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The Nature of Optimal Public Policy

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Abstract: The design of public policy must take human nature as an immutable constraint, both with a view to choosing the appropriate policy objectives and in regard to the human response and hence the effects of the policy. Once human nature is seen in the proper light and the multiple needs of society are recognized, it is not difficult to see the logic of a hierarchy of policy objectives with some being treated as tentative constraints and others as “maximands.” Optimal public policy making in the short term would treat those constraints as given but over the longer term the constraints themselves are also subject to revision by the “policy coordination center.” Throughout this iterative process, public policy analysts will have done a great service if they can lay bare the trade-off among conflicting policy goals and the relationship between policy choice parameters and policy target variables.

Keywords: Public policy, collective decision making, social welfare, human nature

1. Introduction

Policies are designed and implemented for specific purposes, but they are always made in the context of human societies, and against the constraints of human nature, values, and the political reality. In democratic societies policies are often introduced as a response to political pressures, although sometimes they may represent a conscious attempt at problem solving or as a means to achieve specific ends.

The fact that public policies are subject to political pressures is not a problem. Indeed, the political process is needed to translate the aspirations and needs of the community into actual policy choices, otherwise policy choices would be made in a vacuum. However, it is of vital importance that people taking part in the political process should know what they are doing, particularly the implications of various policy decisions on the society at large. To facilitate the process of *informed political choice* policy analysts must spell out, as accurately and as explicitly as possible, the constraints that the community faces and the trade-offs implicit in various policy decisions.

Section 2 will discuss the constraint of human nature. Human nature is reckoned as the only immutable constraint facing policy makers. Section 3 argues that in designing policies and in choosing among different policy options one must bear in mind the full range of policy objectives. There is a hierarchy of policy goals and it is useful to assign some policy goals as “constraints” and others as “maximands.” These distinctions, however, are always subject to revision. Section 4 makes the case that the concept of optimality is generally applicable to all

kinds of policies and that costs and benefits are also very general concepts that can cover economic, social, as well as political, and moral as well as non-moral aspects. Finally, Section 5 concludes the paper, and relates the discussion to a broader discussion of the evolution of institutions.

2. The Constraint of Human Nature

It is very important that policy makers recognize that the results of any policy must always be the joint result of both the features of the policy itself and the behavior of individuals who are affected directly or indirectly by the policy. The observed behavior of individuals must not be assumed to be fixed. The famous “Lucas critique,” which says essentially that macroeconomic policies that do not take account of the behavioral response of people are ill-founded (Lucas, 1976), is a direct application and illustration of this concept. There are also plenty of examples from the realm of social policy which equally forcefully demonstrate the same principle. Thus, in the U.S., it was found that policies intended to help single parent families financially turned out creating single parent families. Policy makers have now also learnt that unemployment insurance always increases unemployment. China has learnt, painfully, that policies in disregard to the universal human aspiration for creativity, autonomy, and choice, and the universal urge to improve the quality of life, are bound to go nowhere. In order to design policies that fully take into account the behavioral response of the affected groups we need to know more about human nature. Thus a good knowledge of human nature is really fundamental to the design of effective policies (Ho, 1998).

Proposition One:

The design of policies should take full account of the interaction between behavior and the policies.

Policies always produce a myriad of different effects, and there are always multiple policy goals. It is very often the case that the policy goals conflict among themselves. Economists sometimes simplify the problem confronting policy makers with an artifact called the *social welfare function*. Once the social welfare function is defined, the policy problem can then be described simply as choosing the policy instrument and the values of policy parameters so as to maximize the social welfare function. In practice, of course, the social welfare function does not exist objectively and there is no scientific way to gauge the social welfare function. Rather than attempting to find the social welfare function, policy analysts should design mechanisms whereby the effects of various choice parameters of the society can be made known and the trade-off among different policy goals can be made transparent (Ho, 1997a). In the end no social scientist is in the position to make choices for society, which must make the policy decisions collectively. Social scientists have learnt, however, that there is a universal concern for basic justice and an aversion to large risks. So it is important that policies and institutions do not contravene basic principles of justice (Ho, 1997b).

Proposition Two:

An important role of policy studies is to design mechanisms whereby the choice parameters of the society can be made known and the trade-off among different policy goals can be made transparent. These mechanisms must not contravene basic rules of justice.

