False economies

DECODING EFFICIENCY

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About the Author

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This discussion paper is the first in a series looking at the false economies that result from short-term, narrow-minded thinking on Australia's public services. Be part of our ongoing public sector discussion on Twitter #ozbigsociety #ozpublicservice #falseeconomies

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Summary

Every Australian needs to understand what politicians mean when they talk about the 'efficiency' of government. Why should we care? Because this is our money, being spent on us and the things that matter to us. It makes sense to demand that it be spent well. Too often, debates on the efficiency of government are conducted by a handful of expert economists in obscure language that excludes the general public. Or they are skewed by politicians who want to promise more while taxing less, or who don't have an eye on the long-term impact of spending cuts or increases. This short paper translates the jargon used in economic debates about the efficiency of government. It also looks at the muddled thinking that can lead to 'false economies' – decisions made in the name of efficiency that end up costing more than they save.

The main message of this paper is that to know whether we are getting public value for public money, we must consider what government does as well as what it costs; to look at results as well as resources. This is true both of decisions to cut back on spending or decisions to privatise or outsource public services.

Strong views

I believe Australians want to see a public service that is efficient and effective and gets the job done.

Julia Gillard, Australian Labor Party, Prime Minister[1]

I respect the professionalism of the public service. In the longer term, though, we have to rely less on bureaucrats and put more trust in the common sense of the Australian people. We need smaller, more efficient government.

Tony Abbott, Liberal Party, Opposition Leader[2]

The efficiency dividend ... is now seriously impacting on the government's ability to deliver services.

Christine Milne, Australian Greens Party, Party Leader[3]

It's not 'efficiency' to default on your social obligations. It's not 'waste' to treat your people with respect.

Kim Carr, Australian Labor Party, Minister for Human Services [4]

We want to find better efficiencies in the public sector staffing levels so that we can increase frontline services.

Scott Buchholz, Liberal Party, Member for Wright[5]

While the Government has a strong focus on achieving efficiencies, we are continuing to invest in frontline services.

Penny Wong, Australian Labor Party, Minister for Finance and Deregulation [6]

The reality is that government employees around the world are known not to be as efficient as the private sector. What the public sector can learn from the private sector is the need for a constant focus on efficiency.

Paul Fletcher, Liberal Party, Member for Bradfield[7]

Through the efficiency dividend, the Public Service is treated like no other agency or business in that they are continually required to pay between 1.25 per cent and three per cent of their annual running costs back to the government in the form of savings.

Stephen Jones, Australian Labor Party, Member for Throsby[8]

...recognising the important role of the Australian Public Service in upholding and promoting our democracy and its key role in ensuring stable government and, secondly, commending the Australian Public Service on continuing to be one of the most effective and efficient public services in the world. These are both commendable motions, and I think that members of this House would largely agree with them.

Jamie Briggs, Liberal Party, Member for Mayo[9]

It was public servants who did so much to get us through the global financial crisis with a temporary, timely, targeted fiscal stimulus program that was recognised by international economic authorities, such as the IMF, as being a world-beating fiscal stimulus program because it was put into place quickly and efficiently.

Andrew Leigh, Australian Labor Party, Member for Fraser[10]

The efficiency of the public system is about half of that of the private system.

Peter Lindsay, Liberal Party, then Member for Herbert[11]

We have seen for some time, public services everywhere being subjected to higher levels of scrutiny and criticism, and greater expectations of efficiency, service and responsiveness to governments and the public at large.

Melissa Parke, Australian Labor Party, Member for Freemantle [12]

The efficiency dividend has increased from 1.5 per cent to a whopping four per cent this financial year, which will have a huge impact on service delivery and nation building.

Adam Bandt, Australian Greens Party, Member for Melbourne[13]

A modern, contemporary employment framework ... will allow greater agility and responsiveness by the APS to the community and to the government. It will result in greater efficiency and more effective use of Commonwealth resources.

