The Eric John Hanson Memorial Lecture Series
Volume III, Spring 1989

The Political Economy of Economic Advice

by
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Research School of Social Sciences
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May 18, 1989
Foreword

The Eric John Hanson Memorial Lecture Series recognizes the many contributions made by Dr. Eric Hanson to the University of Alberta and to the wider community. Eric Hanson taught at the University of Alberta from 1946 to 1975. He was Head of the Department of Political Economy from 1957 to 1964, and was instrumental in building our department. Many of us have benefitted from his dedicated efforts and his wisdom.

Professor Cliff Walsh of the Australian National University presented the third lecture in the Hanson series entitled The Political Economy of Economic Advice -- a topic that Eric Hanson would surely appreciate. Besides making numerous scholarly contributions, Cliff Walsh has advised a variety of government committees and business interests. Most notably, he served for two years as principal economic advisor to Australian Prime Minister Malcolm Fraser. Since then he has returned to his academic career and is now the Director of the Centre for Research on Federal Financial Relations at the Australian National University in Canberra.
The Memorial Lecture Series has been financed by matched endowment contributions from Eric Hanson's friends, colleagues and students, and by a most generous gift from the Alberta Municipal Financing Corporation, arranged by its President, Mr. Chip Collins.

Melville L. McMillan
Department of Economics

Previous Lectures

1. Tax Reform Options for Canada
   by John Whalley
   University of Western Ontario

2. The Work of Canadian Monetary Policy
   by John W. Crow
   Governor, Bank of Canada
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Introduction

I am greatly honoured to have been invited to give the third annual Eric J. Hanson Memorial Lecture. I intend to use the occasion to air publicly some views about problems created by how economists go about offering policy advice. To whet appetites a little while I go through some preliminaries, let me indicate my central argument. I submit that, as typically formulated, economic policy advice — indeed, policy advice given by most professionals — is not only often irrelevant to those who receive it, but also sometimes can be positively dangerous for society as a whole. I also argue, however, that we can make it more relevant and less dangerous without becoming mere "policy prostitutes". I will weave in, by way of illustration, some recent Australian experiences.

Some Preliminaries

Fifteen years ago, I was awarded a Visiting Killam Fellowship at Dalhousie University. The research I pursued on that occasion would, I suppose, seem moderately esoteric to the non-economist — and perhaps even to some economists. It concerned analysis of "market provision of price-
excludable public goods". I will not attempt fully to explain what they are. It is enough to say that among the best examples of price-excludable public goods is knowledge or information which, once created, in principle can be used fully and simultaneously by everyone, but the dissemination and use of which is restricted through the application of patents or copyright laws.

The question of whether patent and copyright laws help to maximise the social benefits from the potential creation of new knowledge is surely an important policy issue. By allowing patents and copyrights to be applied, we inefficiently restrict the dissemination and use of "new knowledge" once it is created: but without them, the incentive to create new knowledge is severely reduced. The challenge lies in finding the right balance between establishing incentives to be creative and ensuring maximum use of new ideas once created.

The models I was involved in developing perhaps could have helped throw new light on this important policy issue. At that time, however, I was not too interested in exploring the policy angle. My fascination lay instead in the unusual structure of models of the way markets handled such goods and services, and in the peculiar results that could emerge. Who could fail to be fascinated, for instance, by the fact that for price-excludable public goods and services, when costs permanently increase, prices charged to users might permanently fall? I certainly was, and I admit that, in part, I was encouraged to be so because that is the stuff of which articles in top professional journals are made.

In case anyone thinks I am about to attack theoretical model building, let me
assure you I am not. We need more of it. The theory of comparative advantage tells us that younger, analytically sharper minds should be the ones to specialise in just such work. My problem, rather, lies with what is regarded as sound policy analysis. Let me proceed to explain the problem by way of what may seem a slight digression.

My second and third visits to Canada occurred in 1981 and 1982. On both occasions I was travelling as Principal Economic Adviser to the then-Prime Minister of Australia, Malcolm Fraser.

When I first was approached to take on the role, I was extremely reluctant. I had no connection with party politics as such; I suspected it would be more demanding, exhausting and frustrating than I cared for; and I also suspected that my professorial rank was being sought to give status to the economic advisory component of Prime Minister's Private office. Independent professional advisers in Private Ministerial Offices, in Australia, were still a relatively new phenomenon at that stage, and the Prime Minister had not previously had a full-time economic policy analyst of senior status in his office. I took the position nevertheless because - setting aside a little subtle pressure applied through the Vice-Chancellor (President) of my University - I had a strong desire to learn about the processes of policy-making within government, and I couldn't imagine a better position from which to do so.

What I experienced, and learned about the processes of economic policy-making, at one level simply confirmed my worst fears: the influence of partisan politics is immense and, in a sense, overwhelming. But it also is an influence, I came to believe,
that is capable of being "managed" - of being shaped by the sort of advice on offer. The greatest failing of we economists (and others) as policy analysts and would-be reformers - within the pages of the professional journals as much as in popular commentary or in direct advising - lies, I believe, in our failure to recognise, analyse and respond to the impact of political processes on policy formulation and implementation.

