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CENTER DISCUSSION PAPER NO. 3

THE SCOPE OF ALLOCATION IN THE PUBLIC SECTOR

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A. Maneschi
February 1966

The Scope of Allocation in the Public Sector

Some ambiguity surrounds the concept of "public good" and "public want" in discussions relating to the allocation of resources in the public sector of the economy. While there is broad agreement that goods to which the "exclusion principle" does not apply clearly pertain to the Allocation Branch of the public economy (to use Musgrave's three-branch approach to budget policy), the case of goods to which the exclusion principle applies at least in part but which either are subject to decreasing costs or give rise to significant external effects is less clear-cut.[1] The aim of this paper is to analyze the relationship between these three types of goods and their relevance to the allocation of resources in a normative fiscal framework.

My definition of public good, which I shall seek to justify below, is a good which the market mechanism either cannot provide at all or which it can provide only with a considerable degree of inefficiency.[2] Goods in the first category, referred to here as social goods, satisfy what Musgrave calls "social wants," those wants to which the exclusion principle does not apply since they must be consumed in equal amounts by all.[3] In this case one can also speak of "indivisibility in consumption " since consumption of these goods cannot be tailored to the individual tastes of consumers as is true instead of goods supplied through the market. In the second category are

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[1] See R.A. Musgrave, The Theory of Public Finance: A Study in Public Economy (New York: McGraw-Hill Book Co., Inc.), 1959, Chapter 1.

[2] This definition differs from Musgrave's (ibid., p. 44), for whom public goods are "goods the inherent quality of which requires public production."

[3] Ibid., pp. 8-12.

found goods of two different kinds, firstly those goods whose provision is marked by diffuse and significant external effects on consumption either at the national or the local level, and secondly those goods produced by indivisible factors of production under the condition of decreasing costs in the relevant range of the market demand curve. For the sake of convenience these two types of goods, which are not mutually exclusive, will be referred to as near-social goods and decreasing-cost goods respectively.

Near-social goods correspond roughly to the satisfaction of what Musgrave calls "merit wants," which are considered so important to society that they are provided publicly, even though the exclusion principle may apply. Musgrave states that "the satisfaction of merit wants, by its very nature, involves interference with consumer preferences " by an "informed group." which exercises leadership in a democratic society.[1] This definition seems to me to miss the point. As Musgrave himself remarks, this interference into the want pattern of others may become a dangerous tool in the hands of an authoritarian government seeking to extend its power and impose its particular views on the rest of the people. Such a government may freely interpret the consensus of society so as to suit its own ends instead of depending on the consent of the governed.

It seems unnecessary to rationalize the satisfaction of near-social wants in that way. Surely the advantages of subsidized low-cost housing and of universal education are seen not only by an enlightened few, but by a majority of the people, and the satisfaction of these wants need not

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[1] Ibid., pp. 13-14.

involve any more serious a departure from consumer sovereignty than is true of social wants proper. A more useful way of describing near-social wants is to say that their satisfaction consists both of direct individual consumption to which the exclusion principle could apply and of collective consumption to which it could not. They are thus located somewhere along the continuum that goes from private wants to social wants, their satisfaction creating significant externalities on the consumption side. This points to the fact that pure social wants are the polar instance of external effects, since their satisfaction is mainly external and collective and little or none is private and individual. This is recognized by Musgrave, as is the fact that his "merit wants may involve substantial elements of social wants."[2] I think it therefore more appropriate to make the degree of externality the criterion for deciding on the social quality of a given good or service as regards consumption, while conceding the difficulties involved in making such a concept operational. Education and vaccination are two examples of near-social goods. In both cases there is a direct benefit accruing to the immediate recipient, as well as an indirect benefit to the society as a whole.

The case of decreasing-cost industries has received considerable attention in the literature.[3] Efficient allocation requires the industry

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[1] Musgrave, op. cit., pp. 8, 13.

