



AN ECONOMIC ANALYSIS OF THE PUBLIC PROVISION OF GOODS AND SERVICES WITH APPLICATIONS TO HEALTH CARE AND EDUCATION

Introduction

A great deal of current political discussion among all parties has to do with "saving" Social Security, shoring up Medicare and increasing funding to public schools. Most of the discussion centers around which particular tax/transfer scheme will produce the best results, while the deeper question of why these services are provided or funded by government rather than private markets is left unasked. It is important to recognize, however, that economic science has developed adequate criteria with which to gauge the probable success or failure of various publicly provided programs. The purpose of this paper is to provide a working understanding of these criteria and to apply them to two policy areas: education and health care. The results suggest that widely accepted beliefs concerning the public provision of these goods come into question when economics is brought into the discussion.

The central problems that any economic system, capitalist (market directed) or non-capitalist (government directed) must deal with are what to produce (allocative efficiency) and how to produce it (productive efficiency).

The Central Problems of Allocative and Productive Efficiency: Whether or not to Build a Bridge; If So, How Best to Build It

Economists often characterize the world as one in which wants are unlimited while the means of achieving those wants are scarce. Scarcity dictates that choices must be made: producing more of some goods means producing less of others. The "cost" of each choice then is the foregone alternative, which is the good or goods that were not produced. In fact, the "economic problem" of

deciding what to produce and what not to produce arises as soon as different purposes compete for available resources.¹

Allocative efficiency refers to the optimal allocation of productive means to desired ends, or, producing those goods that consumers desire most — goods whose valuations exceed the costs of production — while avoiding production of less desired goods. Productive efficiency, on the other hand, can be understood as producing those desired goods at the lowest possible cost, or producing the desired goods using the fewest possible resources. The central problems that any economic system, capitalist (market directed) or non-capitalist (government directed) must deal with are what to produce (allocative efficiency) and how to produce it (productive efficiency). The whole thing can perhaps best be understood by considering the two problems of (1) whether or not to build a bridge, given competing uses for the resources needed in its construction and (2) if so, how best to build the bridge. Whether or not to build the bridge at all, given that other things like automobiles or kitchen appliances could be produced with the materials and labor used to build the bridge, is a question of allocative efficiency. How to best build the bridge in the sense of achieving the desired requirements of strength, capacity, etc. at the lowest possible cost is a problem of productive efficiency.

Free markets provide people with the goods and services they want — allocative efficiency — and do so without using more scarce resources than necessary — productive efficiency.

Achieving Allocative and Productive Efficiency Through Free Markets: It Happens, but Nobody Recognizes It!

Free markets provide people with the goods and services they want — allocative efficiency — and do so without using more scarce resources than necessary — productive efficiency. Efforts to maximize profits automatically lead to those outcomes — the "invisible hand". Imagine the task of trying to decide, in a country (or world) of millions of individuals desiring a vast array of goods and services, which types and combinations of goods and services — food, clothing, shelter, medical care, entertainment, etc. — are most desired, and whether or not producing more of some and less of others could attain a higher overall all level of satisfaction. Then imagine trying to produce all of these goods and services at the lowest possible cost. As incredible as it seems, free markets ceaselessly work to achieve these goals. Allocative and productive efficiency cannot be obtained from government direction but rather through the decentralized direction of market prices.

¹ Hayek, F., *Collectivist Economic Planning* (Clifton, NJ: Augustus M. Kelley, Publishers, 1933), p. 6.

Thinking in Terms of Profit and Loss

When an individual or business produces and sells a product or service for a profit, it has essentially moved resources from lower-valued uses to higher-valued uses. Profit — the positive spread between the price received for a good and the costs incurred in its production — means that consumers valued the final output more highly than the individual inputs that went into its construction. Loss – a negative spread between the price received for a good and the costs incurred in its production – implies the opposite. A firm that records a loss is producing a good or service that is less highly valued than the sum of the resources that went into its production.

Profit-making firms create value by producing goods that consumers value highly, while loss-making firms destroy value by producing goods that consumers value less highly. It is the difference between the prices received for goods and the prices paid for the inputs used to produce them that allows for the calculation of profit and loss. Under a free market system of profit and loss, profit-making firms attract capital and expand. Firms operating at a loss lose capital, contract, and/or go out of business.