I do not mean by that that we fail to be sufficiently partisan. On the contrary, I mean that by typically (at least implicitly) denigrating "politics" and refusing to formally analyse its influence on the policy-making environment, we render our analysis and advice, at once, largely irrelevant and potentially dangerous.

Perceptions of Economists

Having perhaps already made my economist colleagues a little nervous by repeating my claims about irrelevance and danger, let me add to their nervousness by making some observations about how economists are perceived by the rest of the community.

Although our skills are recognised as essential to the public sector and the private sector alike, we economists - at least when we operate in our professional capacity - seem not to be altogether well-regarded. Some popular perceptions (or should I say misperceptions?) of economists are captured in a couple of anti-economist stories that have had fairly wide circulation.

The first involves a conversation between a surgeon, an engineer and an economist, about which of their professions
was the first to be established. The surgeon spoke up first. "Read the Bible" he said. "It describes how Eve was created from a rib drawn from Adam’s side - an impressive piece of surgery. Clearly my profession was the first". "You’re wrong," said the engineer. "Immediately prior to that, the Bible describes how the world was created in just six days - clearly an engineering feat of immense proportions, creating order out of chaos." "Ah!" said the economist, "But who created the chaos?"

The second story has been attributed to a former British Chancellor of the Exchequer and sounds to me remarkably like a modern version of an old joke that ends with an economist saying "assume we have a can-opener". Anyway, the modern version goes: "An economist is someone who knows 49 ways to make love, ... but doesn’t know any women" (or men, as the case may be!).

I’m prepared to repeat those anti-economist jokes - even at my own expense - in part for the humour they contain and in part because they contain some grains of truth. I’m bound to say, however, that we economists are not the only people who are accused of not knowing how to put theory properly into practice, and I do not believe that anyone seriously disputes the view that, on balance, the work of economists has been a powerful source of benefit to society.

It seems to me that, perhaps somewhat paradoxically, the main reason people sometimes feel less than well-disposed towards economists derives from the simple fact that, in a sense, economics is regrettably familiar to us all. Whether economists or not, we all grapple with the problem of "economising" - making a limited budget go
as far as possible towards meeting our virtually limitless needs. And just as we resent having to do so, so we feel ill-disposed towards those who make a profession of the science of economising. The saying "there ain’t no such thing as a free lunch" sums up, in a rather frustrated tone, popular feelings about the economics of life.

But there’s more than that involved. The Prime Minister for whom I worked, coined the saying: "Life wasn’t meant to be easy". When I first heard it, I thought he was reflecting the feelings of economists. When things are going badly, we’re held to blame; and when they are going well, it is assumed they are doing so despite our worst endeavors! I used to yearn for the relative popularity of the auditor, or the tax collector.

Actually, although Malcolm Fraser always claimed independent authorship of the saying, it has a close affinity to a line which I much prefer, from George Bernard Shaw’s play Back to Methuselah. In response to a frustrated outburst about life being hard, The He Ancient says: "Life is not meant to be easy, my child: but take courage; it can be delightful".

It seems to me that what The He Ancient claims to be true of life is true of what economists have to contribute to it - something potentially more delightful than popular opinion concedes.

While the frustrating necessity of having to make choices, and the concepts of cost and economising, are of the essence of economics as a discipline, a major part of what economists have to say - to individuals, to firms, to universities or to governments - is actually that if we organised ourselves and our institutions
better, at least in principle, we could all be better off. Rigidities and inefficiencies in our institutional structures, or in our decision-making, or as a result of the decisions of governments, mean that our ability to fulfill our needs often is more limited than it need be. In a manner of speaking, if we could free up the constraints, there are some free lunches to be had. Given this perspective of what we have to offer, with the aid of a good public relations firm, economists ought to be able to change the image of economics from the traditional conception of its being "the dismal science" to the rather more hopeful view of it as "the science of expanding opportunities".

Unfortunately, while what I’ve just said of what economics has to offer is perfectly true, I had to slip in a qualification that turns out to be profoundly important. It is true that reducing regulations and controls, cutting tariffs or establishing a better mix of fiscal and monetary policies in many cases could in principle make everyone better off. But, in practice, they will almost invariably leave some people worse off, even if we put in place the best "compensation" arrangements we can devise to ameliorate the effects on potential losers. Needless to say, the people who would lose are likely to resist; and the politicians or the bureaucrats or the managers who "serve" them – or whose livelihood depends on them – often are likely to find the pressures to prevent such changes irresistible, for reasons that sometimes could not be supported by reference to any generally accepted notion of fairness.

