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# How Can Economics Contribute to Better Policy-Making in Future?

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It is a great privilege to be part of this session and on a panel with two former colleagues.

I am an unabashed optimist on this issue.

Over the last 40 years, the Economics profession has been front and centre in the great transformation of the Australian economy, which has brought huge community benefits, in terms of increased standards of living.

I don't dispute that we got some things wrong – globally, very few economists predicted the GFC; many of us were slow to appreciate the full implications of China's rise; and I for one was too naive about the role of competition in some areas (I am still scarred by VET).

So there is a lot of room for humility, but we shouldn't give in to negativity and we shouldn't lose ambition. Economists have to keep wrestling with the big issues of the day.

Sadly, there are a lot of incentives for economists to focus on minute modelling exercises or clever (but in my view pointless) theoretical games.

But ours is a social science – a human endeavour which looks at real people and real world policy problems.

Our lot is to immerse ourselves in that messy world, stick our collective necks out – and usually make imperfect calls in uncertain context.

If we are prepared to meet that challenge, with courage and, yes, humility, then the economics profession will continue to have a large positive influence on policy making.

With that in mind, I want to mention three key trends that I think will shape our work and the contribution we can make to better policy.

First, the policy debate is increasingly moving into territory that is less traditional for economists.

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At the Productivity Commission (PC) our work program takes us a lot into the non-market sector – services like health and education. We have done work on the policy issues that arise in the area of data and technology.

Also, the economics profession has rediscovered a spatial lens – looking at urban planning and the functioning of our cities.

In all of those areas, there exists an established policy tradition – and a community of experts – of which economists haven't always been part.

We firmly believe that economics can bring great insight to these areas, but in general, those other professions and professional disciplines represent the incumbents and we are in the role of disruptors.

We have to find our way in - negotiate and carve out our space.

In particular, we have to take seriously our subject matter deficit. We have to accept that we will always know less than the subject matter experts.

So although we have to develop a baseline understanding, we ultimately have to work *with* subject matter experts rather than trying to supplant them.

This often requires close inter-disciplinary cooperation. We have a psychiatrist as an Associate Commissioner on our current mental health inquiry and we brought in a sociologist to help us on problem gambling.

Our comparative advantage is the framework – the application of a logical theory. With pretty strong explanatory power and – crucially – the ability to say something about welfare implications.

Of course, part of what characterises these areas is that the evidence of what works is increasingly context-specific. So more and more, we face the reality that what works in one location or cohort or community, won't necessarily translate to broader application.

That is a big challenge to the economics profession, because our whole intellectual tradition – our professional DNA if you will – is based on generalising. Using some simplifying assumptions to furnish a workable, logically coherent theory which can then be more generally applied.

Despite the challenge, we can't give up on that tendency.

Instead, we have to develop more and more sophisticated approaches to our general theories.

For example, we can try and distill some general lessons learned about where markets have worked well and where they haven't.

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Where we have to adapt the assumption that consumers have stable, predictable or homogeneous preferences.

It's great that we have Tim Besley as part of the conference this afternoon to talk about the importance of values and culture to our work as economists.

In Indigenous policy, we're increasingly realising the importance of culture and the scars of history. This means stronger decision-making by local people, recognition of the importance of kinship, and capability strengthening are factors that must be central to effective policies and implementation.

At the PC, we have often used the insights from behavioural economics in areas like retirement income policy, such as people's tendencies towards loss aversion and myopia.

But these insights offer a complement to the general theory. They don't substitute for it.

And in the end, for better or worse, policy makers need some sort of general framework.

Someone has to provide it.

My second big trend concerns the role of allocative efficiency.

40 years ago if you looked at the Australian economy, you would probably conclude that we had a significant misallocation of resources, because of:

- regulated product and factor markets
- high tariffs
- inefficient government enterprises making up a large share of the economy.

Much of the reform effort of the 1980s and 1990s was focused on correcting that allocative inefficiency.

As economists, our analytic tools – partial equilibrium analysis and CGE models – served us very well, both in explaining the problem and in selling the benefits of reform.

In 2019, with maybe one or two significant exceptions, our challenges are not about large scale resource misallocation (or at least not to the same extent).

I think our challenge is increasingly about dynamism – including the development of human capital, the generation of new disruptive ideas, products and business models and their diffusion through the economy.

A reform agenda focused on those things is - I believe - the key to getting sustained increases in multi factor productivity growth, and with it, real growth in incomes.

But it's hard to model those reforms meaningfully using a static equilibrium approach.

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We have to look at other techniques of analysis and explanation for this purpose.

Part of that requires that we become much more comfortable with contingency, uncertainty and incomplete information.

We can't see the world or the role of policy in terms of achieving perfect, well-defined and concrete end points.

But rather, the incentives, the processes and institutions that can help us evolve towards a future that we haven't imagined.

The third big trend concerns data.

One of the big changes of our age is the proliferation of data and the exponential increase in computing power.

That unlocks big increases in modelling capability.

It is nothing short of an empirical revolution and thus a huge enabler for our profession.

In particular, it allows us to use data where we had previously relied on a (former) priori reasoning.

There are a number of examples where our a priori views were changed by looking at the data. But we should sound two notes of caution.

First, I sometimes observe that economists' research priorities are shaped (distorted perhaps) by finding a really cool data set – maybe with a neat natural experiment.

And while that might help us explain something about the world, the big priority should be policy relevance. The 'so what' factor - both in how we do our work and how we choose research priorities.

Second, working with data is a dance – it needs two partners: empirics and theory.

Good research begins with some theory. A refutable hypothesis, clear idea of what we are looking for and might expect to find. And the evidence that would prove our priors wrong.

If we are wanting the data to speak to us of its own accord, we will be either disappointed or grievously misled. The point is that we can't get seduced by the improvement in computing power and become slaves to the data rather than masters of it.

I want to finish where I started – with the need to do our work with a passion for the real world around us.

When I think of great economists I admire like Ronald Coase or Elinor Ostrom, they brought a passion for understanding how real people deal with real economic problems. They confront. From lighthouse provision to management of common resources.

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And when I think of future economists – those starting out today or working through their honours thesis – I would recommend to them that they can have the career of a Ross Garnaut, a Bruce Chapman, a Jenny Wilkinson, a Maryanne Mrakovcic, a Helen Silver or a Warwick McKibbin.

That is so much better than publishing 100 esoteric articles in the proliferation of esoteric journals.

And our engagement with the real world is a two way street.

The real world informs our analysis, but we also need to inform and persuade the real world through our work.

Sometimes people see our role (often we see our role) as advising politicians – often exhorting them to embrace various reforms. And sure, that is part of our job, but we also have to do more to get out there and convince the community.

To show how our policy recommendations can improve people's lives – through higher incomes, lower prices or greater choice.

That does take courage – and the humility to acknowledge what we don't really know.

But if we get that balance right, then the economics profession is very well placed to contribute to good public policy for many years to come.