production. In contrast public housing provides individuals with services they would otherwise have purchased privately, along with the distinctive public services that public housing is supposed to entail.

Such mixed goods test and stretch definitions. Public education and public housing reflect both quantitative and qualitative differences from the comparable privately produced or producible goods. If the differences are intended and desired, they constitute public goods in this definition. In Olson's phrase, "the achievement of any common goal or the satisfaction of any common interest means that a [collective] good has been provided for that group."⁷

This somewhat vague notion of public goods can be filled out by a more detailed classification of different types of public goods.

A Classification of Public Goods

I have, in effect, defined the vector of public goods as a vector of differences between the goods and services the private economy is motivated to provide and the goods and services the public wants, is willing to pay for, and expects its government to assist it in achieving.⁸ This is, to an important degree, a normative definition,

⁷ *Logic of Collective Action*, p. 15. The word in brackets is "public" in the original. Elsewhere in his book Olson refers to groups other than political states. But it is clear that the notion of a public good as provided by a government, as used here, is also intended.

⁸ The identification of the public is deferred for the moment.

and much of the debate about the appropriate elements of the public goods vector is a normative debate. But there is a positive aspect as well: What is it about particular goods and services that makes them candidates for public consideration? What is it that makes certain activities the traditional province of governments?

It seems worthwhile to distinguish three types of public goods: (1) those arising from intrinsic, perhaps technical, characteristics of specific goods that result in externalities that are not effectively marketed; (2) those arising from imperfections in market mechanisms, rather than in the nature of the goods or services themselves; (3) those arising from concern with the quality or nature of the environment rather than aspects of particular goods or markets. These become, in order, increasingly elusive, but it is impossible to capture the flavor of actual government expenditure programs without all of them.

Public Goods Arising from Nonmarketable Services of Particular Goods

The precondition for a discrepancy between public wants and private supplies lies in the existence of externalities (or, as they are sometimes called, spillovers or third-party effects). Any time provision of a good or service yields side effects the value of which is not reflected in the prices of the outputs sold or the resources used, external economies or diseconomies are produced. There can be many reasons for such externalities: Private producers may use resources they do not consider scarce, or produce by-products that they do not consider valuable because they cannot control and market them. Familiar examples are discharges of noxious wastes into water or air; downstream navigational or flood control consequences of a private power dam; civic beautification or uglification incident upon building of private golf courses, factories, or slaughterhouses. Because some of the resources used or outputs produced are not correctly valued by the market, there is every reason to expect the market to misuse them. Thus, simply for efficiency's sake, collective concern and public action may be required to allocate resources in accord with true valuations. Whether such externalities (which must surely be present to some extent in every good) justify public notice and action depends upon the benefits to be achieved measured against the costs of interference. People will disagree about the costs of in-

terference or the proper cutoff level; but these are matters different from the nature and size of the externalities.

The perfect collective consumption good is really an extreme case of externalities: All of the output is regarded as individually unmarketable; all of the benefits are external. The outputs of those goods from which one cannot be excluded as a consumer—and thus for which one cannot be compelled to pay his share of the cost of provision—play a large role in the thinking of those who have been concerned to derive a legitimate role for public activity. Defense, public health, law and order, and hurricane watches are familiar examples. The common practice of listing a few examples (and not pressing them very hard) and adding, "There are many other examples" is close to fraudulent. If nonexcludability implies no one can conceivably be excluded, the list of such goods is short indeed. One need not police the ghetto nor defend Alaska. Television signals can be scrambled so as to exclude those who will not buy the unscrambler. Movie houses, concert halls, hospitals, and colleges all use walls to exclude those who will not meet the requirements placed upon their use.

Collective goods may arise because exclusion would be relatively costly rather than because it is impossible. If at any moment this cost is above a certain level, there may be no effective private supply of the good. But in other cases the cost of exclusion may be annoying rather than prohibitive and potential consumers may urge public action merely to avoid bearing the costs. Put differently, the cost of arranging exclusion may be an avoidable externality.

Implicit in this discussion is an important attribute of the public collective good: the willingness to appeal to the police power of the state. One can slide in imperceptible steps from situations where there is no viable alternative means of providing the good, to cases where the alternative seems unnecessarily costly, to cases where the alternative, while not very costly, is simply judged to be less desirable, and finally to cases where the alternative differs only in who pays for it.

