

ECONOMICS U\$A
PROGRAM #126

PUBLIC GOODS AND RESPONSIBILITY:
HOW FAR SHOULD WE GO?

BY ARLEN SLOBODOW

AIRSCRIPT
NOVEMBER 8, 1985

26. PUBLIC GOODS AND TAXATION: HOW FAR SHOULD THE GOVERNMENT GO?

PURPOSE:

To define “public goods,” to show how a perfectly competitive market will not automatically result in the production of the proper amount of such goods, to illustrate the hidden cost of taxation, and to show the problems of determining exactly what and how much the government should produce.

OBJECTIVES:

1. Public goods will not be supplied in the proper amounts by the free-market mechanism.
 - a) pure public goods include those goods (or services) for which there is “joint (non-rival) consumption with non-exclusion.” It is difficult to determine how much a public good is worth to each individual because they may be able to benefit without having to declare how much it is worth to them (free rider problem).
 - b) There may be positive externalities (merit goods).
2. Taxes usually have hidden costs. They distort economic decisions regarding investment, work effort, savings and consumption. This usually causes the economy to be less efficient than it would be in the absence of taxation.
3. There are numerous special problems in government expenditures on public goods.
 - a) special interest groups and “logrolling”
 - b) government provision of services is not subject to the “competitive discipline” that private sector firms face.
 - c) because the free-market mechanism will not supply public goods in the proper amounts, political processes are necessary to determine how much and how many public goods will be produced.

KEY ECONOMIC CONCEPTS:

free riders	theory of social choice
positive externalities	non-rival consumption
merit goods	non-exclusion
public goods	tax distortions
inefficient allocation of resources	

ILLUSTRATIVE EVENTS:

1. the creation of the TVA and flood control as a public good
2. proposals to abolish the deductibility of mortgage interest payments from income tax liabilities
3. the passage of Proposition 13 in California

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TEASER

DAVID SCHOUMACHER: It was 1927. Once again havoc reigned throughout the Mississippi and Tennessee Valleys. In the midst of a Great Depression, Congress created the TVA...a federal project to control the ravages of the great Tennessee River. Why would anyone object? Medical advances have added years to the lives of Americans...but not everyone can afford the high cost of today's medical care. So why shouldn't the government guarantee a minimum level of health care? In 1978, Californians voted for Proposition 13 even though it was likely to result in cutbacks of government services. Had the government gone too far? We don't all agree on the proper role and desirable size of government. Some feel government has gotten out of hand, while others feel we're not doing enough in the right places. Public Goods and Responsibility: How Far Should We Go? We'll examine that question with the help of economic analyst Richard Gill on this edition of Economics U\$A. I'm David Schoumacher.

(MUSIC PLAYS - SERIES OPENING TITLES)

(PUBLIC GOODS AND RESPONSIBILITY: HOW FAR SHOULD WE GO? Appears on screen)

PART I

DAVID SCHOUMACHER: We can all enjoy the benefits of public services such as museums, schools, and highways, but somehow they have to be paid for. And they are...most often in the form of taxes. One of the central questions about these services is why the government must provide them. Why can't we rely instead on the free market? It's a controversial question, as we see in the case of private utilities versus the TVA. The great Mississippi flood of 1927 left 800,000 homeless as the swelling waters overran levies throughout the Tennessee River and into the Mississippi. Thousands of acres of farmland were damaged, turning northern Louisiana into an inland sea. Secretary of Commerce, Herbert Hoover, called the flood the greatest peacetime calamity in the history of the country. The disaster was predictable. The Mississippi had flooded before. Local authorities attempted to provide flood control, but their efforts were uneven and the levy system is only as strong as its weakest link. A technical solution, the building of dams, could have prevented the flood. In the absence of initiatives from the private sector, some legislators felt that federal funds ought to be used. But they faced tough opposition on Capitol Hill. Dams not only control floods, but they can be used to generate large amounts of hydro-electric power...and that presented a threat of competition to the private utilities.

ALVIN VOGTLE: "To justify the heavy expenditure of money required to build all these dams, there had to be something else like the sale of electricity...and that would be produced by these hydro-electric units which were going to be installed in the dams. And it was that feature which caught the eye of the people who opposed TVA because they thought that was a function the government ought not to engage in."

