

## Economic Reasoning and Social Policy

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### ABSTRACT

There is growing consensus that in the 21<sup>st</sup> century, broad based economic growth with social harmony would be difficult to pursue without progress in social development. This paper focuses on how incorporating economic reasoning in social policy analysis and discussions could assist in improving design, implementation, and assessment of social programs and schemes. Such incorporation could contribute to better societal outcomes and effectiveness of social policies. The paper provides three inter-related frameworks, for thinking about household welfare, for generating fiscal space, and for diagnosing overall economic growth, or for sector specific constraints, which could be applied to specific contexts of social policy. Their application could assist in pursuing social policies in a more systemic and integrated manner, with requisite understanding of the trade-offs involved in social policy choices.

**Keywords:** *social policy, economic reasoning, household welfare, fiscal space, growth diagnostics*

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## INTRODUCTION

I would like to thank the organisers for the opportunity to address this distinguished group of scholars on Social Policy.

There is growing consensus that in the 21<sup>st</sup> century, sustaining a broad-based economic growth with social harmony would be difficult without progress in social development, primarily focusing on health care; education and generation of requisite skill-sets needed by the society; adequate and sustainable social protection system; affordable housing; and community amenities and safety. Social policy thus covers wide range of sub-disciplines, each with its own extensive literature, analytical frameworks and applications, technological dynamics, and institutional and organisational characteristics. Even within each of the sub-disciplines in social policy, there are niche specialisations.

There is extensive literature on the economics of each of the social sector areas indicated above. The objective of this address is not to try to summarise the literature, but to highlight selected economic reasoning concepts that could assist in improving design, implementation, and assessment of social programs and schemes, and thereby contribute to better societal outcomes or effectiveness of social policies. The intention is not to suggest that only economic aspects of social policies matter. The argument is that economic reasoning integrated in the overall analysis can help improve social policy design, implementation, and outcomes. Application of economic reasoning in a context specific manner is not the exclusive domain of economists. It is available to all researchers. Indeed, not all economists use economic reasoning appropriately, so the following analysis is also applicable to them.

A key difference in the economic and non-economic way of thinking is that the latter is more prone to approach choices through 'yes' or 'no' spectrum, while economic reasoning focuses on the margin, 'little bit more of this', 'little bit less of that'. Such method of reasoning makes the necessity for trade-offs an integral part of the reasoning process.

From such reasoning, it follows that it is not monetary amounts spent, but the relationship between monetary and other inputs and outputs obtained, which in turn impact on societal outcomes obtained from such spending, that should be the main focus of social policy analysis and discussions. This makes the analysis inherently more conservative and perhaps less exciting. These characteristics however accentuate the relevance of economic reasoning for social policy.

Application of economic reasoning to social policy and to other areas has been a dynamic not a static process. This is illustrated by the World Bank's World Development Report for 2015. To quote:

*"The title of this Report, Mind, Society, and Behavior, captures the idea that paying attention to how humans think (the processes of mind) and how history and context shape thinking (the influence of society) can improve the design and implementation of development policies and interventions that target human choice and action (behavior). To put it differently, development policy is due for its own redesign based on careful consideration of human factors."*<sup>1</sup>

## HOW ECONOMIC REASONING COULD ASSIST? SOME EXAMPLES

Let me turn to examples of broad areas where economic reasoning could assist in the analysis of social policies and help achieve better societal outcomes from social sector outlays.

### 1. Focus on Societal Welfare To Define Success of Social Policies

Focus on societal welfare suggests that impact of both market and non-market activities on household welfare be taken into account in assessing the impact of social policies (Figure 1). Moreover, household welfare depends on expenditure needs as well as on income available. Thus, social policies on health or home ownership or on life-long skills development could impact on both reduced need for expenditure (e.g. through productive ageing) and potential generation of income (e.g. through giving tuitions in a given area, imparting a specific skill set, or by sub-leasing of homes).