3. The Hierarchy of Policy Goals

Apart from compatibility with basic rules of justice, economic efficiency and promoting economic growth are often regarded as important policy goals. In recent years, however, sustainable development has emerged as an even more basic policy goal than economic development (Tisdell, 1995). On top of these more long term objectives, there are other, more specific, policy objectives, which emerge under specific contexts, and which may conflict with these general objectives. Thus, public opinion in Hong Kong in recent years had put much pressure on the government to curb the inflation of housing prices, to increase the housing supply, and to increase home ownership. In the face of such pressure, the Hong Kong Government decided to intervene, even though many of the intervention initiatives were widely understood to compromise economic efficiency. Policy analysts should not simply dismiss the objectives of increasing home ownership and raising housing supply as incorrect or inappropriate. Similarly, the aspirations for instituting a minimum wage or a level of income for each household have to be recognized, even though it is advisable to consider whether the benefits outweigh the costs and whether an alternative mechanism may meet those aspirations at a lower cost. Equalizing regional disparity is a common concern in large countries such as Canada and China. Protecting the young people against sexual abuse, drugs, and crimes is yet another important goal. These policy goals are defined at a specific time and at a specific place by the dynamics of social and political actions.

We can see, therefore, that there is a hierarchy of policy goals. In general,

policies that come into being as a response to public demand can be regarded as having specific, "second order" goals. Underlying these policy goals, there are other, more long-standing, more fundamental social goals. As alluded to earlier, economic efficiency and economic growth are longer term and more general goals. For that matter, it has dawned upon humankind that sustainable development is what is required to secure the long term survival of the human race. Similarly, the preservation of freedoms and social justice in the sense of minimizing arbitrary welfare redistribution (Ho, 1997b) are extremely important and have amassed wide support approximating a consensus.

In contrast to these longer term objectives, other objectives are much more specific to the political context and can be described as second order goals. In the face of the specific short term goals it is convenient to treat longer term objectives as constraints. Thus a policy aimed at providing housing for the elderly must not excessively compromise economic efficiency. Policies aimed at promoting economic growth must be consistent with sustainable development and should not unduly disturb the ecological balance in the living world. A policy aimed at curbing excessive speculation in the property market must not contravene society's sense of justice and must not punish investors to the detriment of entrepreneurship and thriftiness.

The distinction between variables designated as constraints and variables designated as maximands is akin to that between fixed costs and variable costs in the theory of the firm. In the theory of the firm, fixed costs refer to costs which are fixed

in the short term, i.e., which are not subject to choice in the short term. This implies that, over the longer term, they are also variable. In the short term, however, it is not wise to treat all variables as choice variables. Operationally, we cannot work out the optimal values of all variables simultaneously and instantaneously, particularly when the socioeconomic and the political environments are changing all the time. Over the longer term, when the values of the society have undergone a fundamental change, it will be necessary to revise the values of the variables chosen as constraints. This is similar to revising the “fixed” factors of production when relative factor prices have settled down to a permanently different set of values.

Proposition Three:

More general, more basic, and longer term policy objectives are treated as constraints while more specific, less basic, and shorter term policy objectives are treated as variables to be maximized or “maximands”. As the system of values in society changes and as we gain more knowledge, policy objectives designated as constraints may change.

4. Costs, Benefits, and Optimality

The concept of optimality, developed in economics and mathematical programming, is most useful in public policy studies. Contrary to what is often believed, the cost benefit calculus that is implicit in the concept of optimality need not relate to economic efficiency at all. The cost benefit calculus is a method of policy analysis, and is not restricted to the economic dimension. In a discussion of crime

and punishment, for example, we can talk about the cost and benefit to society of the size of a jury. Suppose unanimity is required for a conviction. Increasing the size of a jury will reduce the chance of wrongly convicting an innocent, which is a benefit. It will, however, increase the chance of acquitting a culprit, which is a cost. We cannot avoid considering costs and benefits in deliberating on such matters. It is only when all the costs, direct and indirect, present and future, economic and social, moral and non-moral, are considered that we can hope that policies, over the long run, will do more good than harm.

Proposition Four:

Intelligent decision making about policies must consider the full range of costs and benefits, direct and indirect, present and future, economic and social, moral and non-moral. Over all optimality means the maximization of net benefits. This requires an optimal choice of policy and an optimal choice in the values of policy parameters, and implies the optimal trade-off between conflicting policy objectives.

Take the example of the mandatory private provident fund(MPPF) which is now being introduced in Hong Kong. Let us ignore alternative policy instruments for the moment. Each policy parameter within the scheme has an optimal level: the percentage of employer and employee contribution out of the salary, the level of income below which employees are exempt from the need to make contributions, the normal age at which an employee can collect benefits, the age at which early withdrawal is allowed and the conditions. Too large a percentage of contribution

would excessively burden enterprises and reduce disposable income and hurt the quality of life prior to retirement. Too small a percentage would lead to an accumulation of savings that will be too small for retirement needs and would defeat the purpose of the exercise, and would not worth the administrative cost that will be required to service the scheme.

The mandatory private provident fund scheme at its best—i.e., when all its parameters are set optimally-- must also be considered against other alternative schemes. Introducing the MPPF may imply that other viable schemes cannot be introduced, or may be introduced at a greatly reduced scale. The cost of the MPPF is then the net benefit of the best alternative scheme forgone. If the MPPF fails to deliver a benefit at least as large as the net benefit of the best alternative scheme it should be scrapped. Any policy designed for a specific purpose must be considered along with its competing alternatives if we are to adopt the best or the truly optimal policy.

