Economic Decision Making

PRIVATE AND PUBLIC DECISIONS

edited by SISAY ASEFA

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PREFACE

This book contains six essays adapted from the presentations made during the seventeenth annual Economics Department Seminar-Lecture Series at Western Michigan University. The theme of the series, which took place during the academic year 1982-1983, was "Applied Economics: Private and Public Decisions."

Applied economics is viewed as a body of knowledge that comprises applications of economic analysis and method to decision making of private and public economic institutions. The objective of each author was to explore applied economics in its various dimensions and to show the relevance of economic analysis to either private economic decision making or to an area of public policy.

The essays in this book are concerned with applications of economic analysis to crucial economic issues in higher education, health care, corporations, agriculture, economic growth and development, and the environment.

In the preparation of this book, I am indebted to the participants in the Seminar-Lecture Series for their cooperation. I wish to thank members of the Economics Department of Western Michigan University, especially professors Werner Sichel and Raymond Zelder, for their enthusiastic support during my efforts in organizing and directing this series. I would like to thank the Dean of the College of Arts and Sciences and the Department of Economics for jointly sponsoring the Seminar-Lecture Series. Particular thanks should be extended to the members of the lectures committee for the 1982-1983 academic year, Professors Myron Ross and Bassam Harik. My thanks also go to the Economics Department secretaries, Becky Ryder and Bonnie Guminski, for their excellent clerical services.

Finally, I sincerely thank the members of my family, my wife, Wegayehu (Mimi), my daughter, Aden, and my son, Beniam, for their patience and understanding during the long hours I spent with the lecture series and the preparation of this book rather than with them.

INTRODUCTION

James Koch discusses the relationship between economics and academic administration. He raises two central questions in his essay: whether there is a distinctly economic way of thinking about and meeting the challenges and problems of academic administration and whether this economic approach is more attractive than other available approaches to academic decision making.

Koch contends that economic analysis does not provide a set of selected answers and conclusions but instead offers a tool kit and method of approaching academic decisions, such as a recognition of alternatives and choices and an emphasis on substitutions and trade-offs to achieve given objectives. He calls for using the concept of opportunity cost, stressing the point that most services provided by universities are not free and the appropriate pricing of these facilities should eliminate inefficiencies in their use. He points out that the use of marginal analysis, in which the additional benefits of each decision alternative are weighed against the costs, can be a powerful tool in academic decision making.

Koch concludes that most of the necessary and useful economic concepts applicable to academic administration can be learned from a good introductory economic theory course.

Paul Feldstein is concerned with the economics of health and medical care. He addresses two related questions: whether the health care sector is likely to expand in the future and whether hospitals are insulated from the economic and demographic factors that affect the growth, maturity, and eventual decline of other industries. He

discusses such factors as the determinants of hospital revenues and costs, the changing nature of hospital markets, and the economic choices facing hospitals and the rest of the health care sector.

According to Feldstein, population growth has a major impact on hospital revenues. He contends that the use of hospitals and other health care facilities by the aged (over 65) has been increasing in recent years. Hospital revenues from the aged are very much affected by government policy, especially the attempt to hold down expenditures on medicare and medicaid programs. Private providers (e.g., insurance companies) are also attempting to lower hospital costs. The effect of these policies will be to limit the growth of hospital revenues.

Feldstein argues that health care and hospital costs, however, will continue to rise due to: (1) advances in medical technology that may increase the cost of medical equipment, (2) the declining percentage of younger age population that may result in a smaller supply of nurses and result in higher wages for them, and (3) the phasing out of government subsidies for capital and health manpower.

Feldstein discusses the changing markets for hospitals and health care. He points out that the larger supply of physicians will compete with hospitals by performing hospital services in their own offices. A higher level of concentration will occur in the hospital sector to realize potential economies of scale from affiliations with other hospitals.

Feldstein notes that in the 1960s and 1970s the demand for health care was high and hospitals were generously reimbursed on a cost-plus basis. Hospitals in the 1980s, on the other hand, will be pressured to adjust to declining revenues and demand, especially in the Northeast and the Midwest.