This perspective of reduced expenditure needs and income is also relevant for old age income security in countries at all income levels. Its importance increases when institutional retirement ages are relatively rigid, and do not fully reflect improved work capacities of the aged, as it is not monetary amounts per se which are relevant, but a bundle of services needed and affordable accessed by the elderly. The social policy research thus increasingly needs to focus on identifying what is the relevant bundle of services, and how to create policy and organisational coherence to facilitate their access and affordability.

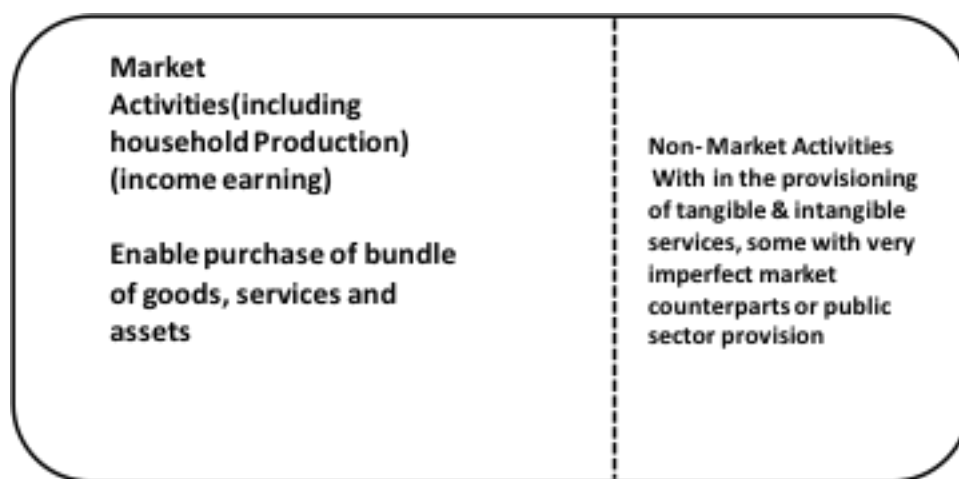
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<sup>1</sup> World Bank, *World Development Report 2015: Mind, Society, and Behavior*. Page 2, Washington, DC: World Bank (2015)

Designing such a bundle of services and turning them into financial product categories is a promising area of research, especially in high income ageing countries. This is particularly urgent research area in de-populating countries of Japan and South Korea.

In low and middle income countries, such as India, where ageing trends are also evident, and where rapid urbanisation and structural changes in the economy, labour markets, and in society are taking place, there needs to be greater professionalism and systemic approach to planning public amenities, improving public health, and designing programs to help the elderly.

*Figure 1. Components of Household Welfare*



## 2. Key Concepts in Economic Reasoning for Social Policy

Below is a partial list of economic concepts relevant for public policies, including social policies.

- Transaction Costs
- Opportunity Costs
- Accounting Vs. Economic Concept of costs
- Cash and Accrual Accounting
- Principal-Agent Issues
- Moral Hazard
- Economic Role of Insurance
- Asymmetric Information
- Adverse Selection
- Learning Curve

- Cost, Value, Price: The Three Pillars of Profit
- Economic Value Added
- Economies of Scale and Scope
- Network externalities

The above concepts find a place in standard textbooks. The art of economic reasoning is to identify relevant economic concepts (not necessarily only from the list given above), understand and assess the interlinkages among them, and then incorporating them in the analysis, including in drawing conclusions and implications.

A social policy analysis, such as for health care or for housing, or education, or evaluating a subsidy program, or compliance with tax, labour, environment, and other rules and regulations, which incorporates only budgetary costs, based on government cash accounting method, and out-of pocket costs of the beneficiaries, is unlikely to be able to fully enumerate economic costs i.e. total value of all economic resources used in a given activity, including opportunity costs. Understanding of full economic costing would improve many social policy schemes and programs.

One of the useful research exercises would be to estimate full economic resource costs (including the civil society's engagement in a program) for delivering one unit of currency to the intended beneficiaries of the program. Its research design would include several of the economic concepts noted above, including the prevalence of exclusion error (i.e. those that were intended to be beneficiaries are included in the program) and inclusion error (those not intended nevertheless are beneficiaries). The economic resource costs of civil society's efforts in a particular program are relevant because of opportunity costs, i.e. these resources could have been utilised in other areas which could lead to greater improvement in societal welfare.

