

### Activity. Who Pays, Who Produces, and Why It Matters

Goods and services can be either produced by private enterprises or supplied by the government. They can be paid for either by the consumer directly or by the taxpayer or some other third party. Does it make any difference whether a good is produced by a private firm or by a government enterprise? Does it matter whether the good is paid for by its consumer or by a third party?

**Exhibit 1** illustrates the four possible combinations of production and consumption. Let's consider the incentive structure accompanying each of these four cases and analyze the impact on the allocation of resources and the incentive to economize. As you consider each of these cases, think about how the incentives confronted by consumers and producers will influence their behavior. **If personal incentives and economic efficiency are not aligned, waste and output below potential will result.**

#### Exhibit 1: The Private and Government Sector Matrix of Production and Payment.

	Good is paid for by:	
	Consumer-Purchaser (1)	Taxpayer or other Third Party (2)
Good is produced by:		
Private Enterprises	Examples: apples; oranges; television sets; food; housing; most other goods	Examples: health-care; food purchased with food stamps
Government Enterprises or Contracting	Examples: Amtrak; post office; water and electricity in many cities	Examples: public schools; national defense

In **Category 1**, goods are produced by private firms and purchased by consumers with their own money. Predictably, consumers can be counted on to make wise decisions because if they fail to do so, their personal well-being will be diminished. Correspondingly, the private producers have a strong incentive to

cater to the views of consumers and supply the desired goods economically. Failure to do so would lead to higher costs and lower profits. In the case of category 1, market forces will bring the self-interest of both consumers and producers into alignment with economic efficiency. As consumers and producers pursue their personal welfare, they will simultaneously engage in actions that will promote the general welfare.

**Category 2** represents the case where goods are produced privately, but are paid for by the taxpayer or some other third party. The provision of health care in the United States financed primarily by government (Medicare, Medicaid, and other government subsidy programs) and by private insurance provides an example of this organizational structure. When someone else is paying, how much incentive does the consumer have to care about price, or to consider purchasing less of the “free” good? The answer is “not much.” Instead of economizing, many consumers will purchase more than if they were paying, and will buy from suppliers that they believe offer the highest quality, regardless of price. The behavior of producers will also be affected. Because consumers are largely insensitive to price, producers have little reason to control costs and provide services at attractive prices. Predictably, when a society organizes provision of a good along the lines of category 2, problems will result. Because neither buyer nor seller has much incentive to economize, prices will rise much more rapidly than in other sectors of the economy. In turn, expenditures will soar. This is precisely what has happened in the health care sector in the United States as government programs have promoted greater reliance on third party payments since the mid-1960s. In the case of category 2, there is a conflict between personal self-interest and the efficient use of resources. As a result, this structure of economic organization will be characterized by waste and inefficiency.

**Category 3** represents the situation where consumers pay for the good or service, but production is handled through the government. Amtrak service, the

delivery of first-class mail by the U.S. Postal Service and provision of water and electrical services by many municipal governments provide examples of this structure. Because they're spending their own money, consumers will have a strong incentive to economize and seek the most value per dollar of their expenditure on items in this category. Thus, consumer spending will be efficient. In government operated firms however, decision makers do not personally pay costs, nor do they pocket gains from more efficiency, so they will generally be less efficient than private enterprises, especially when the government firms derive most of their revenue from political authorities. Cost consciousness is also likely to be reduced if the government firm is a monopolist – if it is protected from competition with potential private rivals. Thus, production inefficiencies are likely in this category.

**Category 4** represents the case where the government both provides the service and covers its costs through taxation. In this case, the political process determines what will be produced, how it will be produced, and how it will be allocated among the general populace. Because the providers of the good do not derive their revenues from customers, they have little incentive to cater to the views of consumers. Under these circumstances, consumers are in an extremely weak position to either discipline inefficient suppliers or exert much impact on the quality and variety of goods produced. Producers will focus on trying to get more money from the granting agency, typically a legislative body, and their incentive to control costs is weak. The expected result: a disconnect between the good produced and the preferences of consumers, production inefficiency, and soaring expenditures. In the United States, the provision of education provides the most vivid example of a good organized along the lines of category 4. Unsurprisingly, the U.S. educational system is plagued by all of the expected problems: high cost, rapid growth of expenditures, unhappy “consumers” and a widespread feeling of helplessness to alter the situation.

The structure of incentives in the four categories helps explain why some forms of economic organization work well, and why others work poorly. Category

1 is basically the market sector. When consumers and producers undertake actions that enhance their personal welfare, they are also promoting the general welfare. What is good for the individual is also good for the economy. This is not the case in the other three categories. In each of those cases there is a conflict between what's best for the individual making decisions and what's best for the economy. These three cases illustrate the problems that arise when a government moves beyond its protective function and begins to subsidize various activities, operate enterprises, direct various sectors, and, in the extreme case, centrally plan the entire economy. Invariably, such government actions create a situation where individuals pursuing their own interest will simultaneously waste resources, undermine national prosperity, and cause living standards to fall well below their potential.

Inefficiency generally results because decision-makers do not have to bear the full cost of their choices or because they are unable to capture fully the benefits their actions could generate for others. This is an important point to keep in mind when thinking about economic organization and the potential of government intervention to improve the quality of our lives.

### **Question for Thought**

1. In recent years, there has been considerable dissatisfaction with the quality and cost of both health care and education in the United States. Given the economic organization of these sectors, is the dissatisfaction with outcomes in these sectors surprising? Why or why not?