DAVID SCHOUMACHER: The private utilities were successful in their opposition until 1933 when a new administration, with an activist view of the role of government, came into power. Franklin Delano Roosevelt created the Tennessee Valley Authority...the TVA. William Jennings Randolph was a member of Congress during the Roosevelt Administration.

WILLIAM JENNING RANDOLPH: “The Tennessee Valley Authority was a product of the so-called ‘New Deal.’ It was a long-range program...It was not doling out some money here and there...It was the planning of an area in the United States of America where there would be a development. Of course...hydro-electric power...that was a part of it.”

DAVID SCHOUMACHER: The plan to provide economic development to the Appalachian region began with the construction of the Norris Dam on the Clinch River. The TVA plan was ambitious. The regional economies could be improved if the water were made navigable and goods could flow all the way to the Gulf of Mexico. The TVA constructed housing, began a malaria control project, worked on agricultural development and provided electrical power to this depressed region. Some thought the government was now going too far. Along with the utilities, others who feared economic loss joined in the opposition. Coal miners feared the TVA’s generation of hydro-electric power would cut into the demand for coal.

WILLIAM JENNINGS RANDOLPH: “I remember when the coal operators and the coal miners of West Virginia came to Washington, D.C. And they were very angry at me because I was an open supporter of the legislation to create the Tennessee Valley Authority. And they said, ‘This will rob us of hundreds and thousands of jobs if this is done over a wide area, turning these rivers into lakes and productive areas for the power systems. That will not stop in the Tennessee Valley Authority,’ they said, ‘but will go out into other regions of the United States.’ So they looked upon it as something that they must oppose...And they did so, vigorously.”

DAVID SCHOUMACHER: The TVA argued that flood control was its primary goal...and the revenues from energy sales only assisted in financing the dams. The opposition argued that the government had no right being in the power business. Within 5 years some 57 suits were brought against the TVA. Finally, in 1937, the legal issues were resolved. The U.S. District Court upheld the TVA, ruling that the projects were primarily for the improvements of navigation and flood control. The legal case was over,

but the political issues lingered. On one hand, TVA had harnessed the great flood waters of the valley, spurring other economic activity in this once deeply depressed region. On the other hand, utility companies continued to claim that the TVA was an element of “creeping socialism.” We asked economic analyst Richard Gill: How do economists determine the extent of government involvement in a free-market society?

(MUSIC PLAYS - COMMENT AND ANALYSIS I)

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RICHARD GILL: As far back as Adam Smith in the 18th century, even economists devoted to the principle of a private market economy have recognized that there are certain areas that virtually require government intervention. Put crudely, if Uncle Sam won't do it, no one else will. The TVA project of the 1930s had many different aspects but, in one respect, it clearly met this test. It provided what economists call a public good...A good that has to be provided collectively or not at all. I am speaking here of the flood control and navigation improvements made possible by the TVA dam. These improvements were in the interests of society, but they would not have been in the interests of private individuals or businesses. Why? Well, for one thing, the benefit of flood and navigation control was spread over the entire region and not limited to a few paying customers. Flood control protects me and my neighbor and thousands of others in the region and, for that matter, thousands more who may move in after the dams are built. This is a general indivisible benefit and, whether it is enjoyed by a thousand or a million people, the cost of providing it is unchanged. And the real problem with a public good like this is that it is impossible, or certainly extremely difficult, to charge any private consumer for the benefit he is receiving. My neighbor decides to pay for flood control, but I do not. There is basically no way in which I can be excluded from the benefit of his flood control. Just as there is no way in which I can be excluded from the benefits of, say, a nationwide polio vaccine program, or...the most obvious case of a public good...national defense. Invasions of flood waters, contagious diseases or foreign armies can rally be handled only in one way: collectively. Public goods provide one clear

reason for government intervention in the economy...a point on which virtually all economists can agree!

