

## 8 THE DYNAMICS OF LOCAL GOVERNMENT BEHAVIOR

by Richard Murray

Public consumption in Sweden makes up close to 30 percent of GNP, private consumption slightly more than 50 percent. A little more than 70 percent of public consumption, or close to 25 percent of GNP is local government consumption.

The picture is similar in most other countries – whether industrialized or not, whether capitalist or planned economies. Local governments play an important role as producers of consumption services even if Sweden and the Nordic countries occupy the extreme end of the spectrum.

Local governments in Sweden manage schools, hospitals, old age homes, roads, parks, swimming pools, libraries, museums .... yes, even golf courses! And they do it in order – such is the argument – to make life better for their citizens.

The nature and importance of public economic activities have been on the research agenda of IUI for a long time, beginning with Eric Höök's (1962) major inquiry. During the last few years the focus of IUI research in public economics has been on taxes and on decision making in local public bodies.<sup>1</sup> This paper relates to a project (see p 206) concerned with local public service production.

### 1. Consumer Preferences Should Govern

One would think that the measuring rod in evaluating the performance of this multitude of public service producers should be the preferences expressed somehow by consumers, i.e. the households of the constituency, for whom the services are produced. Public service producers would then concentrate on activities where the market had displayed difficulties in coming

<sup>1</sup> Murray, R., 1985, *Central Control of the Local Government Sector in Sweden* and Ysander, B.-C. and Nordström, T., "Local Authorities, Economic Stability and the Efficiency of Fiscal Policy", both in Gramlich and Ysander (eds.), *Control of Local Government*, IUI, Stockholm, 1985.

up with good initiatives and solutions. But, more often than not, the supply of public services is regarded as a political matter to be judged by political collectives, according to ideological views. Market supplies of goods and services, on the other hand, are subjected to the judgement of household preferences. In fact, only in very few areas do services overlap and public and private suppliers compete. In general, private competition in “public markets” is prohibited or made impossible through subsidies. They are essentially monopoly institutions. This is why public production of services is the same thing as public consumption in the national accounts, even though the label is misleading.

Why this dichotomy? Why should consumer goods be judged by one standard if produced by the local government and by another standard if produced by a private firm? Why not judge the supply of public producers according to household preferences? Why not judge the supply of private firms by political standards? Shouldn't all types of consumer goods and services be evaluated by household preferences?

Attempts to answer this question reveal a mix-up of means and ends. What is mixed up is the *way* in which goods and services are supplied – by local governments or by private firms – and the *criteria* by which their performance are to be judged. If criteria are different and specific to each sector, of course, it will be impossible to compare performance, and to discuss what would be an efficient organization or division of tasks between the two sectors.

## 2. Distributional Problems and Merit Wants

Anyone familiar with cost-benefit analysis knows there are limits to its applicability. First is the problem of adding together various individuals' willingness to pay. Should the willingness of individual A to pay for a park count as much as that of individual B? What reason is there, moreover for comparing one individual's willingness to pay with that of another? This question concerns the welfare distribution and follows from the project under consideration. There are, of course, individual preferences for the welfare distribution too, but there is no known market process by which to achieve consensus on this matter. Therefore it has to be handled in a political process. Let us call this the *distributional problem*.<sup>1</sup>

In the second place there are instances in which it is thought appropriate to disregard individual preferences. This might concern the consumption of

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<sup>1</sup> I follow the Musgrave (1959) terminology. In *The Theory of Public Finance*, 1959, R.A. Musgrave distinguishes between the Allocation Branch, the Distribution Branch and the Stabilization Branch of the budget.

alcohol or that of education. In either case households are forced to consume less, or more than they desire at the going marginal costs. Let us call this the *merit want problem*.

If distributional goals are very important, or if merit wants rule decisions then there is little room for a market test, and cost-benefit analysis will be difficult, if not impossible to perform even in principle. Everything has to be decided in a political process which can hardly be evaluated in any other way than through that same political process.

Since local governments supply such a vast number of consumption items it is not reasonable to presume that distributional and merit wants criteria dominate the decision process. In fact, most government programs were started with social welfare as the prime objective. Today, however, they have assumed a dominant role as general service providers and they have also managed to acquire the status of monopoly producers. Therefore, the efficiency problem of publicly organized production merits close attention on the same grounds as similar production organizations in the private sector. Public monopolies more often than not are protected by law and may also count on subsidies in case of financial difficulties. In consequence, they deserve an even closer scrutiny than their private counterparts.

Furthermore, the effects on the welfare distribution of zero price supplies of public education, for example, are today quite different than when public education began as a pure social welfare project in the mid 19th century. The early public schools were instituted both to keep poor children off the streets and to give them a better opportunity in life relative to the children of the well-to-do. Later on, the fair distribution of human (worklife) capital became the paramount objective of public education and has been the basic argument for continued expansion. Today's public schools and universities are in fact mainly used by the children of the well-to-do but are subsidized by all income earners. There are reasons to investigate whether in fact public education may not even contribute negatively to its original distributional objectives (also see p. 166). This observation questions the *feasibility* of government programs.