Profit, Loss, and the Achievement of Allocative and Productive Efficiency

Changes in consumer wants translate into increases or decreases in the demands for particular products. Increased demand for a good relative to its supply increases the price — and hence the profit — of producing that good, signaling producers to increase production. Decreased demand lowers the profit and signals producers to produce less. The opportunity for profit motivates producers to move resources out of less valued areas and into more highly valued areas. In the process, above normal profits are competed away, and consumers get the added output they desire at the lowest possible price. Thus profit-seeking results in allocative efficiency.

The remarkable outcome of the free-market ... is that individual producers independently seeking only to make as much profit for themselves as possible achieve allocative and productive efficiency for the economy as a whole. That's what Adam Smith meant when he referred to an "invisible hand"...

But that's not all. The lure of profit also encourages firms to produce goods and services at the lowest possible cost, because lower costs translate directly into higher profits. Again, low cost-producers earn more profit, attract more capital, and expand at the expense of high-cost producers. So profit seeking also results in productive efficiency, or the production of a given quantity of goods and services at the lowest possible cost. By contrast, in a non-market economy we have, writes Nobel Laureate Frederick von Hayek, "the spectacle of a socialist economic order floundering in the

ocean of possible and conceivable economic combinations without the compass of economic calculation [of profit and loss]."²

The remarkable outcome of the free-market process outlined above (often referred to as a "price directed market economy") is that individual producers independently seeking only to make as much profit for themselves as possible achieve allocative and productive efficiency for the economy as a whole. That's what Adam Smith meant when he referred to an "invisible hand" guiding the self-interest of producers towards indirectly promoting the interests of society while all the time intending only their own gain.

Under the guidance of the invisible hand, the market system will automatically promote allocative and productive efficiency even if no one is consciously trying to make that happen. People do not have to understand how the market works in order for it to function. But as Hayek often pointed out, this is also the market system's Achilles heel, for "people are not likely to let it work if they do not understand it."³ Much of the enthusiasm for government provision of goods and services is because most people are unaware that the free market automatically makes the most out of available resources, and that the free market is constantly adapting to changing conditions to achieve productive and allocative efficiency in a way that no centrally managed system can hope to mimic.

An Important Caveat: Open Entry is Essential

In a free market, profits guide firms to enter industries where goods are relatively highly valued by customers. Through the signals of prices and profits, consumer preferences are registered and producers are "incentivized" to respond to those preferences. The market will work as described, however, only if producers and consumers are free to respond to the price signals that pass between them. Imagine a scenario in which the demand for a good increases, but new producers are not allowed to enter the industry, and existing producers agree not to produce more of the product (a cartel). In that case, the higher price and profits enjoyed by existing or incumbent firms could exist indefinitely. Businesses prefer fewer competitors to more, a fact that led capitalism's most influential supporter, Adam Smith, to assert, "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public."⁴

Fortunately, it is very hard for producers to prevent competitors from expanding output, unless the government intervenes to back up the cartel. In fact, one of the most powerful methods ever devised to create and maintain above-normal profits is the use of government-enforced restrictions on entry into specific industries. Government entrance restrictions and licensing requirements, no matter how well intentioned, always have this result: they increase the incomes of incumbents by

² *Ibid.*, p. 110.

³ *Ibid.*, p. 8.

⁴ Smith, A., *The Wealth of Nations* (New York: Modern Library, 1937), Chapter X, Part II, p. 128.

restricting output through the elimination of potential suppliers. The cost to society is of course allocative inefficiency: consumers might demand more of the good, but because of restricted entry, no increase in supply is forthcoming.

Market Failure: Exceptions to the Outcome of Allocative and Productive Efficiency

Markets may "fail" as in the case of inadequate supply of "public goods" or in the under- or over-production of goods involving positive or negative "externalities". Economists have developed criteria for testing whether there is "market failure".