Once relevant estimates are made, their policy implications could be analysed. One relevant economic question is whether the overall societal benefits of the scheme or a program analysed are commensurate with the total resources expended on it? A related economic question is whether alternative schemes or programs could achieve desired societal outcomes with less use of economic resources, and if so, how could current arrangements be moved in that direction. In such an exercise, transition costs of moving from current to desired arrangements become relevant and should be incorporated in the analysis.

Understanding of costs and their dynamics over time is particularly critical in social policy analysis, where what William Baumol has called the cost disease<sup>2</sup>, is quite pervasive. Many social sectors, such as education, health, community services, and waste management have been characterised by Baumol as “stagnant”, implying productivity per worker is difficult to improve, but costs continue to increase in line with the economy’s overall productivity. This increases per unit cost of producing and delivering many social sector services. This phenomenon is termed ‘cost disease’.

One of the ways of addressing the ‘cost disease’ is through being able to take advantage of the ‘learning curve’, a concept of long standing in engineering economics. The learning curve relates input requirements (such as labour hours) to cumulative output over time, thus differentiating from economies of scale that refer to relationship behaviour of costs as output increases at a given point in time.

Feasibility and cost of reversal of existing schemes thus become relevant in assessing a social sector scheme or a program. The type of exercises outlined above are however rare, and represent an opportunity for particularly young researchers in social policy to find new research angles which are largely unexplored.

The above discussion underscores the importance of the quote attributed to John Von Neumann, regarded as the father of modern game theory. The quote is:

*“There’s no sense in being precise when you don’t even know what you’re talking about.”*

The quote suggests the need for conceptual clarity in analysing research questions, and in understanding the robustness of data being used, including analytical foundations forming the basis of data gathering. “How do I know what I know” is always a pertinent question for any researcher. As computing power has grown significantly, and as statistical and econometric tools have become more sophisticated, there is even greater need for corresponding sophistication in analytical framework, and in the data gathering techniques, technology and concepts published by national statistical agencies<sup>3</sup>. Increasing complexity of generating policy relevant socio-economic data has raced ahead of

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<sup>2</sup> Baumol, W. *The Cost Disease: Why Computers Get Cheaper and Health Care Doesn’t*, New Haven: Yale University Press (2012)

<sup>3</sup> This is well illustrated by a recent study on China’s statistical system: Chander, R, *China’s Statistical System: Three Decades of Change and Transformation*, University of Malaya Press, Kuala Lumpur, Malaysia. (2014)

investments in statistical and data collection agencies in many countries. These tensions need to be recognised in research methodology and in drawing conclusions, particularly policy recommendations, in social sector research.

### **3. Framework for Fiscal Space**

For many social sector programs, the usual tendency is to suggest their expansion, with less than rigorous analysis of the opportunity costs involved, and the manner in which fiscal resources are to be generated.

Such a tendency is found in countries at all income levels, but development agencies, including civil society groups, both domestic and international, are particularly prone to mixing advocacy and policy research. It is time to not regard advocates of expanded social programs, particularly in low and middle income countries, as being disinterested analysts. Indeed, a good case can be made that there are many who live comfortably in the name of the poor; and to recognise that policies made in the name of the poor are usually poor policies. This is not to deny the existence of genuine concerns about the poverty and the poor among some development agencies and persons, but as social sector needs far exceed resources, it is all the more necessary to approach social policies not through ‘heart’ alone, but also through ‘head’, necessitating rigorous empirical evidence based analysis.

Let me illustrate the need for a systemic thinking about generating fiscal space from a perspective of contextualising a fiscal framework by referring to study by Ortiz et al<sup>4</sup> entitled “Fiscal Space for Social Protection: Options to Expend Social Investments in 187 countries”.

The study approaches the concept of fiscal space from the advocacy perspective for significantly expanding social sector programs, without considering design, implementation, and actual outcomes of the ongoing social sector programs. It simply enumerates various sources from which government can obtain higher revenue, and assert that government expenditure be re-allocated, usually from defence sector, expenditure on which is inappropriately asserted to be without merit, towards social sector, inappropriately asserted to be of “investment nature”.