### **3. Why Should Local Government Be a Producer?**

These considerations make it more than reasonable to subject public consumption to the test of household preferences – it is urgent. Yet, this opens up a Pandora's box of questions concerning the organization of public production, its financing and the ways of directing the supply of publicly produced goods and services to their end uses.

The reasons for public interference in the allocation of goods and services are well-known. I have already mentioned distributional considerations and merit wants as reasons for political control of production and distribution.

But even when there is no questioning of the supremacy of individual preferences beyond distribution and merit wants there is a third set of reasons for government interference: collective goods, external effects in production or consumption, natural monopolies etc., sometimes summed up under the term “*market failure*”.

But concluding that public interference is justified on these three principal grounds is not enough to advocate that government should also produce public services. Why not subcontract private producers for publicly distributed services? There is a host of ways other than public production to correct market failures; taxes, subsidies, regulations, information etc. Furthermore, public production can be organized in a variety of ways: production can be performed by the national government, by local governments, by public enterprises and all of these organizations can be directed in various ways by grants and regulations. Hence, there is a whole array of organizational alternatives between total public control and a free market arrangement.

#### 4. Efficiency

There are a few instances where the choice between private and public activity can be decided on the ground of *productive efficiency*. In that case we need not take account of allocative efficiency.<sup>1</sup> This, for instance, is the case of refuse collection. But when allocative efficiency motivates a public organization and productive efficiency speaks in favor of the private firm, there is a trade-off and a choice to be made.

For these reasons, the productive efficiency of public organizations merits close scrutiny. In many areas public enterprises and government agencies have acquired a monopoly role and should be expected to exhibit the same efficiency problems as those of private monopolies. What are the distributional or merit want objectives connected with public production of icehockey arenas? Are they important enough to justify a higher cost of production?

There are, however, two arguments against the public organization of production. The first refers to the *feasibility* of achieving stated distributional and merit want objectives, or corrections of market failures. Unintended adverse effects may be achieved instead<sup>2</sup>, or are the negative effects too small

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<sup>1</sup> Productive efficiency relates to the consumption of resources in production, regardless of its outputs and the value thereof. Allocative efficiency relates marginal costs and marginal values to each other.

<sup>2</sup> For instance, the authors of the IUI 1985 Long Term Assessment of the Swedish Economy (see p. 161) argue that egalitarian policies focused on income distribution may in fact – through distorting prices in markets for wealth objects – have made the wealth distribution more uneven, making the total lifetime consumption potential of individuals more uneven than it was when ambitious distributional policies were initiated in the late 60s.

to warrant a change in an inefficient organization of production. There is a case for using experiments and rearranging the supply of consumer services in order to gain information on efficiency and feasibility. The fundamental problem is the lack of information on alternative ways of organizing public production (cf. Pelikans essay in this volume). The information problem can be partly solved through experiments to find out, for example, the willingness to pay for public services. It is also of great help to be able to compare various institutional arrangements, for example, public, cooperative and private schools.

## **5. Competitive Entry**

Competitive entry is a particular side of the dynamic efficiency of an economic system. What kind of competition takes place between local governments and between local government and private producers? Is there any scope for competitive entry in the fields of production dominated by the public sector?

If continued organizational change is the moving force behind productivity change in the private sector and if this force is predominantly sustained through free competitive entry in all private markets (see discussion on p. 19 in this yearbook), then there is no reason to believe that there should be any difference in this respect in the public sector.

Looking back over the past two decades the local government sector has exhibited tremendous growth. In that process it has broadened its product range. Local governments have undergone significant reorganization due to, on the one hand, the urgency to deal with perceived new tasks, like town planning and urban sprawl, and, on the other hand, the need to merge and cooperate with each other. The number of local communities today is a small fraction of what it once was. Garbage collection, sewage, water, electricity, roads and many other local government tasks demand cooperative arrangements. When it comes to growth, local governments have demonstrated a marked ability to adapt to change.

But specific lines of production within the local government sector are often characterized by a technology and an organizational form that has not changed since it was initiated. Sometimes services that are no longer wanted are still produced. But this can also be said of protected private production like the construction sector and that of the banking sector. The "scrapping" decision in particular is difficult to manage within a public body that reports to politicians. Could more intense competition between agencies within the public sector solve the obsolescence problem? Should public production activities even be allowed to be competed out of business by other public agents or by private agents? Is it reasonable to have public health organizations compete for the patients? There is some evidence from the health sec-

tor, from schools and from day-nurseries that such competition isn't enough to generate technological change. There also has to be competition from new entrants, most likely private ones.

## 6. Theoretical Foundations for Comparisons

Where can we find a launching pad for evaluating the current organizational set-up and responsibilities of local governments and compare it with national government and private firms? Public finance theory will take us some way in analyzing government interference in markets. But this theory gives us no answers to the questions of how government should handle this interference, in particular whether national or local governments should be responsible for production, for regulation of markets, for taxes and subsidies. Also it has little to say on the dynamics of regulation and government production and the effects on private production.

An essential ingredient in the theory needed to deal with the dynamics of Local Government behavior is that of public choice. Unless we have a clear picture of the allocative behavior of both national and local governments, as we have of firms, we cannot discuss the merits of various organizational alternatives.

## References

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