

Introduction to Public Policy

Lecture Note 2

Public Policy and Critical Thinking

Public Policy as an academic discipline is still very new in the United States, and in most other countries it is just getting started. Public policy “schools,” including the Harvard Kennedy School, were first established in the 1960s. This was a time of great optimism about the positive influence of “technocrats” on the policy making process. These highly trained social scientists, including economists, political scientists, sociologists and lawyers, would make policymaking more rational and effective. One of the main objectives of the new policy schools was to train these technocrats in preparation for public service, which would enable government agencies to be more scientific in their approach to policy making.

This view was expressed most clearly in one of the pioneering texts of the era, Harold Lasswell’s *The Policy Sciences* (1951). Optimism surrounding the role of technocrats reached its zenith under President John F. Kennedy, who appointed a number of academics and leading business people to his cabinet. The most famous of these new technocrats was Robert McNamara, who applied the information management strategies that he had used to run the Ford Motor Company to the US Department of Defense. Under President Lyndon Johnson, McNamara was a leading proponent of the war in Vietnam. He eventually turned against the war and resigned from the administration (he was then appointed as President of the World Bank, a post he held for more than a decade).

McNamara’s failure to understand the historical and political context of the conflict in Vietnam points to the great weakness of the technocratic approach to policy: policy is ultimately *political*, and situated in a concrete political, cultural and historical context. Good policy therefore requires more than the principles of economics, sophisticated information management and rational decision-making processes. It requires a capacity for critical thinking, in other words the ability to examine the assumptions underlying an idea, a policy proposal or a scholarly argument.

What do we mean by critical thinking? In its essence, critical thinking means the ability to view a situation or a problem from more than one perspective. We all have a point of view or a set of beliefs and opinions that we have arrived at based on our background,

life experiences and professional training. Critical thinking means our ability to question our own beliefs and opinions, not just the beliefs and opinions of others. As a simple example, many Indonesian people believe that if you ride a motorcycle without a jacket a “bad wind” will enter your body and you will become ill. They call this illness *masuk angin*, which means “the wind has entered.” I know many highly educated Indonesians who would never get on a motorbike without a jacket even on a hot and sunny day for fear of coming down with *masuk angin*. Perhaps they have evidence from their life experience that indicates to them that riding a motorbike without a jacket will make them ill, and these experiences have confirmed their belief in *masuk angin*. Modern medical science does not recognize this disease. But perhaps we need some careful experimentation and investigation before we reject the idea. Not only do Indonesians need to critically assess their belief in *masuk angin*, foreigners must also critically assess our belief that it doesn’t exist!

Critical thinking requires that we closely examine our own assumptions. When we analyze policy we make many kinds of assumptions, but this morning I would like to focus on four types:

- Assumptions about evidence: What kind of evidence do we need? Is our evidence partial or complete? Is it accurate?
- Assumptions about causes: What are the causes of an economic or social problem? How did we wind up in the present situation?
- Assumptions about solutions: How do we solve our present problem? Which remedies work and which do not?
- Paradigmatic or structural assumptions: Are the categories or theories that we use to understand the world the appropriate ones? What counts as legitimate knowledge? How do we identify false statements? Who decides what is true and what is false, and on what basis?

Of these, paradigmatic assumptions are the most difficult to assess because doing so requires us to challenge our own worldview and most basic beliefs.

Let’s explore these different kinds of assumptions in the context of a concrete policy case. On August 12, 2010 the Ministry of Finance issued Circular 122/2010/TT-BTC on the registration and regulation of milk prices. The new regulations empower the Minister of Finance and Chairmen of Provincial People’s Committees to “apply price stabilization measures” when domestic prices rise faster (or fall slower) than input costs. Producers, distributors and retailers of milk products must register prices when the goods are first put on the market and whenever prices are changed. Companies found to be in violation of the regulations are subject to warning, fines, revocation of business licenses and other administrative penalties.