It is true that some of the costs and benefits may be very difficult to estimate accurately, and “practical optimality” does not require accurate estimation of costs and benefits. Indeed, sometimes the expected benefit from a full-fledged cost-benefit analysis may not be large enough to justify the cost-benefit analysis itself. However, policy makers and the public should both be alerted to all the dimensions and the nature of the consequences, so that decisions over policy instruments and policy parameters are made with an awareness of the full range of consequences. In this regard social scientists, particularly economists, have a large role to play.

It is a pity that some areas of public policy have been compartmentalized and policy makers in those areas have been given the mandate to focus on a single dimension of performance. This underscores the importance of the “systems perspective” or, to put it another way, the “liberal arts perspective” in a public policy study program in our universities. For example, it is still often held that central banks only need to achieve stable prices. One unforgivable tragedy of the eighties and the nineties is that a number of central bankers have single-mindedly pursued price stability to the complete neglect of economic growth, employment, and social justice. The deep recession of 1980-81 was engineered by Paul Volcker, Chairman of the U.S. Federal Reserve. It succeeded in sharply bringing down inflation but left a legacy of large fiscal deficits and high unemployment. The same mistake was repeated by John Crow at the Bank of Canada. Although Alan Greenspan has taken a much more flexible and pragmatic approach towards monetary policy the lingering fear that a rise in real wages would bring uncontrolled inflation resulted in a monetary policy that is totally anti-labor. As a result, notwithstanding years of good economic growth, workers in America have been intimidated by rising interest rates and the risk of unemployment each time there is some sign of an increase in real wages.

Proposition Five:

Policy studies should follow a systems approach or in other words a liberal arts approach, so that students of public policy are made aware of the different needs of society and the full range of costs and benefits of policies.

Social scientists will have done a great service if they succeed in laying bare the

constraints and trade-off choices faced by society. This requires that they illuminate the relationship between key policy parameters and key target variables. This way policy decisions will not be made by default and will be made as a conscious search for the optimal choice.

5. Conclusions

Earlier on we have argued that a compartmentalized view of public policy is likely to make bad policy and have argued in favor of a systems approach to public policy. We cited the example of monetary policy, wherein the single-minded pursuit of price stability to the complete neglect of the human cost of unemployment in the case of the Bank of Canada under the reign of John Crow and in the case of the U.S. Federal Reserve under the reign of Paul Volcker has proved quite devastating to the over all economic and social health of the society. The recent financial crisis in South East Asia provided yet another example. In an attempt to stabilize the exchange rate of local currencies, central banks in Thailand, in Indonesia, and in South Korea raised interest rates dramatically. As a result the overall macroeconomic environment was hardly stabilized.

Having said this, however, it should be noted that “public policy” is a general term and consists of policies spanning a whole range of quite diverse areas. It is, in practice, not possible or practicable for bureaucrats in charge of specific areas to have an idea of the costs and benefits of policies and programs which are remote from their experience and knowledge. A degree of compartmentalization for “local” policy

makers is therefore unavoidable. This does not mean, however, that there cannot be a “policy coordination center.” Just as earlier explained, there have to be tentative “constraints” for each decision making unit where the “constraints” effectively force upon the decision making units the macro consideration imperative. The policy coordination center can adjust for each local decision making agency the constraints that it faces from time to time. The idea of “global budget cap” is a case in point. In health care it is common for the government to assign a global budget to health care (Poterba, 1994) and for the health authority to assign sub-budgets to local health agencies. In the short run the local health authorities take their budgets as given and the health authority also takes its budget as given. But over the longer run the “policy coordination center,” having regard to the total needs of the community, can redefine budgets according to changing priorities.

The logic of “local” policy agencies optimizing subject to “centrally” defined constraints is quite clear. Given the complexity of public policy making involving many policy parameters, some of which highly technical, it is unrealistic to expect a policy maker from the center to make correct local decisions. Similarly, it is unrealistic to expect a “local” bureaucrat/technocrat to take a global perspective and be able to optimize between vastly different policy objectives. We can summarize:

Proposition Six:

The optimal distribution of the policy making authority among different agencies within the public sector and the optimal division of power between the public sector and the private sector provide the institutional framework for the evolution of public policy.

To conclude, we advocate a perspective of public policy that is consistent with the concept of institutional evolution (Vanberg, 1996). On the one hand there is the overriding importance of the “human purpose” for which all institutions and policies are supposed to serve. On the other hand there is a Darwinian process of selection and iteration, which tends in the long run to filter out all inferior policies and institutions. In the short run, policies are made subject to the constraints of existing institutions. Over the longer run, however, institutions also adjust, and all constraints are revised with reference to the total needs of society.

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