PART II

DAVID SCHOUMACHER: Our country has accepted the need for the government to provide public goods like dams or traffic lights, local police and national defense, but that by no means covers all questions of government involvement in our lives. What, for example, are the responsibilities of government to people who can't afford necessities like decent housing or food...or the subject of this investigation, health care? Health care costs have risen astronomically over the past few decades. Most of us cope with the high cost of medical care through insurance...a way of sharing the risk of high medical bills. But not everyone has medical insurance. Those without it face being turned away from emergency rooms or being dumped to public hospitals many miles away. It is no secret that low income people go without adequate medical services and have a shorter life expectancy as a result. Health care used to be within one's means. But, in the 1940s, health care costs became more expensive as medical technology advanced and grew more specialized. In the process, the cost of medical care went beyond the means of most families. The marketplace offered one solution...private insurance coverage under the Blue Cross/Blue Shield Programs. By the end of World War II, only half of the population was protected by some form of hospital insurance. But many, particularly the aged, the poor and those without jobs, had no coverage at all. In 1946, President Harry S. Truman called for national health insurance to cover all Americans. But his program didn't make it through Congress. Its passage was blocked by the American Medical Association. AMA President, Dr. James Sammons...

DR. JAMES H. SAMMONS: "I think the AMA's opposition was in great part responsible for helping defeat the Truman plan and some other plans that have come down the line. If the doctors of this country had agreed with those plans, I think they would now be in place. On any national health insurance program that is proposed, the AMA is going to have the same objections that we've had all along. It does interfere in

the doctor/patient relationship...It does not guarantee quality of care...It is a form of rationing...It would be incredibly expensive if it were attempted on a national basis...and there is not a need for it in this country.”

HENRY AARON: Well, that question’s one that’s been debated long and hard and I really think the evidence and the arguments on behalf of the government role are overwhelming. They range from the fact that for a variety of reasons we have decided, in all developed societies, that at the time people become ill we are not going to require them to pay for the full cost of the services that they receive at that very time.

DAVID SCHOUMACHER: As the costs of medical care grew, more and more favored some kind of government action. Wilbur Cohen, former Undersecretary HEW...

WILBUR COHEN: “In 1950, when I was the Director of Research and Statistics for Social Security, the Federal Security Administrator asked me if I had an idea as to how to get out of the inactivity we were in, and I said, ‘Yes, I had an idea...Instead of covering everybody, why not cover just the aged who were receiving Social Security?’ He thought that was a good idea and he asked me to draft the Bill, so, in 1950-51, I drafted that sort of a Bill for him and it was introduced in Congress in 1951, 1953, 1955, 1957, 1959, 1960...But in 1959 I persuaded Senator John f. Kennedy to be for the idea and that’s what changed the whole situation. Kennedy and Johnson, in the campaign of 1960, came out for Medicare...Kennedy appointed me the Assistant Secretary of HEW to get the Bill through Congress...I spent 5 years doing that.”

DAVID SCHOUMACHER: Finally, in 1965, during the Great Society era, Medicare, an insurance program for those 65 and older, and Medicaid, a joint federal-state health program for the poor, were passed. President Lyndon Johnson flew out to Independence, Missouri, and, in the presence of Harry S. Truman, signed the Bill into law. Many were aided by these programs. Medicaid covered the health care costs of millions of low income people. We asked Henry Aaron if that met our responsibilities to those who couldn’t afford medical care.

HENRY AARON: “This wouldn’t be a problem if all states provided benefits as generous as those in, say, the upper third or upper half of the distribution. Some states in the United States, however, provide extremely meager Medicaid benefits...fewer than ten days a year of hospitalization, severe limits on the number of doctor’s visits one can receive, a narrow range of services covered...so that even moderate illnesses may not be fully protected under the Medicaid Program. In addition to which, the population that may be served by the Medicaid Program in many states is really quite narrowly defined. So notwithstanding the fact that Medicaid is the federal health program for the poor, millions of poor Americans, in fact, are not covered by Medicaid benefits and, in fact, are not covered by any benefits of any type at all. They don’t have government protection...They don’t have private insurance because they have been out of work or because they work in types of jobs that do not provide such coverage...and the result is that on the order of 15 to 20% of the American population at the present time has little or no health insurance protection, either through private insurance or through government programs.”