[2] For a succinct statement of the problems involved, as well as an extensive bibliography, see Musgrave, ibid., Chapter 7, pp. 136-140.

to produce at a level where price falls short of average cost. A subsidy is therefore needed to secure an optimal output. An oft-cited example is that of a bridge. If maintenance costs are independent of the rate of its utilization, the cost of an additional crossing is zero and so therefore is the efficiency price once the bridge has been built. The exclusion principle can normally be applied to decreasing-cost goods, if at great administrative cost (as in the case of roads in an urban area). Its application, where marginal cost is zero leads however to inefficiency. Even if MC is not zero, efficient pricing can only cover variable costs but not fixed costs. To know whether investment in such industries is justified, it is necessary to have recourse to a political decision-making process just as in the case of social wants (and, I would add, near-social wants).[1]

The feature which is common to social goods, near-social goods and decreasing-cost goods is neither the non-applicability of the exclusion principle nor the presence of externalities or of decreasing costs, but the fact that their efficient provision can only come about through a political process instead of through the market mechanism. It is this feature which I invoke as my justification for including all three as public goods in the Allocation Branch of an efficient Fiscal Department.[2]

The above classification shows that the difference between social and near-social wants is one of degree rather than of kind (hence the designation

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[1] Ibid., p. 139.

[2] These of course do not exhaust the functions of the Allocation Branch, which comprise others such as antitrust action and the control of monopoly due to lack of free entry. See Musgrave, ibid., pp. 6-8.

I use for the latter), since both involve to a greater or lesser extent externalities or indivisibilities on the consumption side. In the limit (that is, in the case of pure social goods) the consumption of X does not subtract anything from the consumption of Y or Z. The cost of marginal use is therefore zero. Decreasing-cost goods, on the other hand, usually differ in kind from the other two types of public goods since the indivisibility is on the production rather than the consumption side.[1] This point appears to be overlooked by Bator in his otherwise admirable discussion of the scope of the public sector.[2] Bator identifies "public goods" with the satisfaction both of Musgrave's "social wants" (he then refers to them as "pure public goods") and of what I have referred to as near-social wants. He cites a bridge as an example of a pure public good on the strength of the fact that the cost of an additional crossing is zero.[3]

It seems to me that the case of a bridge belongs instead to the immediately preceding section in the same chapter [Where the "Invisible Hand" Fails (1)], where Bator discusses the failure of the market to efficiently allocate resources in the decreasing-cost situation.[4] Indeed, in that very section he cites the bridge as an example of a good with a large initial fixed cost and low (zero) variable cost. The reason for

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[1]This is not to deny that a decreasing-cost good may also give rise to externalities of consumption. For example, a new road or bridge may raise nearby real estate values or lead to increased economic activity in the neighborhood.

[2]See F.M. Bator, The Question of Government Spending: Public Needs and Private Wants, (New York: Harper & Brothers), 1960.

[3]Ibid., pp. 93-98.

[4]Ibid., pp. 88-83.

using the bridge as an example in both sections is apparently the confusion of a good or service the cost of a marginal unit of which is zero (such as an additional crossing of a bridge) with a good satisfying a social want, where the cost of marginal use by an additional person is zero, since consumption is a function of total supply. The first involves the marginal cost of production, the second the marginal cost of consumption, and these are conceptually distinct. In the first case demand schedules are added horizontally, in the second case vertically. It is therefore incorrect to say that "in a sense, as use of the bridge as an example has already implied, a 'public good' situation is simply a polar instance of decreasing costs."[1] Instead I have argued above that it is more appropriate to regard such a social want situation as a polar instance of external effects on collective consumption.

The above considerations apply both to developed and to underdeveloped countries. In the latter, however, a fourth responsibility of the Allocation Branch adds itself to the three already discussed, namely the integrated planning of the industrialization of the country. The need for this springs from the presence of what Scitovsky has called "pecuniary external economies" derived from (indirect) interdependence among producers through the market mechanism.[2] The social benefit arising from the expansion of a given industry diverges from its private profitability because (inter alia) of the cheaper products it makes available to other industries.

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[1] Ibid., p. 96.

[2] T. Scitovsky, "Two Concepts of External Economies," The Journal of Political Economy, April 1954.

Investment therefore tends to be less than optimal because of the impossibility for a certain industry to forecast what future demand and supply conditions will be. These externalities on the production side call for action by the Allocation Branch just as much as the previously mentioned externalities on the consumption side and indivisibilities both of consumption and production.