Feldstein concludes that as hospitals face limited increases in revenues, rising costs, and increased competition, they must make difficult choices, such as hospital merger into large health care and multihospital systems, seeking protection through legislation, and diversification.

Alvin Karchere argues that the standard theory of the firm is more useful in making normative decisions than in describing the behavior of businesses. Even in the normative sense, he notes, the usefulness of economic theory is

somewhat limited because most important business problems are concerned with innovation in manufacturing, management, or product development, rather than with optimization of known demand and production functions. He disagrees with John Kenneth Galbraith's view that corporations do not operate within the market system, instead controlling the economy through planning mechanisms. He agrees with Herbert Simon's and Gunnar Eliasson's notion that corporations are satisficers rather than optimizers. He considers Baumol's theory of contestable markets to be useful in defending and modifying the standard theory of the firm. According to Baumol, a situation similar to perfect competition exists in a contestable market because of the threat of entry by potential competitors.

Karchere, while considering the concept of the contestable market a useful idea that needs further research, points out that Baumol's assumptions are as unrealistic as the assumptions of the original standard theory. He suggests that the application of the contestable market concept to international trade, which implies trade barrier removal that increases potential competitors and thus enhances economic welfare by creating greater efficiency and innovation, adds very little to the conclusion reached by traditional international trade theory.

Earl Heady deals with the potentials and restraints of world food production, pointing out that as long as the world experiences oscillating transitory patterns and food cycles, sustained long-run solutions are unlikely.

In his assessment of world food production restraints, potentials, and policies, Heady evaluates six sources of increasing world food production: (1) increasing yield through improved technologies; (2) intensive use of currently cultivated land through multiple cropping and other related methods of efficient utilization of available rainfall and solar energy; (3) bringing uncultivated land into production; (4) preventing against crop losses to rodents, birds, and spoilage; (5) diverting greater proportions of grain from livestock consumption to human consumption; and (6) producing more food from sea and ocean resources.

The diverting of world grain production from livestock to human consumption is difficult and controversial, according to Heady. It implies shifting grain consumption from rich countries, where per capita consumption of grain through meat is high, to poorer countries, where it is

low. The most promising source of increasing food production in developing countries is through land already cultivated. If developing countries could raise their land productivity to the level of developed countries, world food production could be increased by 67 percent.

Heady contends that many developing countries, although threatened with future food shortages, tend to adopt policies that undervalue agriculture. This is reflected in policies that depress prices to farmers in order to reduce retail food prices for urban consumption and that keep input prices high and impose taxes on farm exports. He argues that policies of some developed countries also have adverse effects on agricultural productivity of developing countries, such as the United States' P.L. 480 program.

According to Heady, realization of potential sources of food production, which depends on removing restraints, does not involve new and mysterious processes but rather the effective execution of processes already known and practiced in agricultural research and a conducive administrative and political climate in developing countries.

Heady warns that producing enough food to keep up with population growth, as well as eliminating existing global malnutrition, over the next thirty years will not solve the even longer run problems of population growth over the next hundred years. The means of dealing with this controversial issue must include, in addition to current educational and technical birth control methods, increased per capita income, adequate social security or old-age pension programs, and the further improvement in the education, employment, and socioeconomic participation of women.

Heady is cautiously optimistic about future world food production. He considers the socioeconomic policy restraints to be more crucial than the physical restraints and believes that in order to increase world food production over the next thirty or forty years it will be necessary for developing countries to remove all policy restraints that depress incentives to use more purchased farm inputs, that interfere with trade, or that discourage investment in agricultural resources and personnel.

Robert Dorfman addresses the underlying ethical standards of environmental laws and their effect on the national effort to protect and improve the environment. He contends that indecisiveness and confusion in implementing

environmental laws originate from two contradictory standards that the government is trying to work under simultaneously, the natural rights doctrine and the principle of utilitarianism. The essence of the doctrine of natural rights is that every person has certain inherent and inviolable rights (e.g., life, health, sanctity of property) that cannot be legitimately invaded by the government for the benefit of others. The principle of utilitarianism implies that it is the right of the government to take action to increase the public welfare.