Public Goods

Public goods are goods that everyone can enjoy without diminishing their value to others — non-rival consumption — and that producers cannot keep people from using whether they pay or not — nonexcludability. That's not true of things like automobiles and hamburgers. If I drive a car, you cannot drive that same car, and if I eat a hamburger, then you can't eat that same hamburger. These goods are characterized by *rivalry in consumption*. They also exhibit *excludability*: producers can readily prevent me from driving the car or eating the hamburger, if I refuse to pay. Markets may fail to adequately supply public goods. Such goods, e.g., national defense, may have to be produced (or at least contracted for) by the government, and paid for through taxation.

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But look at national defense. If my neighbors build a missile defense system for the nation, I can enjoy the benefits of it without reducing the benefits that they derive from it. Consumption of defense services in this sense is said to be *nonrival*: *use by one person need not diminish the quantity consumed by anyone else*. Furthermore, goods characterized by nonrival consumption are also usually characterized by *nonexclusion*: *it is impossible or prohibitively costly to confine the benefits of the good to selected persons*.

Therein lies the rub. If a private firm in a free market were to try to build and sell a missile defense system, it would have a problem. It has to be able to charge enough for the missile defense system to cover its costs, but with goods that have non-exclusion characteristics this might be difficult to do. Many individuals might choose to avoid bearing any costs in financing the missile defense system because they know that if their neighbors build it anyway, they cannot be excluded from enjoying the benefits whether they pay or not.

This is referred to as the free-rider problem: with nonexclusionary goods people have an incentive to understate their preferences for them and opt out of paying for them. Unfortunately, if everybody "free rides" it will be unlikely that a firm will produce and sell goods that are characterized by nonrival consumption and nonexclusion because they will not be able to collect enough money to cover their costs. These goods are thus called public goods because they will not be provided by private firms under a profit and loss system, even though they might be valued by consumers at more than their cost of production. But this is allocative inefficiency! The nonrival and nonexclusionary nature of a public good creates a type of "market failure" that requires government to produce or pay for the good in order to achieve allocative efficiency.

Only True Public Goods Should Be Publicly Provided.

In theory, when nonrival consumption and nonexclusion exist, allocative efficiency can only be achieved if government steps in and produces or pays for the good or service. Governments can tax, so they don't have to worry about making a profit. Therefore, the government intervention may sometimes be able to come closer to allocative efficiency than the market. Some cautions are in order, however.

First, in the absence of a market test — the offering of a product and the determination of the public's willingness to buy it — it is really impossible to know how much the public actually values the good, or, given the cost, how much the public really wants to consume. Government can only guess at the appropriate outcome. Second, government may be under political pressure to satisfy vocal, organized special interests rather than heeding the less intensely expressed preferences of the general electorate.

[T]he [government's] provision of public goods should be undertaken with caution, limited only to those goods that display genuine public goods characteristics — nonrival consumption and nonexclusivity — and not carried to excess.

Third, whereas a private firm suffers losses if it provides more goods than the public wants, governments have no such built-in stop mechanism. More often than not, shortages of funds in the government sector are used to rationalize the need for even more resources. Government may overdo the provision of a genuine public good, or misuse public good theory to intervene where there is really no market failure or public good situation. Thus, the government will often make allocatively inefficient choices. The resulting allocative inefficiencies can be staggering.

Furthermore, since governments are not guided by profit considerations, the incentive to provide goods at the lowest possible costs — productive efficiency — is lost. Consequently, one price of

having government supply goods or services to achieve allocative efficiency where public goods characteristics exist is inefficient production.

For all these reasons, the provision of public goods should be undertaken with caution, limited only to those goods that display genuine public goods characteristics — nonrival consumption and nonexclusivity — and not carried to excess. All other goods should be provided by the market rather than by the government.

For example, we often hear about the "free-rider" problem during the semi-annual fundraising drives for the "viewer and listener supported" Public Broadcasting System. In fact, a substantial portion of PBS costs are covered by government support, i.e., taxes. Many viewers and listeners who do not make added contributions to PBS are nonetheless forced to contribute through their taxes, as are many people who do not view or listen to PBS at all. Whether the government subsidy over- or under-compensates in the aggregate for the "public good" element of the System is anyone's guess; it certainly does not match any particular individual's view of the value of the service except by accident.

Externalities exist when parties external to a particular transaction are affected by that transaction... Goods that produce benefits for third parties beyond those received by the immediate consumers and producers are under-produced. Activities that impose costs on third parties are over-done.