The political motivation for the new policy is the government's desire to respond to public concerns over the prices of infant and child milk powder. Over the previous three years Vietnamese newspapers had run numerous stories about the rising price of baby formula. For example, in April of 2009 a number of stories appeared claiming that Vietnam's milk prices "are the highest in the world," a charge that was repeated on the Communist Party of Vietnam website. The focus on milk prices can be partly explained by the surge in international milk powder prices in 2007 and 2008, which passed through directly to domestic prices given Vietnam's dependence on imports. Yet when world prices retreated in 2008 and 2009, milk powder prices remained high, fueling suspicion that consumers were being over-charged for milk products.

Many of these newspaper stories failed to critically assess the quality of the evidence used. The claim that Vietnam's milk prices were the highest in the world was based on opinions rather than established facts. The source for the *Vietnamnet* story shown in the slide was Mr. Raf Somers, Chief Technical Advisor of the Vietnam-Belgium Dairy Project. According to *Vietnamnet*, Somers stated at a conference in Hanoi that while milk prices in Europe and South America averaged from USD0.50-0.90 per liter, prices in Vietnam were on the order of USD1.10. Nowhere in the article does Mr. Somers state that Vietnam's milk prices were the world's highest.

Similarly, the *Saigon Times* newspaper quotes a claim by Ms. Vu Thi Bach Nga, Head of the Consumer Protection Division of the Ministry of Industry and Trade's Competition Department, that domestic milk prices were twenty to sixty percent higher than in neighboring countries and may be the highest in the world.¹ No evidence was provided for this claim.

Claims such as these, if repeated often enough, tend to take on a life of their own. But they are not a solid basis on which to make policy. Vietnam's domestic milk prices are in line with other milk importing countries in Southeast Asia. Heavy reliance on imported milk means that fluctuations in international prices are passed directly to Vietnamese consumers. This was not a major issue during the first half of this decade when international milk prices were stable and relatively low. However, from late 2006 global prices began to rise sharply, reaching their peak in October 2007. At that time the international whole milk powder price exceeded \$5,000 per ton. Although prices subsequently fell during the world financial crisis of 2008/09, prices have since recovered in US dollar terms. The graph also illustrates the role of exchange rate movements in the determination of domestic milk prices. Successive rounds of currency depreciation have weakened the dong against the USD. Thus in VND terms, imported milk powder is now nearly as expensive as it was when international prices reached

¹ Thoa Nguyen (2009) "Vietnam's Milk Prices Stunningly High," *Saigon Times Daily*, July 9, <http://english.thesaigontimes.vn/Home/business/other/5371/>.

their peak in October 2007. It is likely that most of the “excessive price rises” cited in the press can be traced to this combination of raw material prices and currency movements.

Fulbright School researchers conducted a simple test of the proposition that domestic milk prices in Vietnam fall within the expected range for Southeast and East Asian countries. We selected one major city in each country and recorded manufacturers suggested retail prices for popular products. We used only one major retailer in each city, and we did not include special promotions and other discounts. We then converted these prices into US dollars using market exchange rates. Price information was taken from published advertisements, store websites and direct observation (in Jakarta, Ho Chi Minh City and Singapore). We found that prices in Ho Chi Minh City do in fact fall within the range of those in other major cities in the region (Jakarta, Bangkok, Singapore, Shanghai and Hong Kong). On the whole, our hypothesis was confirmed: prices in Vietnam were higher for some products and lower for others, although not markedly different from regional norms.

The articles also make *causal assumptions* about milk prices in Vietnam. They assume that milk prices are high because foreign companies are making unacceptably large profits. But there is a problem with this causal assumption everyone recognizes that there are many competing brands of infant milk in Vietnam, and that the largest producer is a domestic company. If there are so many competitors, and indeed a large domestic competitor, then why would consumers pay high prices for foreign milk? Is it just a simple problem of foreigners cheating Vietnamese consumers?

Asymmetric information is another possible cause. Buyers do not know as much about the quality of milk products as sellers. Scandals like the discovery of melamine-tainted milk in China heighten public fears that some producers are willing to market unsafe or unhealthy products. *Screening* is not an option for consumers acting on their own since it is neither feasible nor cost effective for them to subject all of the milk products that they consume to laboratory tests. The government has a clear role in providing screening services as a public good, but this assumes that consumers trust government inspectors to act in their interests.

