Preview

American cities offer many advantages to their residents. The main virtue of living in a city is the variety of alternatives available to a resident. However, the obvious urban problems that burden many American cities significantly increase the costs to a city dweller of enjoying this variety. Unfortunately, many urban problems either are made worse or are the result of ignoring the role that the incentives created by public policy play in determining behavior. Local governments, by ignoring or refusing to explicitly employ the price system, have created in its place a perverse price system that was never intended. One of the unintended effects was to actually reduce the variety of alternatives available to residents. This chapter investigates several specific urban problems to discover their causes and explores some potential solutions that involve explicitly employing a price system.

Key Economic Points

The first step toward solving any urban problem is to identify the incentives that cause people to behave in the way that causes the problem.

Employing a policy of zero pricing for publicly supplied goods means that some other nonprice way of allocating resources must be substituted.

Some of the social costs involved in employing nonprice mechanisms to allocate scarce publicly supplied goods are identified.

What are the incentives created by the property tax?

Three functions of publicly provided goods and services are reviewed, as well as whether a zero price is always appropriate for these goods and services.

30

Urban Problems: The City as a Perverse Price System

No one needs to be told that urban problems exist. Most people experience every day some of the frustrations of dealing with congested streets and roadways, an unresponsive educational system, the sight of urban blight and sprawl, the dangers of pollution, and inept and insufficient public services. These problems are not new; they have been with us as long as cities have existed. However, they are more important today than ever before because of the mass migration of Americans to urban areas during the last century.

Cities also offer some significant advantages to their residents. Because of their large concentrations of people, cities provide a large market that supports a wide variety of consumer attractions. Large cities simply have more of everything, more goods to choose from and more services to enjoy. Urban problems, however, increase the cost of taking advantage of this pluralism. The mass flight to the suburbs to avoid the problems of the central city has reduced the welfare of both the suburban dweller and the residents left behind in the cities. The suburban dweller bears higher commuting costs and reduced access to the city's attractions. The remaining city dweller enjoys less pluralism and directly suffers from the deterioration of the urban environment caused in part by the financial pinch resulting from a dwindling tax base. It's a vicious circle; the worse the plight of cities becomes, the more the middle class moves to the suburbs; the more that move, the worse the urban problems become.

The root of many urban problems is the failure of city, state, and federal governments to consider the incentives current public policy provides individual decision makers, and to explicitly use the price system to allocate scarce resources. Prices in the private sector ration the use of existing facilities, signal the direction for new investment, and influence the distribution of income. Whereas prices perform such a function in the private sector, they have been virtually eliminated in the public sector. The goods and services produced by the public sector are generally allocated on a nonprice basis. The result is widespread inefficiency, which wastes valuable resources and affects the distribution of income in our cities in unexpected ways.

Much of economics deals with the problem of how a decentralized decision-making system can be made to provide the proper incentives, so that individuals acting in their own best interests collectively behave in a way that furthers the public good. Most of the major urban problems require solutions that channel the decisions of millions of individuals toward socially desirable objectives. Currently, the incentives provided by existing laws, institutions, and government practices provide incentives that guide individual decisions in perverse directions, actually causing some of the problems for which we now seek solutions. A price system allocating urban resources is not absent, but is present in a distorted and, until relatively recently, unanalyzed form.

The beginning step toward any solution to a particular urban problem is to identify the incentives that channel people to behave in the way that causes the problem. What incentives, for example, cause a neighborhood to decay, a school system to become unresponsive, either to the pupils or to the parents it is supposed to serve, or the streets to be filled to capacity with traffic jams during rush hours?

Consider the traffic congestion that chokes the entrances and exits to the downtowns of our cities during rush hour. A motorist, under our existing tax structure, is subject to the same license fees and gas taxes to pay for the very expensive streets, freeways, bridges, and tunnels whether he or she drives at rush hour or not. In order to facilitate rush hour traffic, multiple lanes must be provided that are empty of motorists during off-peak hours. Thus drivers at off-peak times subsidize the rush hour commuters, paying for facilities they do not use. Because rush hour drivers do not pay the full cost of traveling during this time period, too many choose to travel during peak hours.