More important, the "public good" label for PBS programming is a misnomer, first, because some other networks provide "highbrow" entertainment, and, second, because there is a clear market alternative to the government subsidy: commercials. Commercial stations flourish without government operating subsidies (although they may get something of a "free ride" by not paying an appropriate auction-based fee for their pieces of the broadcast spectrum). In the case of commercial stations, advertisers make a profit and loss calculation based on ratings data as to how much ad time to buy and what to pay for it, and commercial stations make a profit and loss calculation based on what advertisers are willing to pay and how much it costs to run the station.

Externalities

Externalities exist when parties external to a particular transaction are affected by that transaction. Externalities are due to ill-defined property rights that prohibit the achievement of productive and allocative efficiency. Since external effects can be positive or negative, it follows that there can be positive or negative externalities. Goods that produce benefits for third parties beyond those received by the immediate consumers and producers are under-produced. Activities that impose costs on third parties are over-done.

Pollution is a good example of a negative externality. If consumers decide to buy goods produced by a factory that emits pollution into the air, then many people — people who do not have anything to do with the transaction between the factory and the buyers of its products — are adversely affected. Hence the emitted pollutants are a negative externality. If, however, the factory engages in lavish landscaping of its facilities, creating a scenic value to the houses that surround it, then it has created a positive externality. Neighboring homeowners have been enriched free of charge.

The term externality stems from the fact that these effects are outside of, or external to, the price system, so their impact is not determined through mutual agreement among those affected.⁵ Immunization is often cited as another example of a positive externality from consumption. A person's inoculation against disease makes others around him or her safer.

Externalities and Allocative and Productive Efficiency.

When negative externalities occur, too much of a good tends to get produced from the standpoint of allocative efficiency. If the external cost borne by others was somehow "internalized," that is, borne by the producer creating the externality, costs — and prices — would go up, reducing the quantity of the good purchased and produced, and hence, reducing the externality. There are generally two ways in which government policy can be used to internalize externalities. One way is to assign property rights where they have not yet been assigned. Air or river property rights could be assigned to communities affected by pollution, and these communities could then require a polluting firm to compensate them for the destruction of their "property". Alternatively, the rights could be assigned to the producer, who in turn might agree to pollute less for a fee.⁶ It does not really matter to whom the rights are assigned, so long as someone is "in charge" of the situation and is motivated by profits to optimize the outcome.

The second way to achieve allocative efficiency by reducing the externality-creating activity is to tax the goods produced by the firm(s) involved.⁷ This same reasoning also argues for subsidizing positive externality-creating activities. But how do you know how much tax it would take to restrict production to the point of allocative efficiency? But how do you attach property rights to a beautiful view? There are no easy answers to these questions. Prudence dictates that allocative and productive efficiency are best achieved by private markets. If externalities occur, the first course of action should be to establish property rights, if possible. If not, then it might be necessary to apply

⁵ Browning, E., *Public Finance and the Price System* (New York: MacMillan Publishing Company, 1994).

⁶ The assertion that allocative efficiency occurs regardless of where property rights are assigned, *as long as they are assigned*, is an insight attributed to Nobel Laureate Ronald Coase and is referred to by economists as the "Coase Theorem".

⁷ Taxing externalities was recommended by economist A.C. Pigou, so this method of dealing with externalities is often referred to as applying "Pigouvian Taxes".

a tax, if it is felt that the negative effects of the tax — lower production and higher unemployment — are outweighed by the positive effects of mitigating the externality.

Unfortunately, it is impossible, in the absence of a market test, to measure the subjective discomfort (or pleasure) of persons affected by negative (or positive) externalities. Consequently, it is impossible for the government to devise and implement a perfect corrective tax that will accurately produce an ideal result. The government should not rush to impose such corrective devices; usually, the less that is done, the better. There is a constant danger that the government will use the excuse that an externality may exist as a justification for a large revenue-raising tax.

With externalities, allocative and productive efficiency are best achieved through the assignment of property rights or, failing that, cautiously subsidizing or taxing, respectively, private sector output of the positive or negative externality-generating goods and services.