The inviolable natural rights are the rationale for environmental regulations (e.g., the Clean Water Act), which protect an individual's life, health, and private property from contamination by pollutants and other toxins. Utilitarianism, however, is clearly implied by the benefit-cost goals of the Water Resources Act.

Dorfman argues that most legislators believe in both principles, to varying degrees. Therefore, government regulations in general and environmental laws in particular are written to implement contradictory ethical principles. He presents three examples of environmental legislation that illustrate the problems that arise: the Clean Water Act, the Clean Air Act, and the Toxic Substances Control Act. Dorfman argues that benefit-cost analysis alone is insufficient to resolve the conflicts in the principles, because monetary values cannot be placed on natural rights.

Borrowing a concept from philosopher John Rowls who classifies social goals into primary and secondary values depending on whether they concern natural rights or the public welfare, Dorfman proposes a decision-making approach for the EPA. He would like to see the agency perform standard benefit-cost analyses by keeping track of the extent to which natural rights are invaded and then judge whether the superior economic choice is advantageous enough to justify any infringement on individual rights.

Arnold Harberger begins with three general points: (1) economic science can be useful in various kinds of political environments and ideologies; (2) trade-offs occur when people give up economic goals in order to achieve political and social ones; and (3) policymakers may be forced to accept inferior economic solutions because of political realities.

The remainder of Harberger's essay is devoted to an application of economic analysis to the economic growth of

developing countries. He notes that development economics in the 1950s was heavily influenced by the Harrod-Domar models and "surplus labor" theories that placed physical capital as the only constraint factor to economic growth. The result was an outgrowth of misguided policies with little relevance to the economic realities of most developing countries. He believes that modern development economics recognizes the complexity of the growth process and does not succumb to the naive oversimplifications of the 1950s. Among the factors that influenced this new view of economic growth, according to Harberger, are the modern theory of economic growth and the theory of effective protection, which call for the liberalization of trade and the equalization of tariff rates.

The modern theory of economic growth, Harberger contends, is an application of the neoclassical theory of marginal productivity, in which the national income growth is divided into contributions of labor, capital, and a residual factor.

Harberger points out that development economists have gained experience and learned some modest lessons, such as the limitations inherent in large macroeconomic, input-output, and sectoral planning models; the limitations in using taxation as a means of improving income distribution; the fact that fulfilling basic needs may be more reliable than income distribution as a guide to economic policy; and the fact that under certain circumstances potential efficiency can be gained from public enterprises. When comparing recent successes and failures in many developing countries, he finds that the successful countries consider the economic growth policy decision to be a technical problem of doing the right thing, while the unsuccessful countries tend to be entangled in political and ideological problems.

Harberger argues that a sound economic policy is one that leads private decision makers in the direction of socially desirable action, while recognizing the complexity of the growth process. This may be accomplished by making private benefits and costs as close as possible to social benefits and costs and by using government policy to offset negative private externalities. He stresses the importance of human capital formation as one of the best prescriptions for the long-run economic growth of developing countries.

CONTENTS

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1 *The Economist and Academic Administration*

JAMES V. KOCH

The relevance of economic analysis to the administration of higher education has always been a matter of some dispute. In the eyes of many academics, the field of economics has dealt with the baser and less attractive aspects of human existence. The oft-quoted judgment of Carlyle that economics is the dismal science continues to hold sway in many academic precincts. By inference, economists themselves have often been considered to be proponents of a secular Philistinic religion antithetical to the humanistic ideals that underpin a liberal education. The lament of Edmund Burke that the age of the "sophister, economists, and calculator" has dawned still has currency in much of the professoriate (Samuelson 1973, 1).