There is real purpose in downgrading the distinction between inability and unwillingness to provide a good privately. If a practical definition of specific collective consumption goods and services is to

⁹ See, for example, Richard G. Lipsey and Peter O. Steiner, *Economics* (Harper & Row, 1966), p. 497.

be established, it seems difficult to escape the view that a judgment is required about reasons for turning to the political process and the coercive power of the state, rather than dealing with the second-best solution. These reasons must be judged meritorious by the social decision processes. *If this is so, collective consumption goods are defined by, as much as they define, the exercise of legitimate governmental decision processes.*

Among the positive issues that underlie the normative debate about whether a particular collective good ought to be publicly provided are (1) whether private market alternatives to public provision are impossible, impractical, merely costly, or simply unwanted; (2) why the market solution is unsatisfactory to members of the group and to society as a whole; and (3) what the identity of the group of beneficiaries is. The last deserves comment.

A collective good need not provide joint benefits to all members of a society, only to some subgroup. But which group? The larger the group the more persuasive its demand for public action is likely to be, or (put differently) the less willing its members will be to accept a costly alternative. There are bases other than size for weighing the merits of the demands of any group, and these may vary over time. Importers, farmers, labor unions, small businessmen, and minority groups are among the identifiable groups that have asked and received special treatment. Today, for example, our society seems more responsive to the demands of the underprivileged than to those of the wealthy; a half century ago it was clearly otherwise.

One reason many collective consumption goods lead to demands for public provision is because the potential willingness to pay of different consumers cannot be tapped by private suppliers. Weisbrod, in an important paper, suggests a further source of values for which there is no market: option demands.¹⁰ Consider several examples. I value the existence of Yellowstone Park, despite the hope that I never have to visit it again; I value the Everglades because I may want to visit them, even though I probably will not. Similarly, I value a first-rate tuberculosis sanatorium, although in all probability I shall never need its services. Were any of these threatened with ex-

¹⁰ Weisbrod, "Collective-Consumption Services of Individual-Consumption Goods." Millard F. Long has recently challenged Weisbrod's concept in "Collective-Consumption Services of Individual-Consumption Goods: Comment," *Quarterly Journal of Economics*, Vol. 81 (May 1967), pp. 351-52.

inction I should be the loser, but there is no market in which my willingness to pay for the option to use them can be translated into revenue to the providers.¹¹

Weisbrod's most suggestive example concerns the standby availability of transport. How much is it worth to the New York-Washington air travelers to have a good rail alternative in case of snow or strike? Suppose that it is worth enough to justify the rail service, but that the railroad has no way of being reimbursed by those whose option demands are critical to continuation of the services. In these circumstances, the public good may be provided by the government's insistence that the railroad's passenger service be maintained with or without subsidy. In this view governments may not have been irrational in trying to preserve passenger train service even in the face of the inability of the carriers to develop a set of user charges that succeed in covering costs.

Public Goods Arising from Market Imperfections

In practice there can be no sharp distinction between market failure caused by technical characteristics of particular goods and market failure caused by market imperfections. Inability to handle externalities, for example, may be regarded as a shortcoming of existing markets rather than as the absence of markets for specific services. But a distinction suggests additional sources of unsatisfactory private market performance that generate demand for public collective action. Efficient markets frequently presuppose adequate information, timely adjustment, sufficient competition, and modest transaction costs. The absence of any of these may motivate replacement of market determination by nonmarket provision, or supplementation of markets with ancillary public goods.

INFORMATION. Suppose all conditions for ideal resource allocation are satisfied except that market signals are systematically not read or are misperceived by economic actors. An allocation of goods and resources will occur, but it will, in general, differ from an allocation based on adequate and accurate information. Information may be a

¹¹ Option demands are not really a brand new concept. They are, in a sense, much like consumers' surplus: They arise because the price charged for the good or service is below the maximum each buyer would be willing to pay. Thus the option to buy at a low future price has present value. Weisbrod's insight is not in identifying option demands, but in recognizing that they are a significant source of demand for public action.

collective good (and thus generate a demand for its public provision) because even if there is a well-articulated private desire to have information, there may be no effective market in which to buy it efficiently.¹² It may also be a public good because the externalities of having misinformed traders may be judged to be socially undesirable.