Gary Gray, Australian Labor Party, Member for Brand[14]

Your money spent on you

Through a combination of income tax, GST and various other taxes and duties the federal, state, and local governments take a percentage of every Australian's income. (The average household pays about a quarter of its income in taxes.[15]) With this money governments:

- teach 65% of our children – and substantially co-fund the other 35%[16]
- co-fund nearly all Australian university students
- provide 67% of hospital beds – and co-fund the private beds[17]
- co-fund medical services and medications
- regulate to ensure the safety and/or reliability of:
    - food and beverages
    - medicines
    - buildings
    - road, rail, water, and air transport
    - workplaces
    - the finance sector
- provide and police the entire justice system and the system of property rights
- undertake all diplomatic and national security tasks, such as pursuing our interests in foreign relations, ensuring safety and security through border controls for people and goods, and defence of the nation
- provide infrastructure, such as the majority of roads
- supply essential community services, such as protecting vulnerable children, assisting those with disabilities, and providing help when bushfires, floods, or other emergencies occur
- give financial assistance to those in need, for example, aged pensions
- run trusted information sources, such as the Bureau of Meteorology and the ABC
- run a myriad of other services that, directly or indirectly, affect every Australian everyday

Politicians make the major decisions on how the money is to be spent, but the big job of collecting the money and providing the services is done by the public sector; that is public servants (teachers, police, health workers and their support staff, the defence force, policy officers and many more) and the employees of government owned corporations like the ABC, the CSIRO, and various water and energy providers.

So this is your money being spent on you. Every Australian therefore has the right to know that the money is not being wasted; that is it being spent as efficiently as is reasonably possible.

Getting 'efficiency' wrong

Politicians and other public figures who comment on public sector efficiency are well aware of the need for an efficient public sector, and parliamentary and public discussions feature strong opinions on the topic (see quotes above). Unfortunately, the word 'efficiency' is often misunderstood or misused, leading to decisions that cause waste. In our day-to-day lives, all of us have experienced similar 'false economies', decisions intended to save time or money that end up costing more than they save. In public services the two most common kinds of false economies are: inappropriate cuts or savings, and inappropriate privatisation or outsourcing.

Inappropriate cuts or savings: Often debates on the efficiency of the public service or sector focus on reductions in resources. These cuts are usually either staff cuts, such as promises to reduce the number of public servants by a certain amount, or general budget cuts, such as the 'efficiency dividend' which requires most federal government departments to spend 1.25% less to meet the same responsibilities each year. Cuts to the funding of an existing service or decisions not to fund a planned service are often referred to as 'efficiencies' or 'savings' when they are announced. However, cutting spending on activities that deliver more benefits than they cost, or failing to invest in projects that should be undertaken, can make government less efficient, not more. How this works is discussed below.

Inappropriate privatisation or outsourcing: A range of different terms have been used to describe these actions, but here 'privatisation' refers to the government selling a physical asset or an organisation, and 'outsourcing' refers to paying a corporation or other organisation to undertake a service that was previously provided by the government. There are important differences between privatisation and outsourcing, but they are grouped together here because the same misunderstanding of efficiency is often used to justify their inappropriate use. Again, the way misunderstandings of efficiency lead to waste is discussed below.

Getting efficiency right

Note the use of the word 'inappropriate' in the description of both of the above mistakes. To be clear, this is not an argument that the implementation of outsourcing, privatisation, cuts or savings in the public sector are inherently bad public policy. What is argued is that these measures are sometimes detrimental to efficiency (and so a waste of taxpayer resources), and we need a clear understanding of efficiency to avoid such problems.

In some cases cuts to government operations are the right decision, and in other cases they are the wrong decision. This statement might seems so obvious as to be not worth making, but too often the word 'efficiency' is used as though it means the same thing as 'cuts', and this implies that cuts are always the right decision.

In some cases the outsourcing or privatisation of government operations is the right decision, and in other cases it is the wrong decision. Again, this statement might seems obvious, but there is a widespread belief that the private sector is always more efficient than the public sector and this implies that privatisation or outsourcing is always the right decision.

These two misunderstandings of efficiency not only bias some towards cuts and privatisation, they can also cause those who support the public provision of a service to argue against efficiency or argue it is not important. This is a mistake as pursuing efficiency is critical tool in achieving any aim, but only if the full meaning of efficiency is used.

Three kinds of efficiency

The field of economics has developed a thorough understanding of the concept of efficiency. Unfortunately this knowledge is generally expressed in the jargon of the field and has not tended to inform the public debate on efficiency of the public sector. This is a shame because the concepts are readily expressible in plain English.

