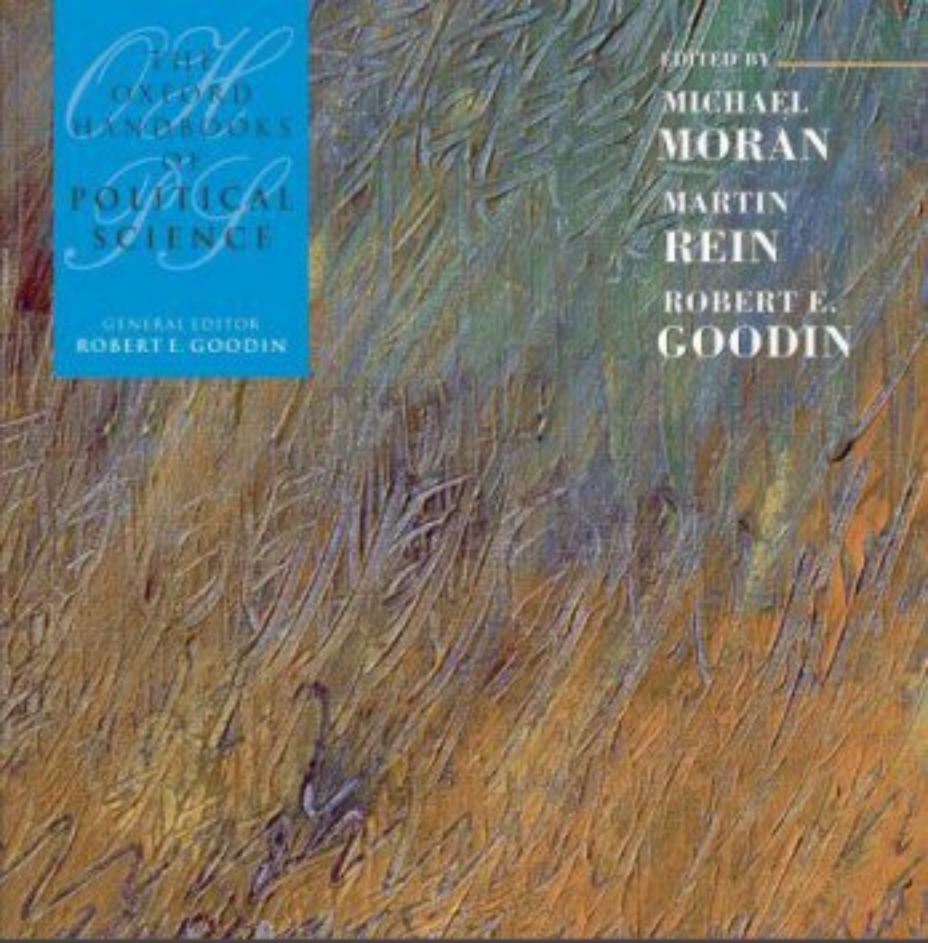

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niques (especially CBA) constitute the primary economic tools used by policy scholars to analyze problems of social choice (Levin and McEwan 2001, 27–8 provide an excellent summary of the various cost analysis approaches). Though readily adaptable to *ex post* policy studies, the most commonly employed cost analysis techniques—especially CBA and CEA—are used almost exclusively as *ex ante* techniques (Boardman et al. 2001).

Essentially, the big attraction of cost analysis is that it offers a way systematically (and its most fervent proponents would argue, objectively) to judge the social worth of alternative policy options. If, for example, policy makers are focused on the problem of high secondary school dropout rates, there will undoubtedly be a constituency for a wide range of responses to this problem: smaller classes, vouchers, more qualified teachers, after-school programs, a back-to-basic curriculum; the potential policy permutations are virtually endless. Given limited resources, which of these alternatives should policy makers pursue?

Such problems of social choice are common in public policy decision making and represent a significant challenge to policy analysts for two reasons. First, there are high levels of uncertainty in *ex ante* analysis. Exactly what a program or policy will achieve is unknown until it is implemented and its outcomes analyzed. Proponents of, say, vouchers may argue their favored policy will result in fewer dropouts, and will cut educational costs with no adverse consequences. Until a voucher system is actually in place and given time to work, however, the empirical merits of such a claim are unknown.