TIME LAGS. If resources respond to market signals surely but slowly, the market process may prove an expensive way to achieve resource shifts. If physicists are in short supply, their price may be expected to rise and this may motivate additional youngsters to undertake education leading to careers as physicists. Since education is a slow process, available physicists may earn high rents over long periods due to the long supply lags. It may well be that public policy can increase the supply of physicists more quickly and more cheaply by fellowships, research grants, and other means than the unaided market.¹³ If increases in the supply of physicists, but not increased incomes of existing physicists, are desired results, then such programs supply public goods.

A large and growing literature is concerned with the extent and causes of factor immobility. Education is but one of the sources; others include unemployment rates, prejudice, and institutional barriers to greater mobility, such as seniority and pension rules and state laws affecting eligibility for relief. Whenever markets work to reallocate resources too slowly, a collective demand to supplement or to replace the market mechanism may arise. Retraining programs, moving allowances, public employment services, and even attacks on prejudice may be public goods if they serve to reduce the lags that the market economy produces to the point that society finds tolerable.

MONOPOLY POWER. Noncompetitive imperfections require little

¹² George J. Stigler, in "The Economics of Information," *Journal of Political Economy*, Vol. 69 (June 1961), pp. 213-25, provides a conceptual analysis of the costs and benefits of obtaining information. Lester G. Telser, in "How Much Does It Pay Whom To Advertise?" *American Economic Review*, Vol. 51 (May 1961), pp. 194-205, deals with the problem of buying information in the form of advertising as a joint product with news, entertainment, and so forth.

¹³ A study by J. Kenneth Little, *A Survey of Federal Programs in Higher Education* (Department of Health, Education, and Welfare, 1962), supplies some evidence on the incentive effects of subsidies to scientists and other academic personnel.

comment. Public activities to encourage or compel competitive behavior, or to replace monopolistic, private supply by public provision, are further sources of public goods.

TRANSACTION COSTS. It has been seen that an important aspect of collective goods concerns the inability of the market to translate potential willingness to pay into revenues. Related is the situation where the private market is technically able to collect revenues, but at a high cost. Toll collection on interurban roads and urban bridges may or may not be both feasible and efficient, but intra-urban toll roads would surely involve intolerably large collection costs and time losses. Because the transaction costs of high speed intra-urban travel as a private good are prohibitive, if it is to exist at all it must be a public good. Metering costs may be justified for commodities of high unit value, such as gas and electricity, but not for sewage (and, in some areas of high population density, for water).

Where these high transaction costs inhere in the particular service they are simply an externality; where they reflect the institutional arrangements of the market they are a potential additional source of collective concern. The higher cost of attempting to gear a pricing system to an individual's willingness to pay is a repeated source of turning away from the market. Suppose for many goods willingness to pay increases at least proportionally with income. With a few exceptions most private services are not provided on a basis that reflects income, because of the enormous administrative costs that such pricing would entail. If such a basis of payment is appropriate, reliance on the income tax, and thus on state provision, may suddenly appear desirable.

Public Goods Arising out of Concern with Environmental Quality

Up to this point public goods have been discussed in terms of market failure—failure because of either the absence or the imperfections of private markets. This is the grand tradition of classical economics. But even perfectly functioning markets for *all* goods and services would not eliminate the desire for market interference. Men may choose to reject market solutions to allocative problems with respect to the distribution of income, the nature or quality of goods produced, or the patterns of consumption that markets produce.

The most compelling examples of collective public goods appear to be national defense, law and order, and public health. What is their particular appeal? Is it that they are collective consumption goods? So is television. The appeal is not in the specific planes, rockets, soldiers, policemen, vaccines, or nurses that are their elements, for each of these can be readily provided as private goods to private users, but rather in the fact that they are part of and condition the environment of the society. Even the criminal who detests the legal framework is affected by it. Looked at this way these goods suggest other things that affect the environment and thus create externalities not linked to particular goods: the literacy rate, the level of unemployment, the incidence of crime, the pace of technological progress, and, importantly, the pattern of distribution of income and wealth.