One kind of efficiency is doing the work you are doing with the fewest possible resources, getting 'more for less' or 'value for money'. So that every item that is produced, or service that is provided, is done with the least expenditure of time, money, materials, etc. Taking a quicker route to work, shopping at a supermarket that is cheaper and just as close, and printing documents double-sided, are all examples of ***technical efficiency***.

Another kind of efficiency is about doing the right work. This is allocating resources to produce and provide items and services of the highest total value. Value is often thought of as the amount of money someone is willing to pay, but this is not always reliable for all

circumstances. A print-out of a document that is read and used by many people is more valuable than a print-out that's read by only a few, or no-one at all. Buying more nutritious and flavoursome foods gives a greater value than buying unhealthy and unappetising food. So, using paper on printing the most useful documents and getting the best food for the weekly budget, are examples of ***allocative efficiency***.

A third kind of efficiency involves finding new ways to fill needs. This is ensuring that new technologies, new ways of operating, and new ways of thinking are able to be used. Saving time and petrol by working from home, or using electronic paper instead of printing, can be examples of ***dynamic efficiency***. This kind of efficiency is in many ways the least well-understood, while technical and allocative efficiency are well-grounded in economic definitions, dynamic efficiency is a more fluid concept.

To illustrate the differences with a public sector example:

> Technical efficiency: Building a road using the best mix of labour and capital. Using picks and shovels when machinery can do a lower-cost job is technically inefficient
>
> Allocative efficiency: Building a road where it's most needed. Even if a road is built with the optimal labour-capital mix and no waste, if it is in the wrong place, or if a more heavily trafficked road is neglected, that's inefficient in an allocative sense. Those resources could have been used elsewhere with better outcomes.
>
> Dynamic efficiency: Attending to transport needs as opportunities change over time. That may mean taking on new modes – such as high-speed rail or intelligent roads.

All three kinds of efficiency are important. But often the pursuit of one can get in the way of achieving the others. This is particularly important in areas which are complex and continuously changing, which is very often the case in public services. A simplistic approach to efficiency, particularly cutting across the board, often fails to recognise that resources are necessarily being devoted not only to produce current outputs, but also to make sure these are of the most value to citizens (for example by tailoring them to different needs in different locations or to different groups), and also to making sure that they change and improve over time as new technologies and new needs emerge.

The blind pursuit of technical efficiency is quite often disastrous for companies if they do not themselves recognise these issues in their own investment plans, because competitors soon destroy them as their products or methods become outdated. It is equally disastrous, and sometimes more so, if public services are not run with the same eye to all three types of efficiency. How damaging is it to overall efficiency if our defence equipment is the wrong type for changing needs, if our schools are using the wrong models of education, or if our payments system is using outdated technology?

Misunderstandings of these three kinds of efficiencies and their interactions lead to the two errors listed above.

Inappropriate cuts or savings & misunderstanding efficiency

Most of the discussions of public sector efficiently are concerned with technical efficiency. Phrases such as 'doing more with less' show this, since doing more work with fewer resources is an improvement in technical efficiency. Unfortunately, beyond this rhetoric there is often a misuse of the word 'efficiency' because the proposed plans focus on the resources being used and don't sufficiently consider the outputs being produced, the value of the outcomes that they seek in different settings, or the possibility of developing future capacities that are just as important to invest in as today's outputs. So promises are made that there will be cuts to the public sector, but that the services it provides will not be affected. The cuts are usually measured in detail and get strong media attention, but the services are not so well-measured and so decreases in quality or accessibility of the services are not as noticeable. And the opportunities lost in the future are also undervalued, until we

get there and wonder why our performance has slipped behind that of other countries, or why critical needs were not anticipated and met.

A large part of the reason for the focus on inputs is that they are relatively easily measured since they can be expressed as dollars in a budget. Outputs in the provision of public services are generally less easily measured since, unlike many other markets in which a straightforward measure of profit can be applied, their value is based on a range of different factors many of which a difficult to directly price. Public services cannot be regarded as a simple discrete 'product' because their objectives are complex. For example, an aim of promoting local economic growth is complex because growth can be measured in a number of ways each emphasising different values such as employment, wages, consumption, or investment. Other common public service aims such as greater equality of income and wealth and the provision of public goods (like a legal justice system or the security provided by the military) are equally difficult to value.