For example, in the case of tobacco, there is much evidence that the government has (1) frequently misused the externality concept by incorrectly labelling as externalities various costs borne by smokers and (2) exaggerated the externalities that might be present. Although many in government use the externality argument as a rationale for higher tobacco taxes, careful studies indicate that tobacco taxes are *already too high* relative to external costs of smoking.⁸

Furthermore, according to economic theory, allocative efficiency only requires that the production of the offending good be reduced to the "efficient level"; it does not require that the victims of the remaining external "bad" be compensated for their discomfort. Governments have taken this theoretical principle to heart. Those that impose such "corrective" taxes often keep the revenues for general use, rather than compensating the parties injured by the externality. The recent settlement between the states and the tobacco companies is a flagrant example. The states are spending the money on many things other than caring for people made ill by smoking.

Summary of Criteria for Evaluating the Public Provision or Subsidization of Goods and Services

Free markets lead to the desirable outcomes of allocative and productive efficiency, provided the condition of open entry for suppliers of each good is met. Because governments are not guided by the dictates of profits and loss, there is little incentive and hence little possibility of achieving either allocative or productive efficiency under government provision of goods and services. Exceptions

⁸ See Stephen J. Entin, "There's No Economic Excuse For A Higher Cigarette Tax," *IRET Policy Bulletin*, No. 72, April 1998.

involve the existence of either public goods or externalities. In the case of public goods, government provision of goods or services is justified if nonrival consumption and nonexclusion characteristics exist. If these characteristics are not present, then there exists no economic rationale for government provision of a good or service. The existence of externalities implies no justification for government provision. With externalities, allocative and productive efficiency are best achieved through the assignment of property rights or, failing that, cautiously subsidizing or taxing, respectively, private sector output of the positive or negative externality-generating goods and services.

Applications: Health Care and Education

The best way to understand the economist's tools for evaluating public policies is to apply them to concrete examples. One area of increasing interest to many has to do with the government's role in the provision of health care (and health insurance). The daunting complexity of various government programs, both current and proposed, can be very intimidating to anyone wishing to understand the health care industry. But the application of the concepts discussed above can strip away the mind-numbing minutia of detail and get at the essence of the health care environment and what role, if any, the government should play.

"The planners [of the Medicare system] seemed to have overlooked the fact that if you shift the demand curve outward without moving the supply curve, prices go up."

The Economics of Health Care

"Many people have a basic distrust of a market system; many are also concerned that the patient would not be adequately protected when providers are motivated by profits. This concern for consumer protection resulted in many restrictions, which were promoted by health associations. However, restrictions on who can perform certain tasks, who may enter the health professions, and who may be reimbursed for providing medical services did not eliminate the public's concern that unnecessary services were being performed and that unethical health providers practiced medicine. What these restrictions achieved, however, was the reduction of competition in the provision of medical services." — Economist Paul Feldstein⁹

Health care has been at the forefront of policy discussions in recent years as expenditures on medical services have risen more rapidly than expenditures on most other goods and services in the economy.¹⁰ This increase in health care expenditures has coincided with an increase in the price of

⁹ Feldstein, P. *Health Care Economics* (New York: Delmar Publishers, 1999), pp. 600-601.

¹⁰ Feldstein (1999).

health care and in the government's share of those expenditures. All of these phenomena are related and are easily explained using the most basic economics.

Increased Demand + Restricted Supply = Increased Prices and Expenditures.

Government policies since the mid 1960's have involved massive increases in tax-supported funding of subsidized health care under the Medicare and Medicaid programs. These programs have greatly increased the demand for health care among groups covered by these programs. At the same time, most of the major restrictions on the supply of health care services, like medical school accreditation and physician licensing, remain in place. The result is straightforward: increasing the demand for any good or service while restricting supply results in higher prices that are not effectively reduced through the entrance of new sources of supply. Medicine is no different: "The planners [of the Medicare system] seemed to have overlooked the fact that if you shift the demand curve outward without moving the supply curve, prices go up."¹¹

Writes economist Paul Feldstein:

"In 1966, the passage of Medicare and Medicaid produced dramatic changes in the medical sector. Medicare is a federal program for financing the medical services of the aged; Medicaid is a federal-state financing program for the medically indigent. With the enactment of these two programs, the aged and the poor had increased access to medical care. Hospitals were paid according to their costs and physicians received their usual and customary fees. As a result of Medicare and Medicaid, the price of medical care increased at a faster pace than previously. The role of government payer of medical services increased dramatically, from paying 20 percent of medical expenditures before 1966 to 45 percent currently, with the federal government paying three-fourths of that amount."¹²

[M]ost medical care procedures fail the public goods test. There is no economic rationale for the government provision of health care, nor for the use of government funding for health care.

