

Public Choice Challenges, Future Implications

The cost of a number of services has been increasing at a higher-than-average rate in recent years. This is happening to services in both the private and public sectors. Continuation of this pattern raises some serious issues. The growing costs of providing key public services will require additional revenue. Imposing new taxes on the public is very difficult, but reducing the level of services is equally unpopular. In the private sector, growing health care costs will require a greater proportion of household income to purchase the same level of services. Why is this happening and what are the implications for the future?

The key to these increasing costs is productivity and the rate at which it grows. Productivity growth in some service sectors has fallen behind that of other industry sectors. This creates a condition described by William Baumol¹ and referred to as the “cost disease”. There are a number of services affected by this phenomenon, including many of the services provided by governments, e.g., education, law enforcement, library services, highway maintenance, and others. Baumol observed that services with currently low productivity growth have had low productivity growth for as far back as historical data is available. He looked at data for automobile repair, automobile insurance, health care, education, and law enforcement. These services are all labor-intensive, with little room for capital substitution.

Baumol divides the economy into two sectors:

1. *The technologically progressive sector*, which is capital intensive and exhibits economies of scale, all of which make for a cumulative rise in output per man-hour. Since labor is paid according to marginal pro-

ductivity, wages will be high because of the large amount of capital each worker is working with. For example, automobile production has shifted much of the work previously done by people to machines. With the number of workers decreasing and capital input increasing, the marginal productivity of each worker has been going up over time.

2. *The non-progressive sector*, which is labor-intensive and has little room for substituting capital for labor. This sector includes activities in which quality is judged directly in terms of the amount of labor. A live concert performance illustrates this point. A half-hour horn quintet calls for the expenditure of two and one-half man-hours and “productivity” can’t be increased, i.e., you can’t play it in fifteen minutes or replace the horn players with machines.

Cost disease arises because the wage rates in the economy are set by the progressive sector. Workers are fairly mobile between industries and wages significantly influence occupational choice. Firms in the non-progressive sector must compete for workers by raising their offered wages to match wages in the progressive sector. As a result, the price of any given service produced in the non-progressive sector will rise as the price of labor rises in the technically progressive sector. Hence, the price of medical services has been rising as well as the price of hand-made jewelry and fine hand-worked furniture. The

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reaction to higher costs and limited revenues would be to reduce output. However, with respect to the public sector, voters are not likely to accept this. There are vigorous complaints if the level of service falls for schools, roads, police and fire protection.

Baumol points out that even if the level of activity in a municipal government remains constant, costs will continue to rise. This is because governments have to compete with the more technologically progressive sector when recruiting workers. They have to match the wages paid in the progressive sector close enough to attract quality workers.

For current levels of services like health care and education to continue into the future, the mix of capital and labor resources going into non-progressive industries relative to progressive industries will have to change. In order to produce the same amount of total goods and services, an increasing proportion of labor resources will have to go into non-progressive industries and a decreasing proportion into progressive industries. Over time, progressive industry goods and services become relatively less expensive, while non-progressive industry goods and services become relatively more expensive. This means, over time, a greater proportion of household income will be spent on services and a smaller proportion on goods in order to purchase the same overall basket of goods and services.

It will be very difficult to convince the public that even though the cost of personal services appears to be rising at a rate that is out of control, in fact the cost is gradually declining in real terms. Because the cost of manufactured goods is declining so much faster than service sector costs, the relative difference is what people are reacting to. It is challenging to convince someone that an item becomes less expensive when the price increases by a factor of 2, while at the same time his wage increases by a factor of 2.1.

This pattern implies a growing proportion of national spending will be from the public sector. This is a concern because of the difficulties associated with raising taxes to obtain additional revenue. A greater concern lies in the

prospect of more than half of the economy's output being devoted to services, whose funding mostly comes from the public sector. With the poor record of centralized economies around us, this is a route that will be resisted. The alternative of privatizing more government services will be resisted as well. Thus, as Baumol put it, "Here is a problem for public choice that is likely to prove critical for our quality of life. . . . the nature of the right choice is by no means clear." While Baumol's cost disease model is fairly simplistic, there are other reasons behind the increasing cost of government services. Still, this phenomenon generates serious implications for future government policies and programs.

¹ William Baumol is a Senior Research Economist and Emeritus Professor of Economics, Princeton University, Princeton, New Jersey, and Professor of Economics, New York University, New York City, New York.

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