In fact, in some cases – perhaps many – proposals to eliminate inefficient arrangements wouldn’t even get on the agenda for discussion even if everyone who, as a
consequence, would lose their job or have their income reduced would be fully compensated. This is so precisely because part of the very reason for the existence or continuation of inefficient arrangements may be to disguise the benefits which flow from those arrangements to certain groups. Our tax systems, for example, are shot through with loopholes and concessions that could not be supported by appeal to fairness or efficiency criteria - and many would be the subject of persistent public criticism if they were converted into equivalent explicit subsidies, obviously paid for out of other people's tax payments. They are there, of course, because they are intended to be - because they benefit politically powerful groups and do so in a relatively hidden way.

Economists who devote their life to identifying and publicising ways in which society as a whole could get more out of its resources and create more fairness by eliminating such inefficiencies and distortions will collect an enormous number of enemies. That is not a good reason for abandoning the search for more socially desirable policies. But if reformers really are intent on changing social conditions, they are likely to find themselves disappointed more often than not: their advice frequently will be neglected or rejected because it is essentially irrelevant to the institutions they are dealing with.

This disappointment reaches its greatest significance when the advice being offered is to governments or politicians. For reasons that are entirely obvious, political parties are much more interested in who gains and loses from policy change - and often in how they gain or lose - than they are in selecting policies that, in some sense, give "the greatest gain to the
greatest number". Let me immediately add that this is not intended as a criticism of politicians. I'm not suggesting that their behaviour is intentionally malevolent: indeed, they may be much more than averagely motivated by genuine social concern. But the structure of incentives and constraints within which they operate inherently promotes certain kinds of outcomes. Let me take a moment to explain what I mean.

The Political Market

Businesses, unions and ultimately all of us as citizen-voters, presumably want to exert influence over the particular conditions and circumstances in which we live, work, produce and so on. We citizen-voters and the organisations to which we belong may offer advice, and attempt to exert influence over political outcomes, according to our views of the nature of "the good society". On the whole, however, it seems much more persuasive to argue that our own personal interests - and the interests of the socio-economic group(s) to which we belong, and of the organisations from which we derive our livelihood - are likely to dominate in determining our political behaviour; and this will motivate us sometimes to attempt to exert influence in ways which are inconsistent with the promotion of the well-being of society as a whole.

The central point is simply that, while citizen-voters, industry organisations, unions, and so on may exhibit altruism, and may in many respects see themselves as promoting the "interests of society", on the whole there is little reason to suppose that the self (but not necessarily selfish) interest we expect them to exhibit in making market or commercial decisions will not also dominate in their exercise of "political
influence" - through voting, writing to Ministers, joining lobby groups, and so on.

I have to admit that this view is not totally uncontroversial, even among economists. When you think about it, voting in general elections is a peculiar phenomenon - not least because, when we enter the polling booth, we usually cannot conceivably (or rationally) imagine that our individual vote will have any influence on the outcome. This raises serious questions about why people bother to vote (unless it is compulsory as in Australia), and about how they choose to use their vote if they do. In recent times, my colleague, Geoffrey Brennan, in collaboration with Loren Lomasky, has constructed an argument based on the peculiar nature of voting which suggests the possibility of strong differences between "political" and "market" expressions of preferences. Nonetheless, there is enough evidence available both from a priori reasoning and everyday experience to suppose that private interests play a large part in driving the political behaviour of citizen-voters and organisations, especially through lobby-group behaviour which can be expected to be more instrumental in changing outcomes.

To the extent that this is so, we must also expect that - as much as they might be informed by and wanting to implement notions of the good society - politicians will, in the end, have to be responsive to those expressions of private interest. They will be especially responsive to politically powerful special interest groups which can deliver votes in critical electorates, or can provide resources to enable parties to promote themselves, in exchange for policies which promote their special interests. Often, this will occur at the expense of the interests of the society as a whole.
Political scientists will rightly point out that our political institutions contain a range of "checks and balances", including the effects of political competition, which, with varying degrees of effectiveness, limit the extent to which grossly unjust or grotesquely inefficient policies can be introduced or sustained. But it is a simple fact of life that our political institutions are not anywhere near "perfect"; and even with our best endeavors we couldn't make them completely perfect. For what they are worth, they are what we've got: and while we've got them, we're doomed to perpetual frustration if our critiques of governments, and our advice to them, ignores the institutional realities.

I'm sure I'm not saying anything that's unfamiliar. But I'm surprised how often its implications are ignored (even by me!).

Economists and Policy Advice

In formulating advice, most economists, social scientists more generally, and indeed professionals in any area, in effect adopt an implicit presumption that government decision making can be treated as if it were controlled by a benevolent dictator, whatever the precise nature of the political system. That is, the way in which the advice is formulated, and offered, implicitly assumes that, once convinced that the advice is designed to promote "the good society", governments have the capacity and the desire to implement it.

The fact that those offering such advice do not believe this literally to be anything like reality - and, indeed, that they often complain about the inadequacies, perversities and sometimes apparent malevolence of the political process - is really beside the
point. So, too, is the observation that in transmitting this advice for public consumption through the media, or for direct presentation to politicians, economists often make minor concessions to 'political reality' in discussing its possible implementation. The fact is, we typically behave as if the power of good ideas, soundly based on generally accepted social welfare norms, will prove to be not only persuasive, but also ultimately decisive in the political process.