The typical academic notes that the profit-maximizing assumption underpinning many economic models is substantially inappropriate to the world of higher education. Also, most academics have greeted with hostility the introduction of modern management techniques often associated with economists (for example, zero-based budgeting). Further, as scientific philosophers some economists are logical positivists who, when their attitudes are especially hardened, aver, "If you can't measure it, it's not worth knowing about" or even "If you can't measure it, it doesn't exist." Such philosophic positions, when combined with the propensity of some modern economists to engage in highly abstract and quantitative analyses, have led to skepticism in the academy about whether economists have any special competencies to contribute to academic administration. As a consequence, economists have often been banished to the most remote rooms of the academic house, to be summoned to academic administration posts only when

they are perceived either to ignore or to reject the reputed postulates of their academic discipline.

Two questions will be raised in this chapter: Is there a distinctively economic way of thinking about, and meeting, the problems and challenges of academic administration? and Is the economic approach to academic administration more or less effective than other approaches that are available? To answer these questions we must establish what economics is all about, hastening our progress in that direction by specifying what economics is not.

A TOOL KIT, NOT A SET OF PROBLEMS AND SOLUTIONS

While there are many different views concerning what the field of economics is all about, an increasingly popular view is that the study of economics is designed to furnish a way of analyzing and thinking about choice situations so that intelligent decisions can be made. The study of economics is not designed to produce a canned set of answers concerning what decision makers should do, or a list of policies, which if pursued by a university president will always lead to good results. It is of course true that economists, fledgling and otherwise, generally hold opinions about which economic policies should be followed in certain circumstances. However, as Keynes once noted, "Economics does not furnish a body of settled conclusions....It is a method, rather than a doctrine, an application of the mind, a technique of thinking which helps its possessor to draw correct conclusions" (McKenzie and Tullock 1978, 500).

The manner in which economists think about making choices, the assumptions that they make in so doing, the models that they utilize to generate explanations and predictions, these are the tools in an economist's kit. It is this kit of tools, and not specific subject matter, that seemingly differentiates the economist-administrator from other administrators. For example, it is apparent that many fields of study examine issues such as the appropriate level of tuition to charge students or the effects of released time on research productivity. Economist-administrators are not distinguishable from other administrators on the basis of the issues confronted and examined; rather, they are arguably unique in the way that they approach and solve these problems. (We must bear in mind that neither knowledge as a whole nor academic

disciplines in particular are so rigidly compartmentalized that we can realistically state that the attitudes and approaches we attribute to economists are not sometimes characteristic of other academic disciplines. But just as surely as we live in an intellectual age of multidisciplinary endeavors and borrowing of knowledge across disciplinary lines, so also we operate in a milieu in which disciplinary specialists are in fact trained rather narrowly and often rigidly in their graduate programs. For example, very few Ph.D. degree programs in economics involve more than a smattering of course work in fields other than economics. Hence, a specific academic discipline acquires logics, attitudes, rites, and even people peculiar to the confines of that discipline. This helps us explain why the "tribe" we call economists is reasonably separate and distinct in terms of its attitudes and approaches to problems.)

DISTINCTIVE ECONOMIC ATTITUDES AND THEIR EFFECTS ON ADMINISTRATION

The following five different attitudes and approaches, which are characteristic of economics, can result in a differentiated style of academic administration.

Alternatives: There Nearly Always Are More Than We Think

Economic analysis stresses that in almost any situation there are a variety of ways to accomplish a specific goal. The task of the economist is to identify those alternatives and then to assess accurately the costs and benefits associated with each. What the economist does is to construct what might be considered a menu, complete with pictures and prices. Customers (decision makers) can then choose what they wish to purchase.

Academics (the author included) are often guilty of ignoring or failing to consider relevant alternatives. Consider the faculty member who desires a salary increment higher than the 5 percent provided by the state legislature. He or she typically regards as retrograde and unthinkable any suggestions that a larger salary increment of, say, 10 percent, might be generated by decreasing the size of the faculty. Many faculty members talk with a disapproving air about suggestions of this sort, which they view as requiring the "cannibalization" of worthy colleagues. Yet; the mean student/faculty ratio in