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## *REVIEW*

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### **Economics of Sectoral Reform**

*Joshua Gans and Stephen King, **Finishing the Job: Real-World Solutions in Health, Housing, Education and Transport**, Melbourne University Press, Carlton, 2004*

*Reviewed by **Harry Clarke***

**T**his slender, non-technical volume outlines the economics of reforming public housing, health, education and road transport systems in Australia. Policies are sought which advance efficiency and social goals, with the latter comprising mainly an assurance of universal availability. The discussion draws on few theory papers and on little empirical literature. The book is written in the plain language appreciated by the editors of *Agenda*. It is intended to reach non-specialists.

There are a few general themes. One is that pursuit of cost efficiency and the desire to achieve universality involve quality compromises in order to limit demands. This idea, outlined at the start of this book, is not used subsequently to unify the ongoing discussion, which is a pity since common themes are implicit.

When governments seek to optimize the net benefits from taxing, they must account for excessive public goods consumption. One approach is to effectively increase the user costs of such services by under providing service quality. This encourages consumers to limit consumption, and enables government to conceal the total costs that are effectively charged. For example, encouraging parents to send children to 'better quality' private schools economizes on public costs but does not reduce total education costs. Parents who do not opt out of the public system still consume too much, for public good reasons, while those who choose the private system do so in insufficient numbers because they receive no refund for the net savings they provide the public system. Explicit tax costs are reduced by widening the quality differential between alternative services, by reducing the service quality of goods funded by taxes. This is socially inefficient given low costs of improving public service quality.

The 'fooling the voter' line implicit in this argument seems implausible. As a parent who sends his children to private schools, I am aware both of my tax burden and of the school fees I pay. I am also aware of the extent to which I am providing implicit subsidies to public schools. In this case I look at the total education costs I bear, including the net advantage I provide to parents who choose public schools, and not only the total public education costs incurred by government.

## **Housing Affordability**

The authors distinguish between short-run and long-run housing affordability, arguing that policy has tended to focus on the latter, which is essentially a problem of low income. The issue then is to boost the purchasing power of the poor, rather than for the government to build housing. This is ‘Second Theorem of Welfare Economics’ analysis and seems sound.

However, much of the ensuing analysis is taken up with insurance-type schemes to deal with short-term distress issues in paying for housing. The schemes advanced are based on income-contingent loans. These are not self-funding, though their viability is improved by abolishing the distributionally unsound first home buyers’ grant.

This seems a narrow perspective for examining this key *merit good*. The authors have written a report that focused on short-term distress issues and seek to turn this into a general policy approach. More generally one can ask: Why is housing affordability falling and what types of capital gains tax and or other policies can offset such rises? How can the efficiency of the rental market be improved? What is the case for increasing urban land supplies or for fostering urban decentralization?

## **Health Insurance**

Universal access to basic health care is funded by strongly redistributive taxation. In accord with the ‘opting out’ thesis, agents can improve the quality of the services they receive via a private supply option. Again, the extent to which this is drawn on depends upon the quality of the publicly-provided service, which in turn reflects the extent of public and private health insurance. It is those with poor health risk status who have greatest incentives to take out private health insurance. These same people are cross subsidizing those with good health status in the public insurance system. This is the key dilemma of the current system.

The specific proposals for reform are plausible. On the one hand, hospital ownership should be decoupled from the issue of public or private provision of insurance. Then fixed rebates for services should be recouped for any service, irrespective of whether a public or private hospital provides it, and hospitals could cater to any type of patient. In addition, a universal public health insurance system should be funded by taxes, with agents topping up their cover through private cover if required, so the additional insurance does not overlap with public insurance.

## **Education**

I found the discussion of education policy to be the least satisfactory part of this book. Like health, the Australian mixed public/private school system essentially delivers a private good, for which universal access is sought. Like health, a minimum level of service is provided to all, irrespective of income. The authors’

arguments on the case for addressing education spillovers are unclear. They do not question the existence of such spillovers (as others do) but, after making the claim that spillovers *only* motivate a case for providing basic education, they go on to say that if individuals under-invest in education, then governments should focus on subsidizing higher education. Of these conflicting views, the latter seems more reasonable. The authors also reject ‘delegated care’ arguments for intervention, on the grounds that this interferes in family autonomy. They then return to an equity-based argument for intervention at basic education levels. They characterize education as a *club good* although citizen preoccupation with class size issues, and some empirical literature, suggests non-rivalry does not obtain here.

Then, as with the health industry, the authors favor government schools being given the same options to specialize and seek funding as private schools. Then funding is provided to all, based on a transferable universal allowance that can be ‘means tested, by top-up fees determined by the school community and additional compulsory fees, subject to provisions that ensure access to the less advantaged. These propositions seem sensible but I question how dependent they were on the foregoing discussion and whether the key ideas might have been presented more succinctly and simply.

## Roads

This final discussion deals with road congestion. No data are presented on Australian congestion costs but the presumption is that the direct pricing of road use is desirable. This analysis skates over important issues. For example, it is true that pricing access to CBDs alone is a second-best reform, but there are substantial transaction costs of *comprehensive* road pricing. Translating the experience of Singapore, or even London, to Australia is unrealistic. Given the recent political heat generated by even the limited decision to price the Scoresby Freeway, the authors underestimate the ‘distributional’ heat generated by well-intentioned efficiency-based reforms. The issue of *convincing* people of the desirability of reforms must be addressed. Indeed this has become a key part of the road pricing literature.

The authors identify the misdirected attempts to pursue cost-recovery, rather than externalities on projects such as CityLink, and the consequent overpricing of such tollways. I also liked the analogous arguments that criticize the overpricing of public transport by pursuing cost-recovery. However, the deficits that would stem from a move to price public transport at marginal cost would be large. This is why such pricing is usually optimized as a second-best issue within a public budget constraint. Prices are subsidized but not at levels nearly as low as marginal cost.

Given that congestion in cities like Sydney and Melbourne is not yet critical, piecemeal policy reforms, such as cordon pricing schemes coupled with heavily subsidized public transport, are worthwhile interim reforms. They allow breathing space for the introduction of more comprehensive road pricing.

The difficult problems of improving the efficiency of cross-town journeys is mentioned but not resolved in this book. This is a difficult and important road management issue and might best be approached indirectly. Entirely deregulating bus services and encouraging the formation of self-contained urban centers of the type now proposed by the New South Wales Carr Government is a possible solution. Urban planning needs to be integrated with road planning by pursuing smaller, more compact, cities with less low-density urban sprawl.

To sum up, this book brings some sensible microeconomic vision to important policy issues on the demand side. Although it is accessible to non-specialist economists I would be very happy to set it as reading in a public policy course. I do not think it could stand alone as a text and is not intended to serve that role.

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