DAVID SCHOUMACHER: In the 1970s, the cost of Medicare and Medicaid mounted. As the burdens on state governments increased, the programs ran into criticism from state Governors like Ronald Reagan...

RONALD REAGAN: “We find that Medical as we call our Medicaid Program in California, is increasing by 50% a year. In its first sixteen months it was budgeted for 746 million dollars...But 876 million dollars were spent, meaning that this program went 130 million dollars in debt in that limited time. And we’ve been informed that debt has to be paid off out of this year’s working budget. We’re in deep trouble in this phase of welfare. In California alone, hastily drawn legislation in this field can bankrupt our state unless we have major revisions.”

DAVID SCHOUMACHER: Despite the efforts of government to cut back on Medicare and Medicaid throughout the 1970s, the cost of these programs continued to rise at an

alarming rate. As a result, legislators have shied away from providing the national health insurance system called for by President Truman, even though large numbers of Americans have inadequate access to health care. We asked economist Richard Gill about the economic rationale for government subsidized health care.

(MUSIC PLAYS - COMMENT AND ANALYSIS II)

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RICHARD GILL: The fundamental argument for government subsidized health care for the elderly, and especially for the poor, is that a market economy doesn't distribute income in the way most people consider fair and desirable. Mind you, a market economy does have its own principle of income distribution, and it isn't an insignificant one. Very generally, a market economy pays people more...the more economically productive they are. This isn't a trivial principle: It probably does keep the productive process running rather smoothly and this ultimately provides more abundance for all of us. However, a lot of people can get left out in this process and the instance of people who are both poor and ill is a clear case in point. When a poor person gets seriously ill, his already low productivity suffers a severe blow while, at the same time, his need for support mounts sharply...often catastrophically, in fact, given today's monumental medical costs! What the Medicaid Program says, in effect, is that this burden is too great for any individual to bear by himself. The market may have a just appreciation of abilities but it doesn't have a just appreciation of needs. Society has to step in. Of course, there is always some cost to this. When you start redistributing income, you are increasing tax burdens on the economically more productive groups in the economy. Also, Medicare and Medicaid Programs do have a tendency to up medical costs generally. As in so many economic issues, the question isn't "whether," but "how much?" A question not infrequently raised during the past decade.

PART III

DAVID SCHOUMACHER: California...a land of plenty...plenty of parks, lavish public schools, and the tradition of providing public services. Californians enjoyed these benefits, but there is a cost for these services as well. Public officials at all levels of government propose and decide what public goods and services are required or desired. But when expenditures and taxes continued to rise in the late 70s, the citizens of California began to ask, "Just how do we determine when enough is enough?"

HOWARD JARVIS: "I am mad as hell, and the people are mad as hell, and I'm getting madder than hell everyday."

DAVID SCHOUMACHER: Howard Jarvis led a so-called "taxpayer's revolt" in California. A combination of inflation and housing shortages led to a rapid increase in land values. This in turn resulted in a steadily increasing property tax. Many homeowners felt the burden of local taxes was too much. The revolt began by collecting signatures...over a million of them...more than enough to place Proposition 13 on the statewide ballot. Proposition 13 would limit property taxes to 1%...a 60% roll-back which would wipe out some 7 billion dollars of local government funds. Journalist Ron Sobel covered the tax revolt for the L.A. Times...

RON SOBEL: "The inflation of the 1970s translated into the inescapable fact that many California homeowners were paying more in property taxes...or faced paying more in property taxes...than the actual mortgages on their homes. And a goodly number of these people were older individuals on fixed incomes who indeed...had this not carried...certainly would have lost their homes. They couldn't meet their tax payments."

DAVID SCHOUMACHER: At the polls, Proposition 13 easily passed...with 65% of the vote...and the tax revolt was in the national limelight.

HOWARD JARVIS: "The victory for Proposition 13 is the opening battle in the new American revolution. We have a new revolution against the arrogant politicians and insensitive bureaucrats whose philosophy of tax, tax, tax...spend, spend, spend...elect,

and elect, and elect...is bankrupting we the American people, and the time has come to put a stop to it.”

DAVID SCHOUMACHER: Just how did Proposition 13 affect local government services? Los Angeles City Council President, Pat Russell...

