

The Market Mechanism and Education Costs

I have asked Professor Alan Blinder of the Department of Economics for permission to reprint his brief and admirably lucid exposition on the rising costs of personal services—including education. Professor Blinder has recently been named to the President's Council of Economic Advisers. — H.T.S.*

Many of the most important ideas in economics are disarmingly simple—the sort that make you mumble, “Why didn’t I think of that?” In talking to various groups of late, I have been reminded of one striking example—a general and powerful idea that sheds important light on issues as seemingly diverse as the health-care crisis, the escalating costs of college education, and the deterioration of municipal services, but is virtually unknown outside the economics profession.

The idea, which was articulated most clearly by my colleague William Baumol many years ago, is that the market mechanism has an inherent tendency to raise the prices of personal services faster than the prices of manufactured goods, year after year. To see why, consider three simple facts about the way markets work.

First, the prices of goods and services reflect the costs of producing them. No news there.

Second, productivity advances much more rapidly in manufacturing than in personal services. New technology and machinery make factory work ever more productive, so that autoworkers, for example, now turn out vastly more cars per hour than they did in Henry Ford’s day. But a waiter serves about the same number of customers per evening, and a barber cuts

about the same number of heads of hair per hour. If these workers raised “productivity” (output per hour), their customers would probably complain that service had deteriorated. Ford’s customers make no such complaints.

Third, over long periods of time, wages of workers in manufacturing and service industries must rise at roughly the same rates. Why? If they did not, restaurants, hospitals, and universities would be unable to attract employees—who would line up for higher wages at factory gates instead. Free markets do not allow such imbalances to persist.

Now put these factors together. Since wages of manufacturing and service workers rise at about the same rate, while productivity grows more rapidly in manufacturing, the costs, and hence the prices, of personal services must rise faster than the prices of manufactured goods. So, for example, college tuition, doctors’ bills, and the costs of police protection should all rise faster than overall inflation.

The data verify this prediction. From 1950 to 1990, the Consumer Price Index (CPI) in the United States rose at an average annual rate of 4.3 percent. But goods prices rose just 3.7 percent per year, while service prices rose 5.4 percent. The gap (1.7 percentage points) is not far from the average economy-wide productivity growth rate (2.0 percent).

Applying this analysis to more specific numbers sheds light on three contentious issues. It is said that medical costs are soaring out of control, college tuitions are rising at unconscionable rates, and municipal services are deteriorating despite higher taxes. Is this because doctors,

teachers, and policemen are greedy or inefficient?

Start with health-care costs, which grew 1.8 percentage points faster than the CPI over the 1950-1990 period (6.1 percent versus 4.3 percent). No one doubts that there were phenomenal technical advances in medical care. Nonetheless, many medical services (like a physical exam) take about the same number of minutes as they used to, and were therefore bound to grow more expensive as wages rose. In fact, if we look separately at medical commodity prices and medical service prices, we find that the latter rose at a 6.6 percent annual rate while the former rose just 3.6 percent per year.

Next, think about the nature of college bills, which go mainly to pay for personal services. Princeton University could easily double the “productivity” of its faculty by doubling class sizes. But I doubt that our students, alumni, and trustees would count that an improvement. In fact, class sizes at Princeton are not much different now from what they were 20 years ago. But faculty salaries have risen roughly in line with average wages. The result? Princeton’s tuition has consistently risen faster than the CPI, just as other tuitions have. A comprehensive index maintained by the College Saving Bank shows that college-cost inflation outstripped overall inflation by an average of 2.7 percentage points from 1957 to 1992.

As a final example, consider the provision of state and local government services like education and police protection. Taxpayers complain when taxes go up while public services deteriorate. But, if no one wants “productivity improvements” like larger class sizes and fewer policemen per capita, this is precisely what we must expect. In fact, price increases for the goods and services bought by state and local governments averaged 5.4 percent

from 1950 to 1990—exactly matching the economy-wide rate of inflation in services.

Are we to conclude from all this that hospitals, colleges, and city governments are paragons of virtue with no inefficiencies? Certainly not. But the analysis does warn us not to jump to conclusions. The fact that, say, tuitions rise faster than overall inflation does not prove that colleges are poorly run.

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It is tempting to label the ever-rising costs of personal services a defect of the market mechanism. But it is not. It is simply the way markets should and do work. We might as well get used to the idea that service prices will rise faster than goods prices for the indefinite future, for they almost always have.