The Economist as Policy Adviser

BY AARON STEELMAN

Economics has made substantial progress since Adam Smith published *The Wealth of Nations* in 1776. Our understanding of how the economy works has improved greatly, as have the tools used to analyze it.

But has this technical progress led to better policymaking? It depends on your time horizon. Economic policy, on the whole, has not been on a steady ascent. There have been significant zigs and zags along the way. The United States started off with a largely free trade program, but at times adopted protectionist measures that harmed material progress and our relations with foreign allies. Currently, the nation's trade policy is relatively liberal, though there are certainly areas where improvement could be made.

The same is true with freedom of contract. Between the end of the Civil War and the New Deal few barriers existed. During the 1930s, however, several measures were adopted that limited the ability of employers and employees to contract freely, from minimum wage laws to maximum hour statutes. Many of those policies remain on the books, though other regulations that were subsequently adopted — such as wage ceilings — have thankfully been lifted.

Monetary policy also has gone through its period of ups and downs since the founding of the Federal Reserve System in 1913. Mishandling of the money supply was arguably the principal cause of the Great Depression. During the 1950s and 1960s, under the direction of William McChesney Martin, Jr., the Fed adopted sounder policies, only to see inflation become both high and variable during the 1970s. It has been a long and arduous climb back to price stability since Paul Volcker assumed the chairmanship of the Fed in 1979 — and the fight against inflation will require continued vigilance.

These are but three examples. One could give many more. The point is: The record is mixed. In some cases, economic principles with a long pedigree — such as open trade policies improve well-being — have been abandoned. In other cases, as the economics profession has made advances — for instance, as the state of monetary economics has improved — so have policymakers. The transmission of ideas, then, from economists to the public and its political representatives is by no means perfect.

What does this portend for future economic research? First, we should not discount those examples where good economics has helped inform good policy. But we also should not forget those examples where good economics has been willfully ignored. Policymakers, on the whole, are charged with acting in the national interest. But each policymaker has an incentive to act in his own narrow interest. Often this results in the advocacy of policies that will benefit his home district or state — even if they will be costly to the general population.

Economists should keep that in mind when they are asked to assume the role of adviser. The tools of modern economics can sometimes help reveal cases that might be viewed as exceptions to the rule. For instance, in theory there is such a thing as an "optimal tariff," which can improve a nation's welfare. However, in practice, efforts to adopt such a tariff could lend cover to policies that are blatantly protectionist. Similarly, one can model cases where the use of eminent domain for narrow commercial purposes, such as the building of a shopping mall where housing used to stand, could be beneficial. But one ought to expect those cases to be rare. More important, one should fear that the power to seize property will be used more frequently than the model suggests — in other words, abused.

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This is not to say that economists should censor themselves. Quite the opposite. They should go wherever their research takes them.

When it comes to the implementation of public policy, though, they should take a more cautious or prudential approach. As economist James Buchanan of George Mason University argued in his 1986 Nobel Prize lecture, "Economists should cease proffering policy advice as if they were employed by a benevolent despot, and they should look to the structure within which political decisions are made."

One way for economists to look at this is through the familiar lens of rules versus discretion. It may be possible to imagine situations where deviating from a well-considered policy rule would be welfare-enhancing, but such action would still be unwise. The goal should be to move from a system of ad hoc decisionmaking toward one in which sound economic principles are applied across a broad set of policy questions, something akin to what Buchanan and his colleagues call constitutional political economy. This might mean foregoing some marginal improvements, but it's also likely to mean fewer big mistakes. I think most people would agree that's a trade-off worth making. **RF**