Second, the notion of what best serves the public interest or makes the greatest contribution to social welfare is very much in the eye of the beholder. Partisan or ideological preference—even outright self-interest—can heavily influence perceptions of what policy is judged to be the best use of public resources. Given this, on what objective basis can policy analysts claim to rank the merits of one policy option over another?

Cost analysis is designed to provide one potential answer to this question. Distilled to its essence, the central objective of most forms of cost analysis is to estimate the relative efficiency (of the Kaldor–Hicks variety) of competing policy alternatives. This is practically achieved by calculating ratios of policy inputs to some measure of outcomes. The inputs represent the resources a program or policy consumes, which theoretically (though not always in practice) are valued as opportunity costs. The outcomes represent the expected real-world impacts or performance of the program or policy. The latter are actually translated into economic values using the WTP approach in CBA, though in other forms of cost analysis theoretical purity typically bows to a more rough and ready notion of efficiency (though one still that clearly springs from the Kaldor–Hicks principle). The logic is simple: however calculated, these ratios allow a comparative judgement of which policy option will provide more of the desired outcomes at the least cost. In economic terms, these are viewed as measures of the relative efficiency of the policy alternatives.

In addition to providing a practical basis for calculating the efficiency of policy alternatives, cost analysis can also address (though not fully solve) the uncertainty

problem. Part and parcel of any good cost analysis is an accompanying sensitivity analysis. The latter involves varying input and outcome estimates across some range of reasonable possibilities. This helps assess how robust any estimate of efficiency is relative to the assumptions underpinning the calculation of inputs and outcomes. This does not remove uncertainty from policy analysis, but it does provide a basis for assessing how the unknowns of the future may influence the efficiency of any given policy alternative. In short, sensitivity analysis allows us to capture the potential consequences of uncertainty across the best- and worst-case estimates of inputs and outcomes (Manning, Fryback, and Weinstein 1996; Drummond et al. 1997).

All forms of cost analysis share this basic conceptual approach, and all commonly use market (monetary) values to quantify the input side of ratio. Cost analysis techniques differ mainly on how they attempt to quantify the costs of policy outcomes. The simplest (and most limited) is cost feasibility analysis, which is simply a ratio of the estimated costs of a policy option relative to the resources available. If the ratio of available resources to estimated costs is greater than 1.0, the project is judged to be feasible given the available resources. The main objective of conducting a CFA is simply to assess whether a particular policy alternative is possible given available resources (for an introduction to CFA see Levin and McEwan 2001, 22–6; for an example see Brewer et al. 1999).

Cost effectiveness analysis evaluates policies on the basis of costs relative to some measure of policy or program effectiveness (i.e. a quantitative outcome measure that reflects the relative achievement of the desired policy goal). Dividing costs by the outcome measure yields a ratio that can be interpreted as the cost per unit of effectiveness (good primers on CEA include Fuguitt and Willcox 1999, 276–95; Weinstein and Stason 1977; examples include Quinn, Van Mondfrans, and Worthen 1984; Levin 1988; Weinstein 1996). For example, in the dropout scenario above an obvious effectiveness measure would be the estimated number of dropouts prevented by each policy option in a given timeframe. Dividing the costs of each policy option by the estimated number of dropouts prevented provides an intuitively easy way to rank the options in "bang for the buck" terms (for good introductions to CEA see Levin 1991, 1995).

For programs or policies that share a single objective, cost effectiveness analysis provides an intuitive way to rank alternatives on the basis of their cost effectiveness. The obvious drawback of CEA is that many policies have more than one objective, or at least have more than one expected outcome, and CEA assesses alternatives on the basis of a single outcome. Cost utility analysis offers a partial solution to the problem. CUA assesses the utility of policy alternatives relative to their costs.

The "utility" of Cost Utility Analysis is generally thought of as "satisfaction" or "preference" and is often operationalized by combining a series of outcome or effectiveness measures into a weighted utility score. A good example is the quality-adjusted life year (QALY) that has been used in a number of health research studies. QALY is a utility measure that assesses a medical treatment by looking at how long it extends life and the health-related quality of life during that time. The concept of

QALY allows health researchers to assess medical treatments on a more holistic level than a single outcome (see Drummond et al. 1997; Nord 1999).