I am, it is true, overstating the case somewhat. But it frequently is argued by leading social scientists that repeated restatements of "the principles of right action" will lead society to choose the desirable paths identified by soundly-based social scientific analysis. The facts, however, appear to be quite different.

Let me illustrate by reference to some of the work of economists. We have put a lot of effort into creating theories and models of behaviour, emphasising the importance of tough, and necessarily somewhat abstract, logic.

How successful we've been is a matter of judgment, but I think it can be said that there are a basic set of conclusions and findings in economics that are, at once, valuable and essentially undeniable and unavoidable. The sort of findings and conclusions I have in mind are essentially about the way individuals and organisations will tend to respond to changes in the objective conditions they face. For example, we confidently predict that when there is a fall in the price of something which individuals value, consumption of it will tend to increase; or if the supply of something is reduced, the price that individuals have to pay will tend to increase. Equally
importantly, in both cases, we can also confidently predict that this will be so even if governments attempt (by regulation or legislation) to prevent these responses occurring.

It can fairly be said, I believe, that when utilised in the evaluation of the implications of particular policy proposals, the findings and conclusions of economics, and the way of thinking that economists bring to bear, make a vital contribution. And, I'll suggest in a moment, this is almost certainly partially reflected in the way that policies are, in fact, implemented in practice.

But there is also another side to economics - its attempts at analysis designed to promote social well-being through the choice of appropriate public policies. Needless to say, this analysis always has been, and always will be, contentious. However, most economists have agreed on a framework of analysis within which they feel comfortable about being able to separate considerations of social efficiency (roughly speaking, promoting maximum national or social income from a given set of inputs) from equity or justice (roughly speaking, ensuring a desirable distribution of that social income). And within that framework, they feel able to speak with some authority, at least on how best to promote social efficiency.

From this framework flow a number of policy propositions that are widely, though not unanimously, agreed to - for example, in support of competitive free markets and free international trade, and against the regulation of activity through controls on output, or the legislation of minimum or maximum prices (rents, wages, energy prices,
interest rates and so on).

There are, moreover, circumstances in which it is equally widely agreed that some public sector intervention in markets is, in principle, capable of increasing social efficiency - although this then raises some difficult, and largely unresolved, questions about how well governments might be expected to perform in designing and implementing appropriate policies.

As I noted earlier, these propositions are not totally contentious even among economists. Sometimes (but I think relatively infrequently) this is so because the underlying value judgments are held to be unacceptable. Sometimes (but I think on the whole mistakenly) it is so because it is thought that equity or justice can be served better by interfering in markets than by simply redistributing purchasing power and letting competitive markets largely have free play. Sometimes it is so because the underlying models and facts are at least partially in dispute (as I believe is the case, at the professional level, in current debates about labour market flexibility and, relatedly, about minimum wages for young people).

But, on the whole, reasonably accurate and generally applicable analysis does support the policy propositions I nominated earlier. Equally importantly, most economists appear to believe - or at least they act as if they believe - that by stating and restating these sorts of propositions their fundamental validity eventually will be accepted by society and acted on through the political process.

The reality, of course, has been - and will continue to be - substantially
different. Governments, always and everywhere, have done things which implicitly deny the acceptance of these sorts of propositions, even after taking into account the exceptions that economists would recognise as valid on a priori grounds. And this is so even among governments that appear likely to share the value-judgments, the conceptions of social well-being, that underlie the propositions.

There are large numbers of possible explanations of why governments behave in this way, ranging from disputes about values, through disputes about facts and analysis, to the possibility of pure malevolence. There is, however, one line of argument that seems to me to dominate all others. When governments pursue policies other than those which support free trade or unregulated competitive markets, when they introduce interest rate ceilings, rent controls or minimum wages in apparent defiance of economists' prescriptions, they do so because they wish to give more income to selected groups in society than they would be given under the (economists') alternative policy approaches - and they would continue to wish to do so even if the economists' alternative policy approaches were combined with sufficient income redistribution to also secure appropriate standards of social justice.

Let me emphasise this last point, because, in a sense, it is critical. The income transfers that I am talking about politicians wishing to make - through, for example, regulating markets or prices - may have nothing at all to do with achieving equity or justice as normally understood. The policies are contrived to redistribute income to many groups - for example: shareholders and workers in the Textiles, Cloth-
ing and Footwear and the Motor Vehicles industries; taxi-drivers; doctors; airline pilots; families with children; government employees; farmers; home purchasers; and so on - many of whom would be far from 'disadvantaged or needy' on anyone's definition. And the desired income transfers are secured by methods which involve interference in markets in deliberate violation of the requirements for social efficiency (and hence involve perhaps very substantial reductions in aggregate social income) because this is politically the best, and perhaps only, way of securing the transfers.