The lack of attention to outputs means that the reduction in services may be greater than the cuts to the resources, meaning that cuts have lead to reduced technical efficiency. For example, technical inefficiency can be created by cutting staff while expecting the same services to be provided. Doing so will usually place a greater burden on the remaining staff. If this makes the work less attractive there may be difficulty in hiring sufficiently skilled staff and salaries may have to increase. There may also be increased turn-over, so more resources have to be devoted to training new staff, and the level of skill and experience of the staff will not be as great as previously. At the same time the productivity of some staff might drop due to lowered morale and motivation, and possibly even stress-related illnesses. So an immediate saving from a staff cut can be gradually exceeded by the costs of increased salaries and training time, as well as the lowered productivity from reduced experience and motivation.

Lack of attention to outputs can also result in important areas being neglected while resources are put towards lower priority issues. So if local roads in marginal electorates receive funding while a major highway is neglected, there may be more road accidents than if the highway upgrade were funded. This is a failure of allocative efficiency in that the more important work is being ignored. It also has a negative effect on technical efficiency because the costs on the health and disability budget of road accidents will be greater, this is in addition to the costs borne by accident victims and their carers.

In some cases there may be a simple failure to allocate resources to important areas. One of the key roles of public services is to respond to emergencies. It looks more efficient when, in quiet times, capacity is cut in emergency services, health services, security services, or infrastructure services. But as incident after incident has shown, this type of apparent efficiency has tragic consequences when problems arise, systems fail, and responses are inadequate.

Inappropriate cuts and savings can also significantly damage dynamic efficiency. The most obvious cases of this are cuts to research and education. For example, from the early 1950's to the late 1970's Australia increased its investment in agricultural research, but increases since that time have been much smaller. There is evidence that this plateau in research funding has had a significant effect on agricultural productivity. Reducing the growth of government investment in research meant that farming productivity growth also decreased.[18] Failing to invest in research will mean that new techniques and technologies are not created, and failing to invest in education means a reduced capacity to implement and adapt to new discoveries.

Other examples of cuts or savings damaging dynamic efficiency include skills loss from staff cuts. The Howard Government cut Australian public service numbers by 32,000 in its first four years. It then found that it had too little investment in public service capacity. It hired 42,000 extra public servants in its next 7 years.[19] The result of the initial deep cuts was a

massive loss of dynamic efficiency as key skills were lost to the service, and as long learning challenges were then faced by the later incoming new staff.

Inappropriate cuts and savings can reduce efficiency due to a failure to acknowledge that efficiency involves results as well as resources (outputs as well as inputs). In a wide range of fields, we see the first things cut by blind efficiency measures have serious consequences for technical, allocative, and dynamic efficiency.

Inappropriate privatisation or outsourcing & misunderstanding efficiency

Outsourcing and privatisation schemes are frequently undertaken with the stated intention of increasing efficiency. Sometimes this is done after a careful and independent analysis that determines the private sector is likely to be more efficient at the particular task. Sometimes it is on the basis of advice given by conflicted private consultants. And at other times it is done simply on the basis of the mistaken belief that the private sector is always more efficient than the public sector. This belief is sometimes called 'private sector primacy'.

A common misconception is that private sector primacy is supported by economics findings that markets always drive efficiency. But this is an incomplete understanding of the economics of markets when applied in the fields for which public services have been built.

Abstract economic models predict that well-functioning markets will match supply and demand so that goods and services are produced at prices and in quantities that will be purchased to provide maximum satisfaction of consumers' needs within their constrained budgets. So no effort is wasted on production of items or the provision of services that people are not willing to pay for. And, where there are limits to what can be made or provided, effort goes towards those goods and services that have the highest value in terms of the amount that people are willing to pay.