By far the most flexible and most commonly used form of cost analysis, however, is cost–benefit analysis (see Haveman and Weimer 2001). CBA was originally developed in the 1930s to aid decision making about federal water resource projects in the United States. The Flood Control Act passed by Congress in 1936 began applying economic principles to policy analysis by requiring federal agencies to calculate the costs and benefits of water resource projects (McKean 1958).

From those beginnings CBA spread to other policy areas and other countries. By the 1960s the British government, for example, was using basic CBA methodology to help inform decisions about transportation investments and nationalizing industries (Fuguitt and Wilcox 1999, 8–9). This general spread of CBA methods progressed through the 1970s, 1980s, and 1990s, its main attraction being its ability to fill a practical decision-making need: "how to assess and prioritize policy alternatives that generate benefits or costs not priced in markets" (Fuguitt and Wilcox 1999, 13). CBA is currently one of the most widely employed forms of *ex ante* policy analysis and is employed across a wide variety of policy fields at all levels of government.

CBA represents the most direct attempt to put the conceptual tools described above into methodological practices. It does this by using the concepts of WTP and opportunity cost to place monetary values on both the inputs and the outcomes of policy alternatives. Once this is accomplished, CBA provides a very straightforward measure of a given policy alternative's economic efficiency. A benefit–cost ratio (BCR) can be interpreted as the monetary units of benefit produced for each monetary unit of cost. Assuming the monetary units are dollars, then, a ratio of 1.0 indicates a project that produces a dollar's worth of benefits for every dollar's worth of costs invested. A ratio above 1.0 indicates a more efficient option, i.e. an option that returns more benefits for every dollar of cost. A ratio below 1.0 indicates an inefficient alternative, one that has more costs than benefits (basic introductions to the methodology of CBA include Boardman et al. 2001; Layard 1974).

In CBA it is also common to produce an even more direct measure of the Kaldor–Hicks notion of efficiency: net benefits. Net benefits are simply the total benefits of an alternative in monetary terms minus total costs. A positive number indicates a project that meets the efficiency threshold set by Kaldor–Hicks, i.e. it is a project where society gains overall.

One of the huge advantages of CBA over other forms of cost analysis is that it can weigh any policy alternative on a common metric of economic efficiency. Thus CBA can be employed to judge the relative merits of projects as disparate as, say, a new road, an after-school tutoring program, and a tax cut. Given that set of choices, which option best maximizes social welfare? CBA has no problem answering this question as long as an analyst can figure out whose benefits and costs should be counted (not a trivial problem—see Whittington and MacRae 1986) and is able to translate the costs and benefits of these programs into monetary terms. Once this is done the economic efficiency of each option is readily calculated and under the welfare economics paradigm the most efficient contributes the most to the social welfare.

As long as the inputs and outcomes of a policy can be reasonably translated into monetary units, CBA thus offers an unparalleled tool to assess the efficiency of various policy options. The rub, of course, is accurately translating the value of things like less traffic congestion and fewer dropouts into monetary terms. There is no shortage of CBA critics who cringe at the notion of putting dollar figures on the worth of clean air, reduced crime, or even life itself. Much of the analytic horsepower used in CBA analyses is expended in estimating the WTP for things that are not traded in efficient markets, things such as clean air and occupational risk.

There are a number of methodologically creative ways to get such estimates. Hedonic pricing, for example, is built on the notion that while we cannot observe WTP for things like the value of green space, we can observe what people are willing to pay for things whose value is partially driven by such non-observables. The price of a house, it is well known, is driven by location. Proximity to a good view or a park will help drive the price of real estate. Given this it is possible to decompose the price of houses in a given geographical area into its constituent parts using basic regression analysis. Market price of the house is the dependent variable, and characteristics of the house (e.g. size, number of bedrooms) and neighborhood (e.g. median income, crime rates), function as independent variables.

It is also possible to include on the right-hand side of the equation things like proximity to a park, the test scores of local schools, and quality of air in the neighborhood. The resulting coefficients can be used to estimate the WTP for the value of green space, a good education, and clean air. Essentially hedonic pricing values things that are not traded in markets by decomposing the values of goods that are traded in reasonably efficient markets (see Rosen 1974 for the theoretical case for hedonic pricing; for primers on techniques see Boardman et al. 2001, 340–4; Lancaster 1966; examples include Uyeno, Hamilton, and Biggs 1993; Smith and Huang 1995).