If all motorists had to pay the true cost of their rush hour travel, some drivers would voluntarily switch to public transit or car pools, or elect to travel during off-peak times. A tax on rush hour driving would accomplish this. Moreover, such a tax is relatively easy to administer. The city of Singapore has instituted an entry-to-the-city tax for motor vehicles. A fee must be paid to drive into the city between 7 and 9 in the morning. After the tax was imposed, congestion in the city was substantially reduced, as

many former rush hour drivers switched to alternative means of transportation. The entry tax thus became a price that rationed existing scarce facilities to those persons who valued their use enough to pay the tax. Those who did not selected another alternative.

Equally important, the entry tax, by reducing the number of cars entering the city during morning rush hour, delayed or eliminated the costly investment required to increase the capacity of the city streets. Resources that would have been channeled into this program were freed for alternative uses. Given the severe budget constraints placed on our nation's cities, with many of them on the brink of bankruptcy, the opportunity cost of resources freed by explicitly using price to allocate scarce existing resources is very high indeed. It is sometimes difficult to realize that the opportunity cost of maintaining and expanding municipal streets is to have fewer other urban goods and services, but it is. If a city has to increase its street maintenance expenditures, it cannot use the same funds to hire police, buy library books, or purchase a kangaroo for the children's zoo. The opportunity cost of providing too much of one good or service is the provision of less of other goods or services.

The use of prices to allocate scarce resources serves another important function; it acts as a guide for further public investment. If the demand for driving into the city employing an entry tax increases, it will be reflected in increased toll revenues, signaling to the city planners that the effective demand for transportation facilities has increased. Political decision makers are thus provided with excellent evidence that more social investment in this area should be considered and may be desirable. Furthermore, the revenues from the tax provide the means of financing the investment. Because the tax is paid only by persons who desire and would benefit from the new facilities, it becomes a user tax par excellence. Those who benefit also pay.

In Singapore, a money price in the form of the entry tax replaced a nonprice means of allocating scarce resources. Space on the city's streets prior to tax had been allocated on a first-come, first-served basis. Commuters paid with their time for the congestion that free access caused. The tax substituted money for time. Another advantage of the tax is that the city collectively (politically) decided to ration scarce street facilities in this way. Prior to that no one had agreed to use time as a rationing device. It just happened as over time traffic density had increased.

It would perhaps have been even better had Singapore instituted an entry tax on one or more roads into the city, leaving some alternative routes for free access. In that case a commuter could choose to pay with either time or money, whichever he or she had more of. One of the problems of unthinkingly offering public services at zero price is that the diversity of options that are a city's great attraction is reduced. Using prices that can be varied to allocate scarce urban resource potentially allows a much wider range of public services to be offered.

Other urban problems are made worse by not recognizing the incentives that existing costs and prices create. A tax is, after all, a cost to the person who must bear the tax and provides incentives for behavior just as powerful as those market prices provide.

Consider the influence of taxes upon another serious urban problem, the decay of neighborhoods in the central city. Urban blight is the consequence of the independent decisions of thousands of landlords to let the buildings they own deteriorate. The incentives that led to these decisions are many and varied, but among them is the property tax. The property tax is levied on the value of real estate, the land and the building. If a landlord remodels the building, installing up-to-date heating, plumbing, and sanitation facilities that are socially desirable, rents must increase to pay for the investment. But the increase in rents must not just cover the costs of the improvement, but also must cover the resulting increases in property taxes. Remodeling the building increases the assessed value, hence the property taxes go up, and rents must rise by more than the value of the newer facilities. The property tax is in this sense a tax levied on improvements, a tax on socially desirable behavior.

The property tax, by creating incentives to allow buildings to deteriorate and reducing the supply of housing in general, has contributed to the current housing plight in the United States. The poor have been left behind to inherit the decaying central city, while the more affluent have escaped the problem by moving to the suburbs. This flight of the middle class has created another problem, known as urban sprawl. The migration of the middle class has even been subsidized by the persons left behind. The price that has been set for using urban fringe space has been too low, that is, below the full cost of extending utility, transportation, and fire and police protection. Ordinarily a flat charge is imposed for extending water, sewer, gas, and electricity to a new suburban development regardless of the actual cost of extending the services. An incentive is thus created for developers to skip over contiguous expensive vacant land and develop instead the less expensive, more remote parcels. The pricing of utility and public services thus creates some of the incentive that results in urban sprawl.

