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Potential competition and public sector performance

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Abstract

This paper considers the roles of actual and potential competition in private government formation. Higher public sector costs encourage formation. Public sector rent seeking discourages formation. Although aggregate welfare always rises, nonmembers may be harmed by private government, and this effect is larger the greater is the public sector cost disadvantage. The public sector may strategically choose to deter the formation of private government as in conventional models of entry. However, it may also make strategic choices that encourage a competing private government to form. Thus, mixed markets are fundamentally different than their purely private counterparts.

Keywords: Privatization; Public goods; Mixed markets; Entry deterrence

JEL classification: H11; H41; H73; L33

1. Introduction

This paper concerns privatization, and like most papers on this subject it must begin with a definition. In characterizing privatization, Vickers and Yarrow (1991) write that there are three kinds: ‘‘the transfer to the private sector of state-owned enterprises operating in competitive product markets . . . ; the transfer to the private

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sector of state-owned enterprises with substantial market power, and [the] contracting out of publicly financed services . . . to the private sector.''

In fact, there is another kind. It involves the creation of so-called 'private governments,' where a group of consumers joins together to tax itself in order to provide supplementary services or regulation. They are 'private' in that the policies are directed at an exclusive group. They are 'governments' in that their policies, and possibly their incentives as well, are like those of traditional public sector institutions. Pack (1992) estimates that there were 900 commercial private governments in various cities in the US in 1992. McKenzie (1996) estimates that there were 150 000 residential private governments in the US in 1993, containing a total of 32 million residents. These organizations provide policing, sanitation, and social services, and they collectively own and manage public facilities like parks and streets. An extreme instance of a residential private government is a gated community (Helsley and Strange, 2000). These communities provide their residents with additional security by denying access to the general public. Egan (1995) reports that as many as 4 000 000 people lived in gated communities in the US in 1995.

This paper considers the roles of actual and potential competition on private government formation. Our analysis addresses three very important questions. How does the possibility of private government formation influence the policies pursued by traditional governments? Is formation or its possibility efficient, or even welfare enhancing? How does the incentive system of the public sector influence its interaction with a private government?

We will answer these questions using a model that incorporates three important sources of dissatisfaction with the traditional public sector.[1] One is heterogeneity in the demand for public services. Traditional governments are usually required to service the entire population, and this forces them to pursue a one-size-fits-all policy. Private government allows high demand consumers to supplement public expenditures. Another is that the public sector may have incentives that conflict with the objectives of the citizenry. Niskanen (1971) argues that bureaucracies may adopt budget maximization as their primary objective, sometimes called 'expense preference' behavior. There is evidence (some anecdotal) in support of this hypothesis. Wolfe (1993), pp. 73–74 reports that managers of Germany's public television and telephone system have stated that their objective was to ''raise rates and sales so as to maximize gross revenues,'' and that in response to union pressures, British rail adopted an objective of ''high employment per unit of service.'' Romer and Rosenthal (1979) argue that the outcomes of school referenda in Oregon suggest that school boards seek to maximize their budgets.

Private government may also arise in response to response to cost differences between the public and private sectors. These differences might arise because of

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[1]See Vickers and Yarrow (1991) for a clear and detailed discussion of the many reasons for privatization in general.