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<sup>4</sup> Ortiz, I., M.Cummins, and K., Karunanethy, *Fiscal Space for Social Protection: Options to Expend Social Investments in 187 countries*, Geneva: International Labor Office, Extension of Social Security Series No.48. (2015)

There are three important questions missing from such studies, which is not surprising as their intention is advocacy not analysis.

The first missing question is that whether society's resources devoted to current social sector (and other) programs bring commensurate benefits to the society. The success of a typical subsidy program is when conditions giving rise to its need are substantially mitigated, and therefore subsidy expenditure and beneficiaries exhibit downward trend. Instead, the assumption is that more expenditure on areas of advocacy and more beneficiaries are by definition desirable. As a result, a requisite rigorous analysis of the current social sector programs and current social sector organisations is precluded.

The second missing question concerns discussion of opportunity costs of social sector expansion, and trade-offs among different sources of government revenue generation. Thus, foreign assistance, which is not sustainable or desirable in the long run, is advocated in such studies as one of the options for generating fiscal space.

The third is the neglect of context-specific factors, including political economy of reform in particular countries, well as globally. This is illustrated by advocacy of shifting defence expenditure to social sector programs; significantly reducing fiscal incentives, and proposals for eliminating shifting of tax bases to low tax jurisdictions. This also neglects transition costs, i.e. cost of reassigning allocations from one set of expenditures to a different recommended set.

Analysts concerned with broader development issues however focus on how additional fiscal revenue and expenditure can be generated from such avenues as reprioritisation and efficiency enhancing of and effectiveness of expenditures, domestic revenue mobilisation, budgetary deficits, and in selected countries in the short-run from development assistance. These analysts also emphasise on how these additional resources are used for obtaining better societal outcomes from specific government spending such as on education or health; and how government spending can help in enhancing broad-based economic growth. This suggests that developmental aspects rather than short-term stabilisation aspects are emphasised in such definitions of fiscal space.

Thus, Roy, Heuty, and Letouze<sup>5</sup> adopt the following definition of fiscal space: "Fiscal space is the financing that is available to the government as a result of concrete policy

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<sup>5</sup> Roy, R., A. Heuty, and E. Letouze, *Fiscal Space for What? Analytical Issues from a Human Development Perspective*. UNDP Paper for the G-20 Workshop on Fiscal Policy. Istanbul, 30 June – 2 July. (2007) [goo.gl/IMwtLb](http://goo.gl/IMwtLb)