DISTRIBUTION OF INCOME.¹⁴ Accept this assertion: It is fully feasible to charge users for use of parks and playgrounds, to charge parents for school bus service and school lunches, to charge fishermen for fishing privileges. Suppose in each of these cases that there is sufficient willingness to pay and ability to collect to assure private provision of parks, playgrounds, school buses and lunches, and fishing opportunities. Should these functions be left to private provision?

There are two issues here rather than one. Does concern focus merely on the distribution of income or on the pattern of consumption? When subsidized public housing is provided to the urban poor, is the aim to make available more or better housing to users who would be excluded by private provision (or who would exclude themselves)? Or is it rather to increase their share of national consumption, and the choice of giving them public housing instead of a cash income supplement is motivated by some other consideration? (One might use indirect means, for example, in order not to impair the self-respect of the recipients.)

It is sometimes argued that purely redistributive objectives which reflect dissatisfaction with the initial patterns of ownership of wealth and resources ought to be satisfied by income transfers rather

¹⁴ For a recent effort to work out the implications of income distribution for public investment planning, see A. Myrick Freeman III, "Income Distribution and Planning for Public Investment," *American Economic Review*, Vol. 57 (June 1967), pp. 495-508.

than by provision of goods and services, in order not to distort resource allocation. This familiar argument does not persuade, if one regards as legitimate a desire of a society to interfere with the pattern of consumption that would result from market determinations. A society may choose to affect income distribution and the pattern of consumption jointly. Provision of housing, education, milk, or recreation to underprivileged children may be a public good because of the externalities which children so treated bestow upon others. Public policies designed to aid small business, the family farm, the needy aged, and the slum child all reflect rejection of market determination, rather than denial of the possibility of market determination.

It is, of course, not clear that all actual interferences reflect a positive intention both to redistribute income and to change consumption patterns. In the United Kingdom (by way of contrast with the United States), fishing rights are sold, and fishing is an upper-class form of recreation. On the other hand, virtually all Scottish golf courses are owned by municipalities and subsidized out of tax receipts, and in Scotland golf is a working-class recreation. But if some consumption distortions are fortuitous, others are intended.

NATURE AND QUALITY OF OUTPUT. The quality and nature of some goods and services are of public concern, quite independent of any distributional considerations. Often the nature of the good or service is affected—for better or for worse—by who provides it. Government newspapers differ from private ones, public television and radio from commercial broadcasting, a system of public schools from a private school system, private from public research and development. In some of these examples the two kinds of goods may coexist; in others an exclusive choice is made. But in all cases a choice among qualitatively different outputs may and can be made; the qualitative difference of public from private provision constitutes a public good or a public bad.

Public Goods: A Summary View

I have stressed the pluralistic nature of the sources of collective demands as arising from technical characteristics of particular goods, from market imperfections and failures, and from other divergences between collective and individual values. The time is long

since past when the primary need is to define public goods merely in order to establish the *prima facie* case for some public interference with private markets; what is sought instead is a framework for debate about whether particular activities merit inclusion in the public sector.

It seems to me useful to identify in each case the source of the alleged collective concern. Is the source a major qualitative difference between public and private provision, or is it merely a wish for incremental output, arising in response to a neglected externality? In this distinction often lies an important policy choice between public provision and a less fundamental public restructuring of private incentives. Similarly one wants an indication of whether public concern is fixed on the specific good or service or on the environment in general. There are more ways to reduce overall unemployment than there are ways to retrain Appalachian miners. Again the relevant alternatives are affected by the real objects of policy. Frequently at issue is whether redistributional policies achieved by provision of specific goods and services bring about changes in consumption patterns deliberately or incidentally.

The basis of *collective* concern having been established, it is worth establishing the basis of *public* concern. Who are the alleged beneficiaries, and what is their claim to recognition? What second-best alternative do they face if their claims are rejected?

Defining as specifically as possible the vector of differences between a private good and its public alternative is a critical part of the public decision-making process. Neither *de facto* definitions (such as Birdsall's) nor neat but narrow ones (such as that of the perfect collective consumption good) prove very helpful for the crucial problem of defining the scope of the public sector.

Sources of a Public Interest: Alternative Views

To convert a collective interest of some group into the public interest requires a distinct act of legitimation. How does it occur? Views differ with respect to both what is aggregated and the requisite degree of consensus.

The discussion among economists about the public interest is surprising in its defensive tone, as if there is some disloyalty in find-