PAT RUSSELL: “Well, we cut our property tax by two-thirds...That was 200 million dollars out of our budget...about 20%. We lost about 4,000 employees over the period of the next year. We cut back on nearly all of our services. The priorities of the city were to maintain police and fire services, and that of course meant that as you got down the line...libraries and parks were severely cut back. Tree-trimming went out the window, virtually, except on emergency...street repair...you know the things that make a difference in your daily life.”

RON SOBEL: “The dire predictions that permeated the campaign by the opponents of Prop 13...they didn’t come true. There were not massive employee layoffs. There was enough flexibility in government to handle the direct impact of 13...So there was not an immediate crisis in government. What I’m telling you is...the changes were more subtle...government did not grind to a halt.”

DAVID SCHOUMACHER: Despite the felling that the taxpayers had come out ahead, there were other consequences that surprised some voters.

RON SOBEL: “The biggest winner from Prop 13...I think this is very important...was California business and California agriculture. As I recall, if one was creating a pie chart, you would say in this chart that about 1/3 of the benefits from 13 went to homeowners. 2/3, though, went to business and agriculture. One group that did lose, in my opinion, was the renter. Jarvis had literally promised renters that savings would be passed on from apartment owners to the renter, and really that never occurred.”

DAVID SCHOUMACHER: But for the average taxpayer, Proposition 13 seemed remarkable...getting a break on taxes with little sacrifice on services. Emboldened by his victory, Jarvis was back in 1980 with a new initiative...Proposition 9...which would cut state income taxes by 50%. The opposition, led by California Public Employees Union, focused its TV campaign on fairness.

ANNOUNCER: “Do you think it’s fair that if 9 passes you get a huge tax break and the average person gets little or nothing?”

MAN: “I didn’t write Proposition 9.”

ANNOUNCER: “Wouldn’t it be better to reduce the sales or gas tax so that everyone would benefit equally?”

MAN: “As I said, I didn’t write Proposition 9.”

ANNOUNCER: “You could have fooled me.”

DAVID SCHOUMACHER: The campaign against Proposition 9 was successful. The tax revolt was put down. What level of public goods is desirable? Well, that depends on your point of view. Some believe the government’s role should be only minimal...filling in the gaps left by private enterprise, while others believe the government should play a more activist role. But as the citizens of California demonstrated, it is the public who will decide. Economist Richard Gill offers a commentary on how the government’s role in the economy is determined.

(MUSIC PLAYS - COMMENT AND ANALYSIS III)

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RICHARD GILL: The sharp controversies over Proposition 13 and 9 in California suggest what is pretty obvious: Namely that people differ intensely about how deeply the

government should involve itself in the economy. From the economist's point of view, this is understandable since there is almost always a difficult trade-off involved.

The more public goods we have, the fewer private goods. The more we redistribute income to the needy, the greater the disincentives for the productive. But the "tax revolt," not only in California but across the nation in the early 1980s, said something more than this. It raised the question of whether or not the governments of the country...federal, state, and local...were accurately representing the will of the people in this matter. The government was pictured by the tax-cutters not as the representative of a national consensus, but as an independent organism with strong drives of its own—drives in one direction only: expansion.

The feeling that government spending was inefficient and getting out of hand was as much a political as an economic statement. It said to bureaucrats and politicians: "You are out of touch with the people you are supposed to be representing. You may want to expand, but we don't want you to expand."

So we not only have the difficult economic question "What are the costs and benefits of government expenditures?" But also the political question "Will the actual government we are dealing with carry out our wishes in this matter?" No wonder there are differences of opinion here. One needs no crystal ball to predict that the debate will continue on in the years ahead.

DAVID SCHOUMACHER: From the time of the founding of this nation, it has been recognized that despite the advantages of the free enterprise system, there are certain goods and services that the market will not provide. So it has generally been accepted that the government will provide those services. The government's responsibilities have evolved, however, pushing beyond the economically well-defined reasons for government involvement into broader social responsibility. How far we should go in this direction depends on the public's perception of needs—of the effectiveness of the

government in serving them—and of course, our willingness to pay. For Economics U\$A, I'm David Schoumacher.

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