The flight to the suburbs has reduced the tax base of cities. While the financial condition of cities has declined, cities have continued to extend "free" public access to an increasing number of activities, with serious consequences for the allocation of scarce urban resources. There are very good reasons for some goods to be publicly supplied at zero price, but these reasons do not extend to all publicly supplied goods and services. Some services must be collectively consumed in one indivisible amount. Once such services are produced, everyone consumes them, and no one can be excluded. Goods with these characteristics are termed public goods. Justice and air pollution control are examples. When the air improves in quality as the result of pollution control, everyone benefits and no resident can be denied the benefits. Once an urban area provides cleaner air

through an air pollution abatement program, the clean air is there for all to enjoy. Public goods cannot be left to the private sector to provide because not enough will be produced. Because no one can be excluded from enjoying the good once it is produced, few persons will voluntarily pay for what can be obtained for free. Therefore government must provide such goods and impose taxes to pay for them. But compare the provision of pollution control with the provision of a city-owned free public library. Although no resident can be excluded from enjoying the benefits of cleaner air, any potential user could easily be excluded from using the library. Thus price could be used to ration library services, charging users to check out books. The public goods that cities must produce include local law, police and fire protection, and a system of legal courts.

But this is not all the goods that cities provide for free. Cities also provide a range of goods and services at zero price, or below the full cost of operation, that, like libraries, are not public goods. These goods are called "merit goods," and are collectively provided or subsidized because their consumption is believed to be particularly meritorious. Basic education is a merit good. It is provided free, not because students couldn't be locked out of schools, but because of the widely held belief that none should be denied an education and the equality of opportunity that results. The range of merit goods offered by cities is large. A partial list would include, besides basic education, public parks, stadiums, arenas, libraries, museums, and perhaps golf courses, garden patches, boat marinas, and urban expressways.

A third function of government is to alter the distribution of income. Welfare payments are an example of one group receiving income supplied by taxes on another group. Cities often provide the merit goods listed above at zero price in order to provide the "poor" with equal access.

Public goods, merit goods, and the distribution of income provide the rationale for free or subsidized publicly produced goods. Unfortunately, this rationale has become entrenched in the belief that all local public services should be provided at zero cost, even if they do not meet any of these criteria. The provision of free public expressways for automobile movement through the crowded cores of our urban areas cannot be defended on the ground that (1) motorists could not be excluded if they refused to pay a toll, (2) the private automobile is an especially meritorious way to travel, or (3) private motorists cannot afford to pay the full social costs of driving. Neither do golf courses, tennis courts, or boat marinas meet any of these criteria. The extension of publicly supplied goods at less than full cost has effects upon the distribution of income that run counter to the general public belief that more equality is desirable. Taxing the poor so that the more affluent may drive their automobiles, play golf, and moor their boats at less than the full cost of providing these facilities does not promote more equality of income.

Attempts to alter the distribution of income provide another example of the danger of ignoring incentives. When we collectively decide that we wish to provide a good or service to one group and charge another, we do so because we feel the recipients to be particularly "worthy" or "needy" of our collective aid. Even here incentives matter. If aid to dependent children is available only to single-parent families, an incentive for family disintegration is created. If all income from work efforts is deducted from welfare payments, little incentive remains for recipients to work to supplement welfare income. Welfare payments may, depending upon how they are administered, reinforce the root causes of poverty.

Sometimes, in a collective concern over the distribution of income, cities have attempted to regulate the private sector—often without full knowledge or consideration of the effects of the regulations imposed. The housing sector has been particularly prone to local regulation. New York City's rent control legislation is infamous. Despite the deterioration of the cityscape that is a direct result of rent controls, other cities are still experimenting with such legislation. Los Angeles recently imposed temporary rent ceilings. Seattle and other cities have legally halted the conversion of apartments to condominiums.

Cities have been particularly active in regulating or operating public transit. Policy in this area has generally been to create monopolies and cartels. Hitchhiking, for example, is often illegal, as is carrying passengers for a fee in a private automobile (the latter law despite government efforts to encourage car pooling). The average rush hour automobile contains 1.7 passengers, but it remains illegal to fill up the remaining 3.3 seats at a price by bargaining with strangers. This situation was not always the case. Between 1914 and 1915, private automobiles, called jitneys, were allowed to carry passengers for fares. During peak usage the number of jitneys operating in the country was estimated at 62,000. Seattle, for example, had 518 vehicles that managed to carry 49,000 passengers a day. The jitneys, because they threatened the existing electric streetcars, were legislated and regulated into taxicabs.

