Chapter VIII

Pricing in Government

Costing Versus Pricing

It should be remembered that costing a service is not the same thing as pricing it.[1] A service does not necessarily have to be priced to recover the full cost of the service because pricing is a management decision process that, ideally, includes knowledge of total cost as one factor but also weighs other, nonfinancial considerations. Such considerations might include the ability of the service population to pay, the perceived presence of a general benefit to the society of a subsidized price such as for free libraries, or the desirability of encouraging consumption through the use of marginal cost pricing.

When to Charge

Service charges (public prices) can be used as a means to discipline demand, ration scarce resources, and shape the government. If waste would result from a free service such as unlimited use of a water supply system, a service charge is very appropriate. The presence of a service charge — often, even a nominal charge — can be a very effective method for reducing waste.

Governments exist in an environment of scarce resources and ways must be found to ration resources to produce the greatest benefit for the public. Under appropriate circumstances, the presence of user fees can be an effective rationing mechanism because it forces the service consumer to choose between the service in question and other possible alternatives, thus associating consumption and need.

A much neglected use of public prices is promotional or subsidized fees to change tastes; for example, low cost parking on the fringe of the downtown area coupled with special fares on public transportation in order to reduce the number of cars in the city center. Use of such fees can be an alternative to the exercise of regulatory authority such as banning parking in the downtown area altogether.

A Special Focus: Peak Loads

Rationing scarce resources is a major function of prices in the private sector and can have a significant role in the public sector as well. One particular problem that many general purpose governments must face is controlling peak loads — those times when immediate demand significantly exceeds average demand. In general, it is extremely costly to design and staff for peak loads. If the system involved has a major capital component — water systems, roads, or transit systems — the capital cost of constructing for a peak load can be enormous. If staffing is planned around peak loads there will be periods of time during which employees will be idle; again, the cost can be tremendous unless other productive work is available.

[1] The author is indebted to several people for a number of the ideas expressed here. Of particular note are Charles Hill of the City of Phoenix, Arizona; Richard Kobayashi of the Commonwealth of Massachusetts; and Wilber Thompson of Wayne State University.

In such situations, a differential pricing policy can be designed that will encourage use during nonpeak times, thus smoothing out the demand and bringing the peak closer to the average. For example, water systems can charge more for water during dry seasons and transit systems can charge more for riding the system during rush hour. Such pricing systems can be used to alter behavioral patterns. When carefully designed, differential pricing is an efficient technique for reducing the cost of handling peak-load demands.

Prices and Benefits

Pricing a public service should be considered whenever there are identifiable benefits to specific groups and in instances where there is a community-wide benefit but where consumption can be measured. However, service charges are inappropriate whenever both users and nonusers benefit from the service or when the cost of collection exceeds the revenue generated (with the possible exception of nominal fees whose real purpose is to reduce waste).

What to Charge

It is one thing to decide to charge for a service and another thing to determine an appropriate price. The pricing decision needs to weigh issues of equity and efficiency. When the primary goal of a pricing policy is economic efficiency, pricing at total cost is appropriate but when public prices are based on other considerations as well, appropriate weight must be given to the nonfinancial issues involved.

Beware of Side Effects

To further complicate that situation, many local governments have discovered that instituting a fee for a service that was free, or drastically raising an existing fee, can have significant side effects that frequently are unanticipated. Such was the case when one local government established a fee for tennis lessons that had been free. Even though the fee was less than the private sector alternative, demand for the service disappeared almost totally.

Making Prices Serve Public Policy

During years of fiscal austerity, there is usually a reexamination of much-neglected pricing policies. Unfortunately, the focus of this review tends to be on raising revenue rather than on the relationship of public prices (service charges) and success in attaining other policy objectives.

An example of integrating pricing decisions with other policy objectives: the City of Phoenix, Arizona decided that user fees for landfill usage needed to be set at a rate that was attractive enough to discourage dumping on vacant lots and roadsides (a policy objective). Phoenix’s solution was to make landfill free to small users but to charge for commercial haulers. The principle was to make public prices serve public policy.

Effective pricing can help in distributing the costs of government more equitably by requiring the consumer of a service to pay for it. Also, unnecessary costs can be avoided and waste can be reduced. In the long run, focusing on the policy values of service charges may yield a greater return to public administration than the amount of revenue produced.