The tough and invisible hand of the market, according to this model, ensures both allocative efficiency (markets provide only those things people want) and technical efficiency (high-cost producers go out of business). The model is limited, however, for the real world departs from the abstract model in many important ways. Sometimes the departures are minor, and the costs to bring about ideal outcomes would be greater than the cost of departures from the ideal. But in many cases the costs of 'market failure', to use the conventional economic term, are such that public intervention through government provision (e.g. roads), funding (e.g. health care) or regulation (e.g. finance) is required. Markets have been shown repeatedly by economic analysis to fail to deliver efficiency in a range of circumstances. The following paragraphs describe what can, and does, go wrong:

Non-competitive conditions

Public services are provided mainly in areas where standard competitive market conditions do not apply. Unlike competitive markets, public services are those where distributional outcomes are particularly important (for example in the tax-transfer and welfare support systems), where services are thought best to follow need rather than willingness or capacity to pay (like justice or disability services), where minimum service levels are desired even if they are high cost (like services to rural and remote communities, or to Australians travelling abroad), where collective goods cannot be produced in a market (like defence and immigration) and so on. Public services often involve elements of regulation, or overwhelming commitment to the public rather than private interest (like parliamentary services, the military, and police). Such services are not best provided in a framework where the primary motivation is profit.

Single buyer

In a public service outsourcing market government is often the only buyer so this is not a genuine market. The market power of the one buyer is often used to get very low prices from suppliers. This can be a benefit since the savings from these low prices allow more services to

be provided to the community. However, this market power can be misused to drive prices so low that there are long-term costs. For example, many Australian charities and other not-for-profit bodies have been used to deliver low cost welfare services, but this has often been at the expense of program effectiveness or dynamic efficiency. Pricing is often too low to sustain adequate training, employ fully qualified staff, or to develop new service models. A range of disasters have come to light over the years in areas like child care and nursing homes, requiring costly fixes, re-regulation, and so on.

Alternative means of competing

As mentioned above, markets can drive technical efficiency in that they involve competition, and being able to produce the same quality of outputs at lowest cost is one way of out-competing alternative providers. However, there are numerous other ways to be competitive, such as reducing quality in ways that are hard for customers to detect, spending more on marketing, greater access to capital, superior access to buyers, etc. This means that outsourcing to create a market will only improve efficiency to the extent that attempting to produce the same quality outputs at a lower cost is the dominant form of competition in the new market. Because of the complexity of measuring public service outputs it can be difficult for even a well-informed government buyer to ensure that lower bids for public service contracts do not simply result in lower quality services, rather than efficiency.

Principal-Agent Problem

This problem occurs when an individual or organisation (an agent) is carrying out work on behalf of someone else (the principal). Where the interests of the agent and the principal are not exactly aligned, problems can easily arise. Because the agent is doing the actual work they will frequently have more knowledge about how the work should best be done (called information asymmetry) and it can be difficult for the principal to effectively oversee the work. The result is a tendency is for the work to produce outputs that are suited to the needs of the agent rather than the principal. A well-designed incentive system can ensure that the interests of principal and agent are aligned. However, as mentioned above, the objectives in public services are often complex and difficult to quantify. This makes designing effective incentive systems extremely difficult, and means that outsourcing works only for simply specified services.

De-skilling

Public service agencies as designers of programs and purchasers of services begin to de-skill as they have diminishing roles and experience of the frontline, and this exacerbates the principal-agent problem. Procurement and recruitment skill problems emerge, and several have been reported in recent years. So have service design and implementation issues, including interactions with policy development. Some departments have reached the point that they must turn to contractors even for the smallest tasks that Ministers might give them. To a large extent, it is only because so many private contractors are former public servants that the necessary skill is available at all. As these public service trained workers start to age and retire, there is a much thinner pool of replacements coming through, depending on how much capacity has been retained in the various areas of service.

Loss of economies of scale

Many fields of public activity involve networks and scale efficiencies. These often are most efficiently delivered as single public systems. An example may be the much lower administrative cost per dollar disbursed of Medicare (a nation-wide health insurance scheme) relative to the multitude of higher cost private health insurance schemes. Other examples arise in road networks, statistical collections, meteorology services, and many others.

The private sector is not inherently more efficient than the public sector in the delivery of public services.[20] Taking a full view of efficiency, there is no evidence that private schools are more efficient than public schools,[21] that private health and hospital services are more efficient than public health and hospital services,[22] or that private regulation and codes of practice work better or are better enforced, than public regulation in many fields. In some situations privately provided services may be more efficient, but in others they are less efficient. This means that decisions on whether or not to outsource or privatise need to be made only after independent, robust, and comprehensive analysis of the likely impacts on efficiency and other key policy goals. Such analysis should try to identify all costs involved, including costs transferred to users of government services. The future must have as much weight as the present in the assessment. Making choices in this way is of course more difficult than a simple rule-based preference for a certain sector, but is likely to lead to better results.