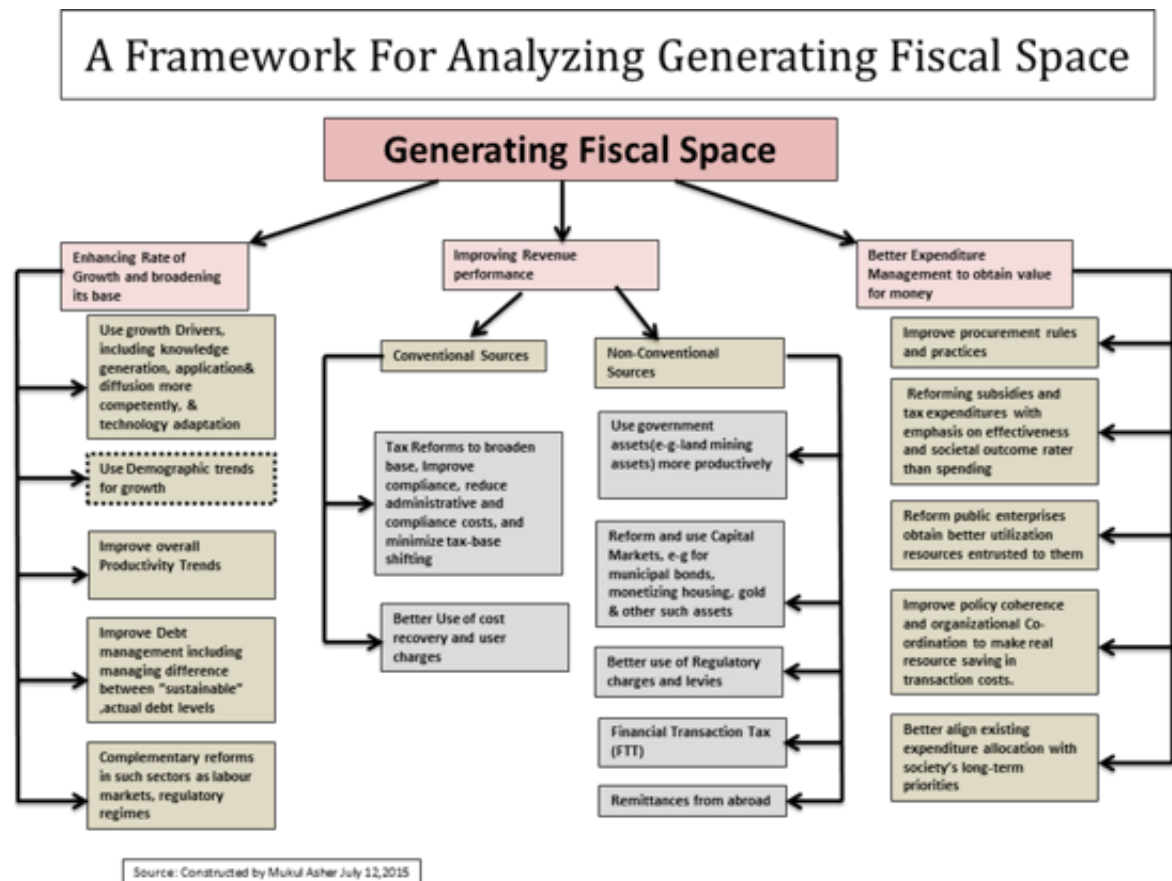


actions for enhancing resource mobilisation, and the reforms necessary to secure the enabling governance, institutional and economic environments for these policy actions to be effective, for a specified set of development objectives.”

Figure 2 provides a possible framework that could be used to think about generating fiscal space in a particular context. The three components of the framework are enhancing rate of growth and broadening its base, improving revenue performance from conventional and non-conventional sources, and better expenditure management to obtain greater value for money from budgetary outlays.

The framework suggests that generating fiscal space in a systemic and integrated manner is a complex exercise. It involves not only flows of receipts and expenditure, but also the balance sheet items. Thus, preparing asset registry of the government organisations, and accounting reforms enabling better understanding of accrued and contingent liabilities are essential pre-requisites for generating fiscal space. The transition costs and reversibility costs are also relevant in this context, particularly when expenditure reallocations are suggested.