The reason that governments contrive to achieve these outcomes (and that voters, at least implicitly, support them in doing so) is not to be explained in terms of their being malevolent or uncaring about the good society. Rather, I suggest, it is because the institutional structures, the constraints and the incentive patterns that politicians work within, drive them to behave in this way.

To be sure, majoritarian principles, constitutional constraints and conventions limit the extent to which egregiously unfair and/or inefficient policies can be pursued, and positively encourage a general framework of government and policies that are, in net terms, beneficial to society. If this were not so, we would expect to see great pressure build-up for institutional or constitutional change, because large groups in society would feel more sinned against than sinners through the political process.

Nonetheless, the political system unquestionably responds to groups who can organise and raise funds to influence politicians, either by the promise (or threat) of direct delivery of votes, or
through the provision of political resources more generally (for example, campaign contributions, media support, advertising on behalf of political parties - or against them - and so on). What these "special interest" groups seek is the income transfers I mentioned a moment ago - income transfers that they cannot secure through voluntary action in the private market but which can be secured through the use of the distinguishing feature of governments in free democratic societies: the power to legislate, to regulate, and to tax - in short, the power to coerce.

Interest groups form to demand policy intervention to serve their own interests, offering in return political resources. Politicians are willing to supply such policies to at least some of these groups because the benefits of the political support, and other political resources they acquire by doing so, exceed the political costs to them from imposing inefficiencies on markets. The costs, of course, are borne by other groups in the relevant market and by society as a whole. But while the benefits are concentrated on a relatively small cohesive group, the costs are dissipated across a much larger, less cohesive group.

The policies that are supplied, moreover, are likely to be predominantly in the form of direct controls on output or on prices or on competition, or through other means (such as tax concessions or loopholes) that do not involve explicit transfers to the intended recipients. This is so both because these approaches are likely to be most effective from the viewpoint of recipients and because they are relatively hidden, minimising the costs to politicians who supply them.
This isn’t to say that all political action is likely to be dominated by selectively responding to narrow private or special interests. If it were, it is doubtful if the political system could survive the pressures that would build up among the less politically powerful members of society for there to be institutional change. Revolution is a political signalling device, too. There must be a balance achieved in responding to the needs of different groups. There are moments when governments feel relatively unconstrained by political pressures and can implement policies promoting their view of the good (or at least better) society, and the system does allow some role for majoritarian pressures more generally. But, on the whole, private interests are likely to have a considerable influence.

When they do dominate, it is nonetheless not easy to predict which special interest groups will be successful at any particular time, the pattern of intervention and distortion is likely to be constantly changing. Indeed, it can be expected to be subject to long term swings in which more or less intervention is politically sustainable as the costs of intervention become less or more widely perceived.

The Politics of Economics

None of this is to claim governments believe that they can suspend or override the conclusions of economists about the behaviour of the market system. That is, I suggest that such policies usually are chosen despite, rather than in ignorance of, their consequences for social income and social well-being. Nonetheless, the results of the social sciences often are applied in the design of policy approaches - even those that in large measure appear to be utilised
in direct opposition to the predominant advice of economists.

For example, where they’ve been applied, rent control policies often have been restricted to the existing rental stock, to help mitigate their potential effect on the supply of new rental dwellings. Similarly, in Australia controls on housing interest rates until recently had been accompanied, among other things, by the maintenance of monopoly privileges for the banks as part of a quid pro quo for their maintaining a larger supply of funds than otherwise would have been available at these below market rates. However, this arrangement became unsustainable once competition in the financial sector increased and undermined the banks’ traditional monopoly. Under the new, more competitive, structure of financial markets, interest rates charged on new housing loans have now been freed of controls, essentially because that’s the only way in the new environment that the supply of funds for housing loans can be maintained at adequate levels. But as with rent controls, old loans (pre-April 1986, that is) remain subject to an interest rate ceiling substantially below the prevailing rate on new mortgage lending.

As this last example clearly suggests, the pattern of regulation and intervention may eventually have to change, despite the government’s preferences. The seemingly unlikely circumstance of a Labor (social democratic) government in Australia deregulating the financial system and floating the exchange rate is to be explained partly by a recognition that the distribution of benefits from regulation had been different from what the government would have wished, and that those benefits had anyway been largely dissipated (in the case of the banks) by the
huge (and, I might add, predictable) growth in the uncontrolled areas of the financial market. But, ultimately, the explanation must lie in the fact that irresistible forces created by the growth of an overwhelming international capital market made politically expedient what was economically desirable. Other things equal, in 1983 the then new Labor government would have preferred not to go in this direction — but economic forces, not good ideas, prevailed.

Recent Australian experience points to just what can be achieved when economic forces create political pressure for change. A dramatic deterioration in the nation’s terms of trade in 1985 into 1986 created a current account deficit of over 6 per cent of GDP and an equally dramatic upward leap in our already strongly growing international indebtedness. Faced with the inevitability of lower living standards, and pressures from the international community for economic adjustment, the government mobilised widespread popular support for a package of policy reforms that have seen substantial real cuts in outlays, the first Federal Budget surpluses for about 35 years, major reforms to public sector business undertakings and phased-in tariff cuts of about 30 per cent on average (higher in the TCF and Motor Vehicle Industries which previously had received disproportionately high protection, including quotas on imports).

