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Private Provision of Public Goods Or Vice Versa
Public provision of private goods.

1. Introduction.

My lecture will focus on the *vice versa* part of the set topic for this session, that is, I will address the issue *of public* provision *of private* goods. This choice is motivated by the limited time available, but also, I admit, my own research background which was presumably a reason why I was asked to give this lecture. And I thank the organizers for the invitation.

Let me make the qualification that when I speak about public provision, I will have *public funding* in mind. My concern will not be whether the goods are actually delivered by government employees or by private firms.

Taking a somewhat simplified perspective, the conventional wisdom of economics has been that *we should rely on the market to provide private goods.* Against this background it is surprising to observe that in practice a large share of public expenditures is indeed allocated to the provision of private goods. In some countries the share of GDP would be as much as 15-20%.

This observation motivates two questions:

1. Does normative public economics provide a case for public provision of private goods?
2. Is there any other explanation, say a political economy explanation, why private goods are publicly provided?

When we take a closer look at public provision we realise that there are certain goods that are typically singled out for public provision whilst most goods are never publicly provided. Furniture, toys, sports equipment, package holidays are not publicly provided. Most private goods that are publicly provided will come under the labels `health', `education' and `care' and there is a striking similarity across countries.

A few observations easily come to mind at this stage.
These goods are *services* that cannot be resold or given away to others.
Secondly, they impact more directly than other goods on *human resources*. They typically affect people's ability to function in society and the labour market in particular.
Thirdly, they are typically the outcome of *labour intensive production.*

An intriguing question is whether such a common denominator explains why it is these goods that are being provided by the public sector. Let us keep the question in mind, and I will touch upon it again when we have more background at the end of my talk.

Beyond deciding to have public provision, choosing the amount to be provided and definition public provision implies that a good is made available free of charge or at a nominal price. Then the amount provided must be expanded to achieve market clearing at that price, or there must be some kind of quantity rationing or administratively determined allocation. Lots of schemes are conceivable: uniform provision, means-testing, income grading, vouchers etc.

This has a bearing on the freedom of choice highlighted yesterday in this conference. I would like to note in the passing that this issue cannot be discussed independently of the need for rationing devices. Freedom of choice in the market means freedom to choose of the prevailing prices. Outside the market there must be other constraints on our choices. In my view this dilemma represents an underresearched topic.

Two major schemes that have been identified, are often labelled `topping up' and `opting out'. Topping up implies that the consumers can supplement any publicly provided amount by purchasing any additional amount they want in private markets. Opting out means that the alternative to accepting the public provision is to forego it and rather buy the whole amount in the private market. For instance: The children are sent to private schools rather than state schools.

Let me now review some welfare theoretic arguments that may conceivably support a role for public provision of private goods, before elaborating on selected aspects.

2. Possible arguments for public provision of private goods.

Transaction costs

A simple argument for public provision is the potential saving of transaction costs as with public provision there is not necessarily any monitoring of usage, or there are simple administrative procedures for uniform treatment of everybody. This may not be a trivial thing as transactions costs in, say, a private health insurance market, are huge[1].

Positive externalities

In discussions of public provision positive externalities are often invoked as a case for public intervention. The argument is appealing, and easy to recognise when it comes to, say, removing illiteracy or stopping the spread of epidemic diseases. But I am inclined to conclude that on the whole the importance of the externality argument is modest.

Merit good and paternalistic arguments

A set of arguments for private goods to be publicly provided are labelled merit goods. They appear to embrace a range of cases. One being that the rich would rather give the poor a euro if it is spent on health care rather than on sport events and electronic games. Another being the view that nobody should seriously suffer because of misperceptions or *lack* of foresight, knowledge or strength of character.

Second best arguments.

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[1] There is evidence to the effect that 15% of insurance premiums are devoted to administrative costs. The proportion of administration in health care expenditures is much higher in the US than in Canada and the UK.

When assessing the role of publicly provided goods we have to acknowledge that these goods are supplied into an economy with a large number of pre-existing distortions. The implication is that there is a potential role for public provision in alleviating these distortions. In particular, there has been an interest in how public provision may mitigate the effects of distortionary taxes. For example, public provision of education may provide a relief from the tax distortions arising when some of the return to non-deductible investment in education is taxed away.

We should, however, observe that if the reason for public provision is to alleviate tax distortions, the situation may easily become paradoxical: Taxes motivate public provision and the latter generates the need for taxes. This puzzle can only be resolved if there are in the first place strong enough preferences for public goods, for public provision of private goods on other grounds, or for redistributive taxes. I believe these phenomena are indeed quite important and contribute to a valid case for public provision of some private goods.

Information problems

Second best approaches take different forms. Modern second best theory addressing distributional policies as well as insurance issues are based on the asymmetric information approach. The characteristics, according to which individuals would ideally be singled out for high taxation or transfers or certain insurance terms, are often private information not available to the authorities. Let us consider how the asymmetric information problem may conceivably support a role for public provision, starting with models originating from optimum tax analysis.