Sellers, for their part, can *signal* higher quality in several ways. The most common form of signaling is to invest in building the company’s brands. In the so-called fast moving consumer goods sector—which includes dairy products—a strong brand is more valuable than any other form of capital that the company possesses. The government’s current policy is to discourage spending on advertising and promotional activities. Under the Law on Corporate Income Tax, corporations can only receive a tax deduction on advertising expenditures up to ten percent of gross revenue. Beyond this limit, spending on advertising comes directly from profits. The impact of the ten percent cap is to increase tax revenues and reduce corporate profits. A simple simulation can help

illustrate the effects of the cap. Imagine a firm facing fixed costs and earning a 30 percent rate of return on investment from its existing market share. In the initial position, the company spends only ten percent of revenue on advertising and promotion and therefore is not penalized by the ten percent cap. At this level of spending the effective rate of corporate income tax is 28 percent. Now imagine that in order to protect its market share, the company must now spend 18 percent of revenue on advertising and promotion. This raises advertising and promotion spending above the ten percent cap, and as a result increases the company's effective corporate income tax rate to 40 percent (see graph). As shown in the figure, if advertising and promotion spending reaches 32 percent of revenue the effective rate of taxation is 100 percent.

In addition to brands and advertising, producers use pricing as a means of *signaling*. A well-established literature in economics has shown that consumers interpret higher prices as a signal of superior quality and lower prices as sign of inferior quality.² Faced with limited information about outwardly identical products, consumers often choose the more expensive brand under the assumption that higher price implies the use of higher quality inputs (and that lower price implies less commitment to quality). What is more, behavioral studies have established that consumers express greater satisfaction when they pay more for a good or service. In other words, in addition to interpreting higher price as a signal of superior quality, consumers are also more satisfied with products that they have paid more to obtain.³ We tend to derive more enjoyment from an expensive glass of wine than a cheap one regardless of the actual taste of the wine. Part of the joy of owning a designer handbag is knowing how much it cost.

This may sound like irrational behavior, and perhaps it is. Yet Vietnamese press reports confirm that consumers interpret price as a signal of quality. In one report, a woman in Ho Chi Minh City remarked that she had switched from cheaper to more expensive milk for her one year old son because she worried less about the quality of more expensive products. Another mother had read newspaper stories about high milk prices, but continued to buy expensive products. She summed up her decision as follows: "You get what you pay for."

In addition to information about the quality of dairy products, consumers in Vietnam also lack adequate information about relative prices. As a result, prices vary considerably even within one region or city. To test the hypothesis that prices vary significantly across retail outlets, we organized a small survey of infant and child powdered milk prices in Ho Chi Minh City. We visited twenty-five shops in twelve districts of the city and recorded the prices of popular infant and child powdered milk products. The results of the survey confirmed our expectations. Prices varied widely for

² For a survey see Kyle Bagwell and Michael H. Riordan (1991) "High and Declining Prices Signal Product Quality," *American Economic Review*, 81:1, 224-239.

³ Baba Shiv, Ziv Carmon and Dan Ariely (2005) "Placebo Effects of Marketing Actions: Consumers May Get What They Pay For," *Journal of Marketing Research*, XLII, November, 383-393.

identical products depending on where they were purchased. For some products prices differed by as much as 250 percent. Some of the smaller shops that we visited were competitive, offering to match or beat prices offered elsewhere. For the most part, supermarkets offered lower prices and more choice than small, local shops.

If asymmetric information is the cause of high prices, then the prescriptive assumption that price controls will lower prices for consumers is not accurate. What is the likely impact of price controls if the cause of high prices is asymmetric information rather than greed?

Finally, the milk price controversy should lead us to question the government's paradigmatic assumptions regarding market behavior. Clearly the government believes that companies price their products by summing up the costs of inputs and adding in their profits. But is this a good assumption or is it a legacy of central planning?