Table 1 shows that the price of medical care during this period as measured by the medical care component of the consumer price index has increased rapidly.¹³

The movement of health care prices clearly demonstrates the basic economic principles of supply and demand at work. During the three decades between 1935 and 1965, the medical care portion of

¹¹ Hayward, S. and Peterson, E., "The Medicare Monster: A Cautionary Tale," *Reason* 19, January 1993.

¹² Feldstein (1999), p. 3.

¹³ Feldstein (1999), p. 2.

the consumer price index (CPI) went from 10.2 to 25.2, an increase of 147 percent. This is not much different than the change for all items, which went from 13.7 to 31.5, a rise of 130 percent. The following three decades, however, which coincide with the massive increase of federal funding to health care through the Medicare and Medicaid programs, tell a different story. From 1965 to 1996, the medical care portion of CPI went from 25.2 to 228.2, an increase of over 800 percent! This is more than twice as fast as the rate of price increase for all items. It is this increased price of medical care in the face of increased expenditures that represents the tell-tale evidence of binding supply restrictions over time. This is the predictable outcome when increased demand meets restricted/regulated supply.

Year	All Items	Food	Housing	Apparel and Upkeep	Transportation	Medical Care	Entertainment	Other
1935	13.7	12.5	15.2	20.8	14.2	10.2	17.0	15.7
1945	18.0	17.3	18.2	31.4	15.9	11.9	25.4	20.0
1955	26.8	27.9	25.3	42.9	25.8	18.2	31.2	28.0
1965	31.5	32.2	29.2	47.8	31.9	25.2	39.1	33.0
1970	38.8	40.1	36.4	59.2	37.5	34.0	47.5	40.9
1975	53.8	60.2	50.7	72.5	50.1	47.5	62.5	53.9
1980	82.4	86.7	81.1	90.9	83.1	74.9	83.6	75.2
1985	107.6	105.6	107.7	105.0	106.4	113.5	107.9	114.5
1990	130.7	132.4	128.5	124.1	120.5	162.8	132.4	159.0
1996	156.9	153.3	152.8	131.7	143.0	228.2	159.1	215.4

The rate of increase in the price of medical care slowed from the mid 1980s to the present.¹⁴ Nevertheless, Medicare expenditures continue to expand with technological advances, longer lifespans, and an increase in the elderly population. Some of the credit for the deceleration of unit health care costs goes to deregulation and heightened competition in the medical care market. Another factor is innovations in the provision of health care by the private sector, such as increased utilization of managed care systems under employer-provided health insurance programs, which have held down demand and price growth (at the expense of less choice for the insured population). However, some of the easing of price growth has come from price controls and other regulations imposed on health care providers under the Medicare and Medicaid programs. The providers are

¹⁴ Medical care markets still remain highly regulated and controlled. Interestingly, the onset of deregulation, which was the outcome of shifting payoffs to politicians and interest groups, was anticipated by one of the pioneers of the economic theory of regulation, Sam Peltzman. See Peltzman, S., *Political Participation & Government Regulation* (Chicago: University of Chicago Press, 1998).

required to provide more for less, or leave the programs. Some have left. These controls serve to restrict supply even further, but the price lid prevents the resulting pressure from showing up in the price index. Instead, quality of care suffers, and shortages emerge.

The Proper Role of Government in Health Care: Using the Tools of Economic Analysis.

Few medical procedures can be characterized by nonrival consumption and nonexclusivity. My tonsillectomy cannot be simultaneously enjoyed by you. If a physician wants to operate on only my tonsils and not yours, he can pretty easily exclude you from the benefits of my operation. If I don't pay him, I don't get the operation, so there's no free-rider problem either. The physician has every incentive to provide those services that I value most highly, and I have every incentive to pay him. Judged then by the public goods criteria of nonrival consumption and nonexclusivity, most medical care procedures fail the public goods test. There is no economic rationale for the government provision of health care, nor for the use of government funding for health care. In this case, markets are the best judge of how much and what kinds of health care to provide, how and by whom it should be provided, and for whom. A few procedures generate positive externalities, like inoculations against disease, but these exceptions represent a very small fraction of total medical procedures and expenditures.