None of this was within contemplation prior to the Balance of Payments crisis. In fact, in many respects we were on the opposite policy track. What was called for was a form of statesmanship — a capacity to weld together and unleash the counter-constituencies for whom reform was desirable but which had not previously had the cohesiveness to
become major political forces in their own right. An economic crisis made this politically desirable and in this instance the major political actors - the Treasurer and the Prime Minister - had the capacity to make it happen. But equally central to what I am saying is that neither of them had shown the desire to implement the changes - to be statesmen in this sense - prior to the economic and political emergency.

Another example might help to reinforce the point, and begin to move us further towards an examination of irrelevance and danger in economic advice. Specifically, I want to refer to the case of tax reform.

The Politics of Tax Reform in the 1980s

The 1980s have witnessed an unprecedented tax reform effort, world-wide. The major focus has been on re-evaluating the progressivity of personal income tax rate scales, but there has also been extensive discussion of reforms to indirect tax bases, with a particular concentration on the possibility of the introduction of value-added taxes by countries outside the European Community (a possibility that now looks like a reality for Canada).

Reform of tax systems is fraught with political dangers, because basic tax structures embody implicit social agreement about acceptable distributional shares. Of course, at any particular moment, actual tax structures reflect, among other things, the cumulative effects of changing economic circumstances (for example, the impact of inflation). As well, they reflect the effects of bargains struck between special interest groups and governments to create exemptions, loopholes and so on. So, at any given point
in time, the effective tax structure may be entirely different from that implicitly agreed to originally. Nonetheless, even those adversely affected by the subsequent changes remain understandably resistant to reopening the inevitable conflict over appropriate distributional shares inherent in any explicit tax reform effort. Equally importantly, the tax system is a vital part of the decision-making framework faced by individuals and businesses. Frequent changes to the system, or even the mere hint of major change, can create a degree of uncertainty regarded as intolerable by those potentially affected. For these reasons, among others, tax systems take on a "quasi-constitutional" character. That is, they tend to remain largely fixed in a structural sense for long periods, with legislated change contemplated only when the political pressure to do so becomes irresistible.

From a political perspective, the only real virtue of taxation is that it delivers the resources necessary to fund public sector activity. As long as it goes on doing so at acceptable political cost, there's no reason to contemplate "reform", no matter how persuasively the intellectual case for doing so may be argued. The (slightly modified) familiar adage - "if it ain't completely broke, do not even think about fixing it" - perhaps says it all.

So why has the political balance shifted decisively in favour of reform, and done so worldwide? The answer, I suggest, is largely to be found in the consequences of the economic pressures of the 1970s and early 1980s. Slower economic growth, but still rapidly rising public sector outlays, led to large increases in budget deficits. The growth in budget deficits was moderated (but
not prevented) by growth of tax revenues resulting from the interaction of inflation with progressive income tax rate scales. The higher income tax rates subsequently faced by everyone - in particular those on moderate real incomes now facing tax rates originally intended to apply to the relatively rich - led both to taxpayer discontent and to adjustments of economic behaviour. These "adjustments" included reduced work effort and incentives to save as well as the development and exploitation of contrived schemes of tax avoidance and evasion. As a consequence, both the acceptability of "the tax system" to the majority of taxpayers and the security of tax revenues to governments were undermined.

From the viewpoint of governments, moreover, the problems were intensified by the fact that the ultimate need to reduce budget deficits relied heavily on sustaining the growth of tax revenues because of political resistance to significant reductions in budget outlays. The relative political costs of tax reform unquestionably were perceived as diminishing. Cutting personal income tax rates, but funding the rate cuts in so-called revenue-neutral fashion (by "base broadening" measures to eliminate concessions and loopholes, or by reforming and expanding indirect taxes) looked like an increasingly viable political strategy - a strategy which could be sold as restoring the integrity of the tax system. Note, however, that while for taxpayer/voters, "restoring integrity" meant restoring fairness and equity to the tax system, for governments it meant protecting, and hopefully expanding, the revenue base.

The orthodox economists' arguments favouring fully comprehensive broad-based taxation of income and/or expenditure to
secure equity and efficiency in the tax system found a political vehicle. Intellectual fashion and political pressures intersected to produce an international reform movement arguably as significant as the (somewhat parallel) case of financial deregulation.

On the other hand, while the notion of introducing constitutional limits on revenue collection (or on outlays and deficits) sometimes was raised, to my knowledge they have not been introduced anywhere as an integral part of a proposed tax reform package. The fact that integrity has a double meaning – connoting fairness to taxpayers, but revenue protection to tax collectors – and that comprehensiveness is a two-edged sword (with a particularly dangerous cutting edge when pursued on a revenue-neutral rather than revenue-limiting basis), was argued by some, but the traditional intellectual orthodoxy on tax reform largely won the day. This is not to attempt to deny the significance of the tax reforms achieved so far, many of which (for example, in the USA and New Zealand) have been fairly dramatic. But in the absence of explicit limits on revenue raising, the long run sustainability of the benefits of the reforms is open to serious question.