Other approaches include contingent valuation, which is essentially surveying people on their WTP for goods and services, and market analogy or intermediate good methods. The latter methods rely on estimating WTP by finding some private good that is either analogous to a public good or is actually produced by a public program. An example of the market analogy approach would be using rents charged in the private housing market to put a value on the benefits of a public housing program (for overviews and examples of these and similar methods, see Mitchell and Carson 1989; Bishop and Heberlein 1990; Nelson 1981; Brown and Mendelsohn 1984; Arrow et al. 1992). While these and other approaches can produce the monetary estimates CBA requires to gain its analytical traction, there will always be questions about their reliability and validity (see Self 1975).

For example, can you really put a value on human life (Zeckhauser 1974)? Is the "cost" of a rape to the victim really equivalent to $81,200 (Miller, Cohen, and Rossman 1993)? Is the "benefit" of a day of fishing really $45 (Walsh, Johnson, and McKean 1992)? To literally put a price on being the victim of a violent crime, the pleasure of a day spent with a rod and reel, or even life itself strikes many as requiring a questionable philosophical leap of faith. Is there, quite literally, a market value for everything? If your answer to that question is no, it is unlikely you will be persuaded

by monetary estimates to the contrary, regardless of their underlying methodological creativity or sophistication.

Yet while acknowledging that critics may have a point, CBA has become the Swiss army knife of *ex ante* policy analysis for good reasons. Many of the targets of policy analysis involve things that are reasonably amenable to economic valuation. The benefits of a job training program, for example, can be reasonably monetized by looking at the earnings difference between those who have the training and those who do not. The difference is presumed to be WTP, i.e. the amount participants would want in order to give up the benefits they received from the program. Once costs and benefits are transformed into monetary units, CBA provides the most direct way of assessing any given alternative's impact on social welfare as it is conceived by the welfare economics paradigm.

Perhaps the ultimate defense of CBA is that when costs and benefits can be reasonably quantified in monetary terms it provides a robust and systematic assessment of social welfare. This does not have to be the end all and be all of policy analysis, and does not automatically have to exclude other views from being taken into account. CBA simply represents an effective means of evaluating public policies on the basis of economic efficiency. The latter represents important information when confronting questions of social choice, and CBA along with other forms of cost analysis, are analytical tools well suited to producing that information.

3. Conclusion

There is no doubt that economics, welfare economics in particular, is a primary supplier of the conceptual and analytical tools used in policy analysis. The reason for this is simple: welfare economics makes available a robust set of theoretical and methodological frameworks that are readily adaptable to problems of social choice. A key challenge in policy analysis is coming up with some systematic answer to the question: what should we do? Given scarce resources, and a range of alternatives to address a problem or issue of concern, how can those resources be expended to best serve the public interest?

Conceptually, the welfare economics paradigm answers these questions by starting with a clear notion of what constitutes the public interest. Public interest is conceived of as social welfare, which is nothing more than the aggregation of individual perceptions of their own levels of utility or satisfaction. The normative benchmark welfare economics provides for judging the public interest is this: given a choice of policy alternatives, the most preferred is the choice that maximizes social welfare.

To measure changes in social welfare, the concept of efficiency is employed, which defines a particular characteristic of a distribution of resources. The conceptual

modifications of efficiency, let alone the methodological calculations, can seem complex to those uninitiated into the welfare economics paradigm. Yet the basic idea of how efficiency is practically employed as a benchmark of social welfare is intuitive and can be usefully captured in lay terms: social welfare is improved if a policy or program results in a situation where those who benefit from the policy could, at least in theory, compensate the losers and still come out ahead. This represents a net gain to society, and thus advances social welfare.

Methodologically, the concepts underpinning the welfare economics paradigm are readily translated into applied analytic tools through approaches such as cost analysis. Among the family of cost analytic techniques, cost–benefit analysis represents the most straightforward attempt to measure the economic efficiency of policy alternatives.