Since that time, in most cities drivers carrying passengers for a fee must have taxicab licenses, which are strictly limited in number. The taxi medallion, the required license to operate in New York City, sells for more than $50,000, reflecting the monopoly profits inherent in operating a cab in the city. In addition to the restricted number of cabs, present policy often causes a perverse allocation of taxicabs during rush hour. Cabs typically operate at a regulated, metered rate with a high initial charge increased by a time and distance meter. This rate is often inadequate to compensate drivers for driving during the slower rush hour traffic, so that drivers have an incentive to sit out rush hour over leisurely meals. In addition, drivers are usually prohibited from accepting another passenger after loading the first one. So taxis during rush hour haul even fewer travelers per vehicle than do private automobiles. The absence of higher rush hour cab fares

and the limitation on the number of passengers carried make inefficient use of the restricted number of cabs that are allowed to operate. The legislation of the return of the jitney by removing taxicab licensing would in many cities go far toward solving the existing public transportation problem.

When governments in general and cities in particular undertake to directly provide their citizens with goods and services, the incentives to provide them efficiently are often missing. Efficiency in the private sector is ensured by competition. The most efficient firm will win the business, and less efficient rivals must improve or withdraw. Often the goods and services provided by our cities are local monopolies exempt from competition.

The reason that publicly owned facilities are less efficiently operated than private facilities is not that publicly employed persons are "dim" or "nasty," but that they are simply confronted with different incentives than exist with competition. The income, job security, and fortunes of public employees do not depend upon efficient behavior in the same way that those of employees of private industry do. The public school system, for example, is widely believed to be inefficient and unresponsive to its clients. Student test scores have been declining for a decade. When the incentives that have been created for administrators and teachers in the public schools are examined, their implications provide substantiation of the general belief that public education is ineffectively supplied.

The publicly owned and supported basic education system is run by professional administrators and teachers supervised by a handful of generally unpaid elected officials. The public schools are essentially a monopoly, providing education at zero cost to a captive consumer forced by law to attend. This service is paid for not directly by the parents of the students but most often by property tax. The amount an individual pays for support of the schools is dependent not upon the number of school age children in the family but on the value of the property he or she owns. Private schools do exist, but parents pay twice to educate their children if they elect to send them to private schools, once for tuition and again with their property tax.

Consider the incentives facing local school administrators. Their clients, the pupils and parents, have no choice but to attend school through the eighth grade, nor do they have a choice of which school to attend. Administrators will not lose pupils if they do not provide an adequate education, nor will their schools suffer a financial loss, since the appropriations are provided by the school board, not the parents. The teacher receives tenure after a probationary period. The salaries of teachers are not dependent upon the achievements of their pupils but on length of service and educational attainments. If he or she survives for 20 years and attains a master's degree, a teacher will make it to the top of the salary scale. Nor is the level of the top salary based upon merit; it is determined by negotiation between the school board and the teachers union. There is little incentive, aside from professional pride, for either the administrator or the teacher to provide a quality education.

The plight of our system of basic education suggests the danger in relying exclusively upon professional pride to provide quality work. Imagine what would happen to the level of performance of local school systems if the education system involved the following incentives instead. Individual parents would be allowed to choose the school their children attend and to pay the tuition with vouchers provided by the government. The salaries of school administrators and teachers would be paid entirely out of voucher receipts, and merit raises would be based upon the increased competence of pupils in standardized pre- and post-test results.

The change in performance is readily imaginable. Schools would compete among themselves by offering a variety of programs designed to attract and maintain student interest. Predictably, schools would specialize in their scholastic offerings. Each program would be designed to attract students and convince them that their time in school is well spent. Individual teachers, if their income were dependent upon the educational attainments of pupils, would have an incentive to create an atmosphere conducive to learning. Much less time would be spent babysitting and assigning make-work projects and much more time spent on productive educational endeavors. The current plight of public education, like many urban problems, is more the result of inappropriate incentives than anything else.

A price system interpreted in its broadest sense is nothing more than a set of incentives. When a social problem exists, it is most probably due to a perverse set of incentives that encourages the behavior which creates the problem. The city as it is administered today is often governed by a perverse price system that provides the wrong signals to the city's inhabitants. There is a need, it would seem, not only for a knowledge of the economy of the city and the price system that prevails, but for some knowledgeable city economists as well.

Additional Readings

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