3. Extensions of self-selection tax models.

A major insight underlying modern tax theory is that the tax authorities cannot observe which tax payers are high-skilled and which are low-skilled. Hence redistributive taxes must be designed subject to the self-selection constraint that no type of taxpayers chooses an income point intended for some other type. Normally it is the high-skilled persons that must be discouraged from `mimicking' the low-skilled.

Several papers have demonstrated that a role for public provision of (properly selected) private goods may be to alleviate the underlying self-selection constraint. Stated briefly, one way to do this would be to tax finance goods that the potential mimicker does not value very much. Then he will be made worse off as the benefits from the goods do not offset the additional tax burden. The goods that exhibit this property are those that are less valued when the consumer enjoys more leisure. The reason is that what distinguishes a mimicker from the low-skilled person he will potentially mimic is that, being more productive, he will earn the same income in less time, and thus enjoy more leisure. Suppose public child care is provided for the benefit of people working long hours. If high-skilled persons were to mimic by working short hours they would no longer benefit very much from the child care. And mimicking would become less appealing. Another way to discourage mimicking would be to limit the supply of goods that are attractive to consumers, like the mimicker, who enjoy a lot of leisure.

We can infer that goods suitable for public provision on these grounds have the following characteristics:

a. Leisure should not be weakly separable from the goods

b. The demand for publicly provided goods should vary much as leisure varies.

c. There should be no close market substitutes to the goods under survey.

d. In cases where the mimicker is induced to over-consume the goods, they should be impossible, or at least very hard, to resell.

Our insights not only establish a possible case for public provision, but also shed light on the efficiency of different provision schemes such as the topping up and opting out regimes. We may observe that administrative schemes to various extents facilitate or impede topping up. Disregarding administrative costs, a system where individuals are not allowed to top up is optimal if the demand for the publicly provided good increases in the amount of leisure. Otherwise the mimicker, by topping up, could escape from the unattractive consumption bundle designed to discourage mimicking. A scheme allowing individuals to top up is warranted if the demand decreases with the amount of leisure. (See Blomquist and Christiansen (1998)).

The case for public provision can also be invoked as a case for subsidizing the market price. This raises the question which is the more efficient instrument. The issue is addressed by Blomquist and Christiansen (1998) and Boadway, Marchand and Sato (1998). It has been shown that if the high-skilled person's consumption of the good is sufficiently large, public provision is the better scheme. Unlike the subsidy scheme it will allocate resources efficiently to the high-skilled person as he will be topping up in the market at an undistorted price at the margin, and, in addition, public provision is more efficient in discouraging mimicking. Also the mixed scheme using both instruments has been addressed. We may note that whereas both public provision and subsidization are welfare improving when used separately, public provision is always part of the optimal policy mix, but subsidies are not.

Efficiency vs distribution

Having referred to efficiency as well as redistribution, it is natural to ask whether the case for public provision of private goods leans more heavily on efficiency or distributional arguments. No brief answer stating either alternative would be satisfactory. To see why we should recognise that public provision may be required to achieve certain Pareto optima, but not others. As Pareto optima differ with respect to distribution, we acknowledge that distributional considerations do play a crucial role. The redistribution might, however, have been achieved by means of other instruments, but at a higher cost, which is clearly an efficiency argument.

4. Health care

Now considering some categories of goods, health care is arguably the most important good being publicly provided. Let us note right away that the funding of health care is basically an insurance issue. Public provision is essentially about ensuring universal access to insurance. The key to understanding the role of the public sector in this area is the recognition that, in a health context, an insurance market is indeed far from the theoretical ideal of a perfect market, and let us briefly review some of the problems.

Even if some people do not buy insurance, for whatever reason, a humane society would still provide some treatment in the case of serious illness. Niskanen and Glazer (1992) have shown that when individuals choose not to buy insurance because they expect to get some provision if ill, even if uninsured, there may be a case for a more generous public provision than this minimum level.

Even with insurance, over time many things change in unpredicted ways: technologies available for treatment, costs, income, health status, etc. Hence re-contracting of health insurance at certain intervals is required. But then one is no longer behind the veil of ignorance. The pre-existing conditions problem arises that those already diagnosed with a health problem may, if at all, be offered insurance on less favourable terms. Even at the time of birth or before there exists no insurance against unhealthy parents, unfavourable test results or recognised deficiencies. The simplest solution may be nationwide inclusion of everyone in a social insurance scheme.

Even if public insurance may serve purposes not duly allowed for by private markets, we should also recognise that the essential problems are the same to the public and private insurer. Both face similar moral hazard and agency problems. In neither regime do patients and doctors have the right incentives for cost containment. In neither system do consumers face "market prices" of health services at source. Insurance reimbursement breaks the link whether the source is public or private.

Insurance contracts can be designed in different ways. In principle the compensation may be in kind (in the form of medical treatment) or in cash to cover medical expenses, to offset loss of income due to disability, or just to compensate for illness if only partially recovery is possible or deliberately chosen (Asheim, Emblem, Nilssen (2002)). In the case of social insurance, the compensation is rarely precisely defined. The indemnity is not explicitly specified, but is rather implicitly defined by the current health policy with its set of priorities, rules, waiting lists, etc.