There exist criticisms of both the concepts and the methods that point out legitimate limits of the welfare economics paradigm of policy analysis. Other conceptions of social welfare can be formulated that pay greater attention to minority rights, or more egalitarian distributions of resources than the efficiency benchmark of welfare economics. Putting monetary figures on intangibles such as the value of a human life or the worth of clean air may strike some as normative navel gazing regardless of the econometric sophistication that generates such efforts.

Such criticisms, however, should not obscure the fact that a policy analyst's tool kit would be very minimal if these conceptual and analytical approaches were removed. Economics provides the means to generate systematic analysis to inform policy-making decisions. Ultimately the value of these tools is practical: they provide "a hard number . . . of the net value of an investment, project, or activity" (Munger 2000, 376). As long as policy makers and policy scholars see value in knowing such hard numbers on net values, the welfare economics paradigm will continue to provide the tools to get that particular job done.

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CHAPTER 37

ECONOMISM AND ITS LIMITS

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1. Introduction

In its broadest sense, "economism" is the claim that decision makers and theorists have overestimated the contribution that the economic realm can make to policy making. Given a society's limited resources, public policy often requires taking decisions among conflicting desires and goals. How best to make such choices—the "allocation of scarce resources among competing ends"—has troubled analysts for quite some time, and economics has been a sought-after discipline to provide guidance in that endeavor. Government agencies, unlike private corporations do not face the danger of bankruptcy when implementing a policy that is not efficient and often find their budget constraints "softened" (Kornai 1986). While private firms have to minimize their costs due to external market pressures exerted upon them, few such pressures exist for government agencies. Hence, inefficiency tends to be more severe and prolonged than in the private sector (Leibenstein 1966). Given that in some welfare states the allocative sector can be as large as half of GDP and that its administration requires an extensive bureaucracy with a plethora of laws and regulations, the quid pro quo question of how most efficiently to organize it is undeniably imminent.

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Privatization, the paticipation of the private sector in the delivery of public services, and the application of private sector management techniques, discussed in Chapters 24, 32, and 36 in this volume, have been heralded as pointing in the right direction. The incorporation, privatization, marketization, and deregulation of public services and the reassigning of policy responsibility from bureaucratic administrators to the most cost-effective private bidder through "temporary contracts" were seen as methods to ascertain the desired levels of efficiency. They were based on economic evaluation techniques that enabled policy makers to identify, measure, value, and compare the consequences of alternative policy programs.

These economic evaluations can be seen as proceeding through a number of stages. First, for any proposal under consideration, including the option of doing nothing, a qualitative statement of its expected costs and benefits is to be provided. Second, each cost and benefit should be rendered in quantitative form. Third, each quantity should be translated into a common currency (usually monetary values). Fourth, the total expected costs or benefits should be calculated. Finally a decision should be taken on the basis of which proposal produces the greatest sum of benefits over costs, so understood. The first stage seems essential to any rational decision-making process, but each further stage is highly contested.

This chapter will address the difficulties that these phases give rise to in theory and practice. We will do so against the background of the most popular economic evaluation technique currently employed in policy making, that of cost–benefit analysis (CBA). After setting the scene, in Section 2, with a brief outline of the meaning of economism as a term and concept, Section 3 will explore the issues related to the measurement and monetary valuation of the items that are to be included in economic evaluations (what we might call the valuation problem). To be sure, if the methodology of economic evaluations is not to be arbitrary or fetishistic, some connection between the currency of evaluation and human well-being, at least broadly conceived, must be established. After all, the monetary value of a good reflects the strength of individuals' preferences for that good, which in turn is a measure of the welfare provided by it. Implementing this rationale exposes serious weaknesses, however. They must not go unnoticed and require comprehensive exploration. Section 4 will then deal with the problem of comparing costs and benefits across lives (what we might call the commensurability problem), while Section 5 outlines the issue of how the intrinsic value of human beings might be overridden by economic evaluations (the intrinsic value problem). Although these charges can be brought against any policy domain to a greater or lesser degree we will place them into the specific context of health care provision and environmental regulation to make the discussion more tangible. In Section 6 we will then briefly develop some alternatives and propose a set of recommendations that we would want economic approaches to public policy to follow if the pitfalls of economism are to be avoided.