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Making Sure Economists Do More Good than Harm

Professor Frank J Convery, Chair Publicpolicy.ie and Senior Fellow, University College Dublin

Economics is the science of choice. The job of economists is to take away the punch bowl just when the party gets going. It's perhaps the only field where, the more they get it wrong, the more their services are in demand – perverse incentives on a grand scale.

In Ireland, the Minister for Public Expenditure has announced that his department will be hiring economists to support its work. Around the same time, Richard Tol resigned from the Economic and Social Research Institute (ESRI) to take a post at the University of Sussex. As he packed his bags, with a series of interviews and tweets, he left a characteristic trail of trenchant and indiscriminate criticism of the ESRI and how it works. This conjunction of events raises the question: what qualities should the department look for?

We can learn a lot from a key piece of evidence that appeared recently on the failure of the profession at the highest level in the US. The committee of the Federal Reserve - which consists of the Governors and Presidents of 12 regional banks – meets every six weeks to review economic performance and chart future economic policy. Its deliberations are recorded and transcribed, and these are released after a 5 year delay. In the New York Times, January 13, 2012, Binyamin Appelbaum ('Inside the Fed in '06; Coming Crisis, and Banter' pp. A1, A3) reviewed what committee members said during 2006, and what their remarks implied.

They all failed to join the dots, to link the performance of the housing market to the financial system.

A few examples:

Timothy Geitner (then president of the Federal Reserve Bank of New York, now Secretary of the US Treasury) in September 2006:

"We just don't see troubling signs yet of collateral damage, and we are not expecting much."

And in December 2006.

"We think the fundamentals of the expansion going forward still look good."

Janet Yellen (then President of the Federal Reserve Bank of San Francisco, now Vice Chair of the Federal Reserve) in September:

"Of course housing is a relatively small sector of the economy, and its decline should be self-correcting."

According to Appelbaum, they also were convinced that financial innovations, by distributing the risk of losses more broadly, had increased the strength and resilience of the system as a whole. This latter proposition - that risk was somehow taken care of – has turned out to be spectacularly wrong, recalling Keynes' insight:

"The ideas of economists, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else."

We had of course our local versions of professional and policy failure, given cover at the time by the complacent choirs of the IMF, ECB, OECD and the ratings agencies. So what does this mean for the government as it sets about hiring economists?

What qualities should they look for?

Technical expertise is essential, but it is not enough. The US Federal Reserve team was the best and the brightest; to have them fail so spectacularly means that being smart and trained at the best universities in the world is not enough. Indeed, to the extent that this results in hubris and self-regard, it can be damaging.

The ability to not only question the conventional wisdom, but to be encouraged to do so, is essential. The case of Morgan Kelly, a Professor of Economics in University College, Dublin who took his PhD in Yale University, is instructive. He highlighted the likely catastrophe implicit in the Irish housing market, even though, as he put it

This isn't my day job. I was working on medieval population theory' (to Michael Lewis in 'Boomerang – travels in the new third world', WW Norton, 2011, p. 92); the outsider who has the skill, credibility and self-confidence to question insider conventional wisdom can be invaluable.

Persistence is key. One of Richard Tol's criticisms of the ESRI does stand up: even though John Fitzgerald and others had cogently identified the potential for a housing bubble, this message was not prioritised and highlighted with vigour and persistence; it got lost in the sea of other outputs.

What should the economists who are recruited do?

- Focus on issues and ways of working that are likely to yield large benefits relative to the costs. Credibly estimate the costs (capital and operating) per unit of output of delivering public goods and services. It's very hard to have an informed debate about expenditure when we don't know what things cost.
- Identify incentives, risks and who carries them associated with current policy and new policy choices. Undertake *ex post* analysis of policies already implemented. Learning from the past is the first step towards good decisions.
- Apply the 'polluter pays' principle. This generates income and protects the environment and natural resources.
- Give fairness explicit attention in assessing tax and expenditure options. This will also help to defuse the 'we are all special cases' syndrome.

Finally, make all of this information available to the general public.

This will help ensure that the economists we pay for do more good than harm.