On humanitarian grounds, a case can be made for government involvement to assist those who could not afford health care... But this is a welfare issue and should be dealt with like any poverty issue — through cash assistance or vouchers financed out of general tax revenue.

On humanitarian grounds, a case can be made for government involvement to assist those who could not afford health care, perhaps through a program covering catastrophic health insurance (with the definition of "catastrophic" varying with income). But this is a welfare issue and should be dealt with like any poverty issue — through cash assistance or vouchers financed out of general tax revenue.¹⁵ The current size and scope of Medicare is in no way justified. Neither is there an economic case for government's large and increasing role in funding and regulating health care for the general population. Government interventions in the health insurance market to regulate coverage, conditions of issue, eligibility, or portability, or to mandate specific benefits (as in a "patients' bill of rights") are not justified on economic grounds.

¹⁵ Entin, S., "Health Care Reform: Why Not Try Real Insurance?" Working Paper, Institute for Research on the Economics of Taxation.

Education

Unlike health care, public education is unique in that it has had advocates since this country's founding. Even Adam Smith, the father of modern economics and chief advocate of "laissez fair" (limited government) policies, was a supporter of public education. But the intent of these advocates is often misstated. Smith, for example, advocated in a limited way some local "public" education, but the system of finance that Smith had in mind was that of the Scottish system of parochial schools in which the teachers' salaries were paid directly by families, while local property owners financed the school buildings.¹⁶

[I]ncreased [education] expenditure, not just in total but per-pupil, has generally been accompanied by falling student performance on standardized tests. Like health care, the pattern in public education has been to increase government funding while limiting entry, thereby restricting supply and competition.

In fact, compulsory education in this country did not begin until 1918. But the government's role in education has grown to become the third largest category of government expenditures, by function for all levels of government, behind only defense and social security.¹⁷ As countless economists have noted, this increased expenditure, not just in total but per-pupil, has generally been accompanied by falling student performance on standardized tests.¹⁸ Like health care, the pattern in public education has been to increase government funding while limiting entry, thereby restricting supply and competition. With education, however, entry restrictions go beyond licensing and certification and opposition to home schooling (though they include these). With public education, the government not only provides educational services directly, but also forces those choosing private schools or home schooling to continue to fund the public system!

The Proper Role of Government in Education: Using the Tools of Economic Analysis.

Economic analysis does not justify government-provided schools. Under a market system it is easy for an educator to exclude me from class if I refuse to pay the required fees. Likewise, my consumption of education in the classroom is not shared by any non-paying students, so non-rival consumption is non-existent. Since the benefits of education accrue to me, I have an incentive to

¹⁶ West, A., *Adam Smith and Modern Economics* (Newcastle: Athenaeum Press Ltd, 1990), p. 98.

¹⁷ Browning (1994) p. 4.

¹⁸ The best discussion of the detrimental effects of government involvement with schooling is still found in Friedman, M., *Free to Chose* (New York: Harcourt Brace Jovanovich, 1990). For a more recent treatment, see Sowell, T., *Inside American Education: The Decline, The Deception, the Dogmas* (New York: Free Press, 1992).

pay for education and cannot free-ride. Because they can exclude me if I do not pay, educators have an incentive to provide the quantity and quality of education demanded in the marketplace. Therefore, no public good exists, and no government provision of education can be justified on economic grounds.

It is often argued that government schools are justified on the ground that they provide educational services to the poor who otherwise could not afford schooling. This is really a welfare issue that should be dealt with like any poverty issue: through cash assistance or vouchers financed out of general tax revenue.¹⁹ The current size and scope of the public educational bureaucracy is in no way justified. Economist E.G. West has noted that, predictably, the increased size and scope of public education was brought about not by the poor or by dissatisfied parents, but "mainly by teachers and government officials."²⁰ In fact, the only legitimate case for government schools is a limited one: it has been suggested that there are positive externalities attributable to having an educated society. Such a claim assumes, however, that a large portion of the population would opt out of education altogether if compulsory government schools were abandoned — hardly a realistic assumption.²¹

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Education and Health Care: Striking Similarities

Government provision of health care and education cannot be justified using the tools of economic analysis. Neither health care nor education can be considered a pure public good, which is necessary to justify government involvement, and externalities generated in the production of health care and education are small. Improvements in either sector are most likely to occur through free markets, and any proposals to the contrary will be ineffective.