Effectiveness and Equity

There is another factor that applies to both of the errors discussed above, insufficient consideration of two concepts that are related to efficiency: effectiveness and equity.

A good definition of ***effectiveness*** is 'the relationship between purpose and results'. So an action undertaken by the public service or a public sector organisation is effective if it achieves the objective that was intended.[23] So, if a health department implements a vaccination program to reduce the occurrence of a disease, the program is effective if it does reduce the number of infections.

In relation to public services ***equity*** most commonly refers to both the equal treatment of equals (where there are similar levels of need and the service is equally accessible to all) and the unequal but fair treatment of unequals (where services account for the special needs of particular groups in the community).[24] Equity can involve equity of access, so all Australians are expected to have adequate access to services, and equity of outcome, whereby all Australians are expected to achieve similar outcomes resulting from service use. So a vaccination might be made freely available to all (equity of access), or may be made available free to certain vulnerable groups, such as children or those with an underlying medical condition, so that those groups are as safe from the effects of the disease as the general non-vulnerable population (equity of outcomes). For many Australians, equity also has other dimensions. These can be important for many policies, and include spatial equity (particularly for those in remote and rural areas), intergenerational equity, and social dimensions such as gender equity.

These two concepts both reflect that the Public Service is expected to serve the wider economy and society. Consideration of efficiency needs to take this into account. So, for example, a vaccine might be most effective at reducing the number of infections if it is delivered to everyone at around the same time. However, it might cost more to provide it in a burst than it does to spread out the provision over a longer time period, because many nurses have to be trained to administer the vaccine rather than just few who can travel around administering the vaccine over time. Providing the vaccinations all at once means that the cost of each vaccination is higher and this might seem inefficient. But a cost cutting measure to train only a few nurses and have them travel to different communities and administer the vaccine would reduce the effectiveness of the program (and potentially the equity since remote communities might be disadvantaged by getting the vaccine late). Even though providing the service in a burst means more resources used per vaccine, this may still be efficient if the additional effectiveness and equity are worth the increased cost.

In practice, it can be very difficult to establish the connections between inputs and outcomes because they tend to be influenced by a range of factors and there is often delay been the outputs being provided and their effects starting to show. However, effects on the Public Service's wider role need to be, to the extent this is possible, assessed in order that a narrow pursuit of efficiency doesn't damage effectiveness or equity.

Conclusion

Given the scale and significance of the work that the public sector undertakes, it's clearly important to have it operate efficiently. Allowing mistaken notions of efficiency to drive policy will result in 'efficiency reforms' that actually increase waste. To avoid these mistakes, policies on public sector efficiency must:

- Focus as much on results as on resources (outputs as well as inputs) of the public service (e.g. when cuts are announced, evidence should be provided that the same services can be maintained with fewer resources, or the likely reduction in services should be outlined at the same time)
- Ensure that short-term efficiency gains will not result in larger long-term efficiency losses
- Conduct independent and thorough investigation into the advantages and disadvantages of in-house and outsourced service provision before any outsourcing decisions are made
- Conduct independent and thorough investigation into the advantages and disadvantages of public and private ownership of public service organisations or infrastructure before any outsourcing decisions are made
- Consider society-wide costs, not just direct costs to government budgets, so that public service cuts do not impose costs on the population that are greater than the savings.

Our public sector suffers the plight of the anorexic. No matter how thin it gets there are voices saying it's too fat. Do we really want a size zero government? The word 'efficiency' is often misused to mean 'cuts', and some cuts to public services can end up costing us much more than they save.

When it comes to privatisation or outsourcing, too many of our politicians have tunnel vision. They can only see the private sector as efficient and are blind to when it fails. This report outlines six ways markets mess up. If you don't want public services run down, it's important to look both ways (left and right) before outsourcing.

Our public services do a lot for us. They need to be efficient, effective and fair. But we won't achieve that by endless cuts or blind faith in market solutions. We need to consider results as much as resources, we need to think long-term, we need to carefully consider the benefits and disadvantages of outsourcing and privatisation, and we need to be aware of society-wide costs, not just direct costs to government budgets.

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