Here, in fact, we have an example that straddles my claims of irrelevance and danger in economic advice. In the absence of the economic changes which gave rise to the political pressures for tax reform in the 1980s, those economists who had long argued for comprehensive tax reform would have been left to continue whistling into a gale-force wind of resistance to major change. Politicians were not interested in "Haig-Simons" conceptions of a comprehensive and efficient tax system. As long as the
existing inefficient system kept working tolerably well to deliver the revenue needed to fund public sector activities, nothing more than minor tinkering would be contemplated. What made the intellectual case for tax reforms eventually relevant was not the fact that it was intellectually sound, but rather that it happened to correspond to a political need. Both political pressure to restore fairness in tax systems and the dangers to governments from erosion of the revenue base made broad-based comprehensive tax reform politically relevant.

When the political window of opportunity opened, the dominant advice available was of the orthodox variety which implicitly assumes benevolent behaviour by governments - or at least assumes that political competition will constrain governments from exploiting their more broad-based tax structures (which are more efficient revenue-generators than the distorted and discredited tax structures they replace). Virtually all previous experience, however, suggests that this is a dangerous, or at least naive, presumption. We can expect that at least some governments, at least some of the time, will misuse the revenue-raising potential of the tax system. Clear and careful recognition of these possibilities, and their incorporation into the formulation of analysis of, and advice about, tax reform might have led to the adoption of at least quasi-constitutional limitations on the use of restored taxing powers.

In Australia, as is also true elsewhere, we didn't even manage to mobilise pressure for the transparently obvious requirement that the personal income tax rate scale should be indexed against inflation, to prevent increases in real tax burdens, and in real tax revenue, occurring by stealth,
through fiscal creep. As a consequence, given Australia's recent inflation experience, despite substantial cuts in marginal income tax rates, tax revenues in the 1988-89 financial year were higher than they would have been if the pre-1985 rates had still applied but the tax thresholds had been fully indexed for inflation. Facts such as this led one wit to suggest that the Australian Treasurer, Paul Keating, was the only post-war Treasurer to have had a fiscal phenomenon named after him - "fiscal creep"!

Towards Institutionally Shaped Policy Advice

Where does the drift of my argument so far leave professional economists and their "good advice"? First, let me say that despite the doubts I've raised the accumulated work of economists has been extremely important - in intellectual and in practical terms - and I'm not arguing that we should diminish the effort we put into the important task of increasing our understanding of the economic system, narrowly conceived.

What I am implying, however, is that both the intellectual rigour of the discipline and its relevance to economic policy debates would be increased greatly if we economists more often, and more carefully, applied our analytical tools and our basic principles to understanding the nature of political institutions and their influence on the economic system - and incorporated the results of this understanding in the shaping of policy advice.

Over the last 25 years or so there has been a resurgence of interest in analysis of this sort. Its results as yet are sparse, and - with a few notable exceptions including a recent Nobel Prize Winner, Jim
Buchanan - few of the really good minds in economics have devoted much of their time to it. I suspect that, at least in part, that's a function of a form of intellectual snobbery. "The economics of politics" looks a bit soft by comparison to the rigour of much conventional economic analysis. I also suspect that it is a function of other forms of intellectual snobbery practiced by some of the greatest thinkers in all areas: a mistaken view of the ultimate power of good ideas and good advice, and a totally misplaced contempt for the realities of practical politics. The problem with such attitudes, as I've already indicated, is not only that they are unrealistic, and doom much that is offered as economic advice to irrelevance. It is also entirely possible that politically "uninformed" advice could lead to unintentional damage.

In case it is thought that my claim that "good advice" can be politically and socially dangerous has limited application, let me offer another example. The great economist, John Maynard Keynes, when he wrote his path-breaking "General Theory", clearly held in mind a vision of macroeconomic policy being run by a corps of public-spirited intellectuals - even though he was well aware of the complexities and perversities of political decision-making. So when he established the important case for governments to run budget deficits and surpluses to counteract recessions and overheating of economies respectively, he gave no recognition to the likelihood that the policy techniques he was discussing were capable of being entirely misused in the context of real politics.

It is unquestionable, however, that governments often have used budget deficits, not as Keynes intended, but rather as a disguised means of financing the growth of
government spending without having to raise taxes, or as ways of avoiding the tough decisions on cutting expenditure programs. Indeed, arguably, the economic traumas of the 1970s, while clearly related to the oil crises, were actually founded in just such misuse of deficit financing in the 1960s—especially, but not exclusively, in the United States, where politicians were unwilling or unable to choose between funding the Great Society programs, on the one hand, and funding the Vietnam War, on the other. It is not obvious that, had Keynes recognised the risk of political exploitation of his ideas, he’d have been able to suggest a means of effectively eliminating it. But its early recognition and discussion might have been prompted by the incorporation of a more realistic view of economic policy decision-making into his way of thinking about policy formulation.

