6 Differentiated Public Goods: Privatization and Optimality

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6.1 INTRODUCTION

Many commentators criticize centralized government production of public goods for not providing sufficient variety. Citizens with widely varying tastes all consume the same type and level of services. With fixed costs of production and variations in tastes and incomes, an efficient solution, familiar in the public finance literature, can be generated by a single government producer that supplies the public good and charges citizens different tax prices to take account of the variations in their tastes and incomes.[1] This solution, while efficient, is not feasible. Citizens have, in general, no incentive to reveal their willingness to pay, and recent advances in demand-revealing processes have not produced entirely satisfactory solutions.[2] In addition, if citizens' tastes diverge sharply enough and if production costs are low enough, efficient solutions may also exist with several suppliers each producing a different variety of output for a subset of citizens.[3,4]

But how should the number of suppliers be determined and how should they be financed given the public-good character of the output? This chapter analyzes a possible solution in which private suppliers provide 'local' public goods financed by tax dollars. Individual tax-payers, however, decide how their own tax money will be spent. The government requires each individual to pay a one-dollar fee for public services but individuals can decide which provider should receive his or her dollar. The central government taxes everyone $1 but permits a 100 per cent deduction from taxes for gifts made to organizations that produce differentiated public goods.

Producers are private organizations that compete for donations by providing both a particular variety of service and a quality (or quantity) of output that is a public good to all contributors. Suppliers seek

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to maximize profits, and entry is free so long as suppliers can cover their fixed and variable costs of production. We assume that the public goods provided by private firms are 'local' in the sense that donors obtain utility only from the services produced by the firm to which they donate. The donor, by his gift, 'buys in' to the supplier's entire output. Thus, each donor finds the provider whose service mix provides him or her with the highest level of utility, and donates his entire dollar to that producer.[5]

Our modelling effort begins after the decision to publicly finance a type of service has been made. Thus we do not analyze the broader question of whether a particular type of activity deserves public subsidy in the first place. Instead, we suppose that the public policy question before us is the choice between direct public production of a uniform service versus a variety of types produced by private firms but financed by tax dollars. Can the efficiency benefits of competitive private markets be captured by letting citizens choose how to allocate their tax dollars among private providers?

The services that most closely match the model's assumptions are recreational and cultural activities where exclusion is inexpensive, but where benefits are enjoyed in common by those who gain entry. Examples are swimming pools, parks, museums, theatrical and musical performances, and sporting events. These services fit the model both because they are excludable public goods and because people are likely to have widely varying tastes for these services. Of course, because it is possible to charge admission, many of these services can be provided without a tax or subsidy. But the resulting pattern of consumption will not, in general, be efficient, and, in addition, public subsidy may also be justified on a variety of distributive grounds.

Also close to our theoretical formulation are advocacy organizations that promote various causes through political lobbying or campaigns of public education, organizations that support research, and those that provide charitable services to the needy. With a totally private system, free-riding behaviour would be a serious problem for all of these activities. Such behaviour would be overcome by the tax credit scheme outlined here. The major divergence between our model and these activities is our assumption that people gain only from the provider who receives their contribution. Nevertheless, since these are services about which people have sharply divergent preferences, our model has something to contribute to an analysis of these services as well.