¹⁹ Entin, S., "Health Care Reform: Why Not Try Real Insurance?"

²⁰ West quoted in Friedman (1990), p. 153.

²¹ Public schooling is no guarantee of an "educated" populace. As Robert Maynard Hutchins wrote, "Our education has undergone so drastic a process of dilution that we are ill-equipped, even after graduation from a respectable college, to tackle anything much above the level of a comic book... This uneducated political power is dangerous, and the leisure of the uneducated is degrading and will be dangerous... The death of democracy is not likely to be an assassination from ambush. It will be a slow extinction from apathy, indifference, and undernourishment." See Hutchins, R. *The Great Conversation: The Substance of a Liberal Education* (Chicago: Encyclopedia Britannica, 1952).

The development of the government's role in health care and in education is strikingly similar in result: increased funding along with restricted competition has increased expenditures and prices while resulting in decreased satisfaction by the users of each.

Some of the primary beneficiaries of the current government health care and education programs have been the professionals working in those industries. Their benefits have consisted largely of higher incomes and protection from competition. The American Medical Association and the National Education Association have been strongly supportive of additional federal funding of their respective sectors. Medicare and Medicaid recipients and recipients of student loans are grateful for their benefits as well.

But he who pays the fiddler calls the tune. Bureaucratic governance and control follow the funding, accompanied by regulations and red tape, which have caused educators and health care providers much grief, and have restricted students' and patients' choices and access to services.

Getting government to pledge an entitlement to a group of consumers may appear at first to benefit suppliers, and for many years, additional money may flow. Eventually, however, the government will ... take action to limit its fiscal exposure. It can do so by restricting consumers' access to the goods and services it has promised them, or it may turn on the providers, mandating the services while skimping on the compensation.

In addition, in the case of health care, government involvement has been accompanied in recent years by *reductions* in compensation for services, with the government demanding that providers do more for less. In particular, reimbursement rates under Medicare have been squeezed over several federal budgets to fight deficits. Getting government to pledge an entitlement to a group of consumers may appear at first to benefit suppliers, and for many years, additional money may flow. Eventually, however, the government will tire of an unlimited claim on its resources. It will take action to limit its fiscal exposure. It can do so by restricting consumers' access to the goods and services it has promised them, or it may turn on the providers, mandating the services while skimping on the compensation.

In a free market, providers would be entitled to walk away from inadequate compensation, signalling consumers that the cost of these services exceeded the price being offered. And in a free market, consumers would have the choice of following their chosen providers, paying for the services they want. In a government-run system, however, neither the providers nor the consumers may be free to exert their economic rights in this manner. In the case of Medicare, physicians must accept Medicare reimbursement rates for all patients, and may not balance bill any patients. If the patients are willing to pay more to see that particular provider for that particular service, they must pay the entire bill out of pocket, not just the additional charge; Medicare pays nothing. And,

following recent legislation, if physicians want to take on any Medicare-eligible patients outside the system for a higher fee, they must give up treating any other Medicare patients under the system for two years!

In both the health care and education industries, federal, state, and local government intervention has resulted in massive allocative inefficiency, not to mention quality problems, shortages, extended waiting times, and much hard feeling among consumers and producers alike.

Consumers are similarly inconvenienced with respect to public schools. They pay for them with their local and state taxes. If they wish to send their children to private schools instead, they get no financial assistance (except in a few cities and states that have braved the opposition to adopt vouchers), and must pay twice. The "captive market" for public schools has resulted in lack of competition and a slump in quality.

In both the health care and education industries, federal, state, and local government intervention has resulted in massive allocative inefficiency, not to mention quality problems, shortages, extended waiting times, and much hard feeling among consumers and producers alike. They may all come to regret asking for government help.

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