In fact, although appropriate techniques for handling such risks would differ from country to country, one way in which they might be handled is illustrated by experience in the USA. In the context of the "taxpayer’s revolt" during the 1970s, there was much discussion of, and some states have acted on, proposals for constitutional amendments, for example, to restrict the circumstances in which budget deficits may be used. In a not unrelated way, the Gramm-Rudman Act in the US may be argued to involve a temporary quasi-constitutional mechanism for securing policy reform.

These examples suggest a politically very important role for the broader perspective of economics and economic advice that I have urged. That is, it may serve not just as a basis for improving advice on day-to-day decisions, but as a basis for an approach to institutional and constitutional
reform - for understanding how we could improve the "checks and balances" in our political system. I realise that I open myself up somewhat to the risk of being accused of the very fault that I have been discussing, for constitutional and institutional reform is subject to the same difficulties and pressures that plague the search for reform of day-to-day decision-making. Nonetheless, there seems to be little structured analytical thinking going on about reform at this level, especially by economists: and successful reform, while hard to win, could be profoundly significant if achieved.

I also realise that I may open myself up to the risk of being accused - perhaps particularly by political scientists - of engaging in intellectual imperialism. But for all that, I believe that many of the most significant advances in economics in the years ahead are to be derived from consistent application of a real "political economy" approach to economics and economic advice - and especially from its application to "institutional design".

All that really is involved is a formal recognition of, and substantially more than lip-service being paid to, what we all basically know - that political processes and pressures are central determinants of policy outcomes. Politically-sensitive, but not partisan, policy advice can be as scientifically detached as more orthodox, institutionally-vacuous, approaches to economic advice - and a great deal more valuable, and successful in my opinion. You do not have to be a policy prostitute to recognise the role of politics in policy formation. On the contrary, failure to recognise the role of political processes and political pressures leaves economists open to the charge of...
helping to create the environment within which policy prostitutes can flourish. The central objective of what I call institutionally (or politically) sensitive advice is to facilitate the actual implementation of desirable change in ways which protect against the dangers that I also have identified.

As an example of what I have in mind, let me wind up my discussion by briefly referring to a project in which I have been a principal participant in recent years in Australia - the so-called National Priorities Project. Our focus has been on identifying how the efficiency and fairness of public spending programs and the tax system can be improved as a contribution to the resolution of the major economic problems that Australia currently faces. The strategic perspective we have adopted is that packaging together a bundle of desirable reforms to spending programs with major structural reforms to the tax system can make possible policy reforms which, taken one-by-one, otherwise would fall victim to the politics of pressure group resistance. The spending reforms we address include especially those in the notoriously difficult areas of health, education and welfare. The taxation reforms include lowering and flattening of the income tax rate structure.

Each individual component of our package would be recognised by most economists as based on sound economic analysis and designed to promote social efficiency and distributive justice. For reasons I've already discussed, attempts to implement each separate component in piecemeal fashion would meet possibly intractable political resistance. However, the pattern of gainers and losers is evened out and to that extent, presented as a bundle, the politics of implementation of the reforms we envisage is in our view,
substantially changed.

We are not so naive as to claim that a radical package of reforms of the sort we have in mind would be easily implemented. But we do see it as a pathway to facilitating what otherwise would be not merely "not easy" but, in fact, virtually impossible. By redirecting the focus of the debate about reform away from its redistributational consequences, we offer a possible path to reaping the benefits of greater efficiency and a more dynamic economy.

Our project has resulted, so far, in two major books at the national level [John Freebairn, Michael Porter & Cliff Walsh (eds), Spending and Taxing: Australian Reform Options (Sydney: Allen & Unwin), 1987; and Spending and Taxing II: Taking Stock (Sydney: Allen & Unwin), 1988] and, through the Federalism Research Centre, I have begun the process of undertaking similar analyses at State (Provincial) level, too [see Richard Blandy & Cliff Walsh (eds), Budgetary Stress: The South Australian Experience (Sydney: Allen & Unwin) 1989].

My claim is not that the approaches we identify represent the only way to proceed to public sector reform, but rather that they are examples of institutionally informed policy analysis which both accept the basic rules of scientific analysis and recognise, in an equally "scientific" way, the realities of political decision-making. Greater political relevance is purchased, not at the price of abandoning professional integrity but, rather, by incorporating into the analysis, in an integral way, what cannot be ignored - that the decisions we want to influence as a result of our professional analysis must be implemented through decision-making structures that need to be
as much understood as we insist should be the case for market decision-making processes.

It often may be hard to discern the logic or rationality of particular political decisions, but - as with other decision-making environments - politics does have a pattern that can be identified. If we recognise that pattern, and respond to it appropriately, we economists will, in my view, serve the interests of society better.