5. Education

The other area in which the government is heavily involved is education. Our traditional perception, in my view, still valid, has been that since one cannot pledge future earnings as collateral, credit markets would easily be an inadequate source of funding. The opportunities for getting education would then depend on the financial resources of the parents and how altruistic they are towards their children. Such a regime would not be expected to select those to be given education to maximise the social return to resources expended on education. The regime would also be likely to reproduce the inequalities of the parent generation. (One could argue that the appropriate policy would be to redistribute the initial endowments of the parent generation, but with costly redistribution a more efficient policy may be to have (some) public provision of education.)

Recent research has questioned the presumption that borrowing constraints present an obstacle to obtaining college education - at least in the US. (Shea (1999), Cameron and Taber (2000)). However, we should keep in mind that the situation that has been studied is one in which a wide range of subsidies to education is already in place so that the lack of evidence of an impact from credit market constraints in this situation does not necessarily dismiss the case for public provision.

Alternatively, public provision may be perceived as alleviating the tax distortion of non-deductible investment in human capital, as I have already alluded to.

The second best approach may lend support to a role for public provision of education. A progressive schedule for labour income taxes on distributional grounds will distort non-deductible investment in human capital. It is typically these expenses that are financed by the public purse, whilst there is *de facto* immediate expensing and no serious tax distortion from the opportunity cost in terms of income foregone. The public provision may thus be perceived as providing a relief from the tax distortions that arise when some of the return to non-deductible investment in education is being taxed away. (Bovenberg and Jakobs 2001).

Boadway and Marchand (1995) have applied the self-selection tax model to explore the case for public provision of education. High and low-skilled types face wage-rates that depend positively on skill level as well as education. By increasing the public provision some threshold level may be reached at which the high-ability mimicker finds that the increase in tax liability no longer justifies the additional education it buys via government spending. The benefits from further education may still benefit the actual agents, but the mimicker is made worse off and the self-selection constraint is softened. The intuition why such a situation may emerge is that the mimicker enjoying a high wage-rate due to his skill level, must limit his labour supply to earn no more than the low-skilled person. Hence he will work fewer hours during which he will capitalise on the increase in labour productivity.

6. The political economy approach.

A number of papers have argued that public provision of private goods can be understood as a means to win political support. Public provision may be used to attract votes even if such a policy would be inefficient by social welfare criteria. Epple and Romano (1996) showed that there exists a voting equilibrium with a positive public provision of a private good financed by a proportional income tax, and consumers possibly topping up. In an opting out model an equilibrium exists in which high-income households, actually opting out, and low-income households, with a low willingness to pay, collide to favour less provision against the middle class favouring more public provision.

Since it is hard to reject the idea that politicians want to win votes, the political economy approach is appealing. However, in my view the political economy models established so far to explain public provision of private goods, have a number of shortcomings. It appears that the results are too often driven by excessively severe restrictions on the instruments available to the government. By moderately expanding the available set of taxes and cash transfers the case for public provision would vanish. Secondly, the models usually argue the case for *some* politically determined private good provision. There is little in the models to explain which goods that would be publicly provided. The case for health care may be no stronger than that for hair-cuts or hard-rock music.

Finally, the efficiency assessment of the public provision does not always allow for the policy restrictions defining feasible allocations.(For further discussion see Blomquist and Christiansen 1999).

7. Concluding remarks

To conclude let us note that public provision of private goods is a young research area, in which I believe the marginal return to further research is still high.

We need to know more about efficient design of provision schemes. We need to compare more closely in-kind and cash-based instruments. We need to ask how to reconcile freedom of choice and non-market allocation.

As I hope I have demonstrated, we know a good deal about welfare arguments for public provision of private goods. Still I have an agonising feeling that we do not fully understand the normative and positive aspects of this phenomenon. In particular the concentration around goods impacting on human resources does not seem to be fully accounted for. In view of what I have said, some common features are noticeable. A basic recognition is that human resources are different from ordinary commodities. Information on human resources is more likely to be private information, for obvious reasons.

Human capital cannot be sold, or pledged as collateral, in the same way as physical or financial capital. Effects on human resources are often long-term effects. Human resources are crucial for labour supply that is seriously tax distorted. Perhaps is there a deeply rooted value judgement that human resources are so fundamental for people's ability to function in society and the labour market, that they should never be unequivocally exposed to whatever imperfections that may tarnish the markets. Perhaps do these suggestions indicate that there is a more universal theory of public provision of private goods waiting to be more fully developed

Apart from this, we still need to know more about the comparative advantage (or disadvantage) of public provision of goods compared to cash-based instruments. We need to know more about the optimum design of efficient provision schemes once we are outside the realm of the price mechanism. In practice there is often a lot of dissatisfaction with the actual provision schemes even if public provision is endorsed in principle. Finally, the political economy of public provision seems still to be in its infancy.

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