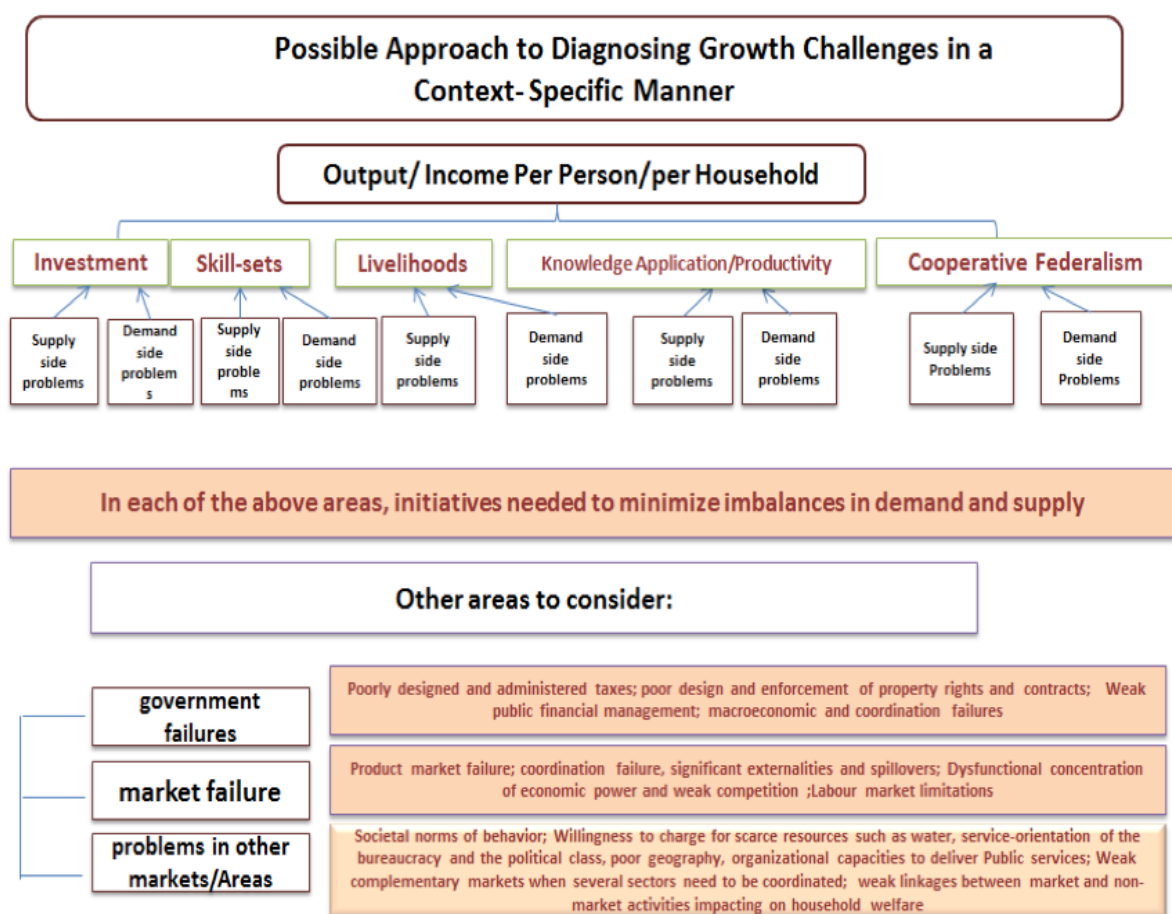
Figure 2. A Framework for analysing generating fiscal space



#### 4. Using context Specific Growth Diagnostics Framework

In many areas of social sector research, and in policy advice by development agencies, including agencies of the United Nations, the term ‘international best practices’ has become quite entrenched. But as Mr. Lou Jiwei, Chinese finance minister, at the launch of new development bank by BRICS nations (Brazil, Russia, India and China), called New Development Bank (NDB) in Shanghai on July 21, 2015, noted, “...development is a dynamic process. There is no such thing as so-called ‘best practices’.”

Figure 3. Possible approach to Diagnosing Growth Challenges in a context-specific manner.



Adapted and modified from Dani Rodrik<sup>6</sup>

<sup>6</sup> Rodrik, Dani. "Diagnostics before Prescription." Journal of Economic Perspectives, 24(3): 33-44. (2010)

The contextual nature of the development process implicit in the above statement is reflected in the diagnostic approach to growth policies in general, and sector or issue specific diagnosis of the steps needed to obtain better outcomes.

The analogy is from medical science, where few vital signs of human body are first assessed to facilitate diagnosis of a patient. Similarly few vital characteristics, focusing on investments, knowledge application, generating productive livelihoods (labour market dynamics has made secure long term jobs with full range of pension, health care benefits less prevalent), developing employable skill-sets, not just for working years, but also during retirement, and cooperative working relationships among levels of government, are used for structuring growth strategies, and for specific sectoral policies, including social sector policies.

The key aspects concern not to permit unduly large imbalances between demand and supply to emerge; and to address government and market failures, and failures in other areas, including improving social norms (e.g. towards better gender equality, or improving public and private hygiene).

As with fiscal framework, growth diagnostics framework also requires context specific strategies, programs, and schemes, with the ultimate objective of improving societal outcomes and enhancing household welfare.

In conclusion, the above examples have attempted to illustrate how incorporating relevant economic reasoning could lead to improved analysis and outcomes of social sector policies.

Thank you.