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ABSTRACT

Ten Lessons for Economic Policymakers*

Economists have played a powerful role in shaping modern Australia. Drawing on my experience as an academic economist and an economic policymaker, I outline ten principles to guide economists seeking to maximise their impact. These are to (1) Focus on wellbeing, not just dollars; (2) Think comparative advantage; (3) Ignore sunk costs; (4) Optimise, subject to constraints; (5) Use the best evidence; (6) Consider expected value; (7) Think in magnitudes, not just in signs; (8) Channel a libertarian; (9) Remember equity; and (10) Incentives matter.

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Introduction: The Power of Ideas

John Maynard Keynes once wrote ‘The ideas of economists and political philosophers, 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.’ (Keynes 1936, 383).

In academia and parliament, I have found that to be true. Economics is surprisingly powerful as a tool for public policy. Economic ideas have shaped Australia's trajectory.

One of Australia’s greatest economists was Max Corden, who died on 21 October 2023. After fleeing the Nazis as a young boy in 1939 (Corden 2017), he became one of the great Australian pioneers of openness. Corden’s work on tariff reform was used by the Tariff Board, the predecessor to what is now the Productivity Commission, to make the case for Gough Whitlam’s 1973 tariff cut, in which all tariffs were cut overnight by 25 percent (Leigh 2002). His intellectual curiosity and global outlook reflects the very best of Australian academia and the economics profession.

Many people have heard Thomas Carlyle’s put-down of economists as being ‘the dismal science’. Fewer people know that the reason that Carlyle described our discipline as the dismal science was that we had what was in his mind the ‘dismal’ view that all human beings – whatever their skin colour – should be regarded as equal.

In that light, I proudly wear the badge of the ‘dismal science’. It is a reminder that economics has its origins in the notion of human equality; the principle that one person's wellbeing is as valuable to society as another's.

In this article, I propose ten lessons for economics policymakers. When I refer to economic policymakers, I’m drawing a broad net. I'm including people who have made a contribution in consulting, those who have worked in the public service, those who are working in journalism, and those who contribute to the public debate. I'm thinking of the policy conversation writ large, not simply some narrow slice of it.

Ten Lessons

Lesson one: focus on wellbeing, not just dollars. As Robert F. Kennedy famously noted ‘the gross national product does not allow for the health of our children, the quality of their education or the joy of their play. It does not include the beauty of our poetry or the strength of our marriages, the intelligence of our public debate or the integrity of our public officials’ (Kennedy 1968).

The notion that we teach first year students is that economics is about maximizing ‘utility’, also known as happiness or wellbeing. It's why the Australian Government has brought down a *Measuring What Matters* statement, grounding the objectives of government, not just in national income, important as that is, but also building out a wider dashboard of indicators.

One way of thinking about that is to imagine that you could only have one of the two developments that Australia has witnessed over the last half century. Imagine you could only have either a decade's more healthy life or the doubling of per capita incomes. Which one would you choose? I would choose the extra decade of life. Opting for decades over dollars is to eschew merely maximising income per capita. Such an approach also takes into account the number of birthdays we have to spend with our loved ones.

This matters too when we consider policies that might boost employment rates. We know that the wellbeing of someone who loses their job goes down by more than you'd expect if a job was just an income delivery mechanism. The drop has been estimated to be somewhere between $40,000 to $80,000 in addition to the loss of income (Carroll 2007). A wellbeing approach better captures the social value of full employment. Wellbeing also matters in the domain of mental health. As the Australian Government works to build a more connected community, wellbeing is one of the things that drives us.

Lesson two: think comparative advantage. My guess is that most of you don't fix your own car when it breaks down, don't cut your own hair, and don't make your own clothes. What goes for the labour market can apply to international trade. Australia constitutes only about 0.3 percent of the global population. So it makes sense that we can benefit the most when we focus on what we do the best.

Just as comparative advantage suggests that you might be better off spending another hour in the office and paying someone to cut your hair, so too it suggests that Australia may be better off to focus on what we do well, whether that's extracting minerals or advanced production of pharmaceuticals, and then importing things that other countries produce more cheaply, such as smartphones.

Comparative advantage was cited by MIT's Paul Samuelson as the best example in the social sciences of a proposition that is both true and non-trivial. You can meet plenty of brilliant lawyers who seem not to understand at all why Australia shouldn't produce everything domestically. That demonstrates the power of economic thinking. Comparative advantage embodies the notion that if we stick to our strengths, that we can enjoy higher levels of prosperity, and higher levels of fulfillment.

Economics has a history of favouring free trade, whether it is John Stuart Mill's campaign against the British Corn Laws, the open letter against the Smoot-Hawley Tariff Bill in 1930, or the work that Keynes and others did establishing the Bretton Woods Institutions, and slowly unwinding the protectionism that had emerged in the interwar period. To choose openness is to make the case against isolationism and autarky (Leigh 2017). In the face of rising threats from autocracy and populism, it is to believe that global engagement can boost wellbeing.

Ignoring comparative advantage – trying to do everything in-house – risks turning ourselves into the human equivalent of a multi-tool: with an ineffective saw blade, a screwdriver that lacks purchase, and a clumsy set of pliers. There's a reason tradespeople don't use multi-tools in their everyday work. If we recognise the value of comparative advantage in our own lives, we can also recognise the benefits for Australia of comparative advantage.

Lesson three: ignore sunk costs. It is tempting to continue to throw good money after bad, to feel once you've engaged hard on a project you should see it through to completion. 'Winners never quit and quitters never win' goes the saying. Economics teaches us that very often quitting is exactly the right strategy.

An insightful experiment that Steven Levitt conducted online invited people facing a major decision to have Levitt toss a coin to decide whether or not they should quit (Levitt 2021). Levitt asked participants to let him know afterwards whether they had followed the coin toss, and reported how happy they were.

The research found that the single most common decision was whether or not to quit a job. When the coin advised quitting at when the coin came up leave, people were a little more likely to leave and as a result of that were significantly happier. It turns out that if you're on the verge of quitting, then it makes sense to quit. Why might it be that we stay on for too long? Most likely, because non-economists forget the notion of the sunk cost. People forget the idea that often, we may have invested in something which turns out to be a mistake.

Lazy firms maintain projects long after they've exhausted their value. More rigorous firms recognise that shutting down a team can be exactly the right thing to do. Astro Teller, who runs Google's moonshot innovation unit, has a strategy of celebrating projects that are shut down. Here's one of his stories: 'Not long ago a team of 30 engineers killed a project they'd been working on for 2 years… The next week, I stood the entire team up on stage at one of X's all hands meetings, and I announced they were getting a bonus for killing their project. I said, "Thank you! By ending their project, this team has done more to speed up innovation at X this month than any other team in this room." And they got a huge round of applause from their managers and peers. They then went on vacation, came back, and found new roles in other teams around X, enabling us to go even faster at other ideas with brighter futures.' (Teller 2016).

Lesson four: optimise, subject to constraints. When analysing a policy problem, economists should have in mind the first-best solution. If there is a path to achieving it, economists should be the ones making the case for adopting the socially optimal policy. Equally, economists should recognise that decisions are often subject to constraints. Moving from the fourth-best solution to the third-best solution is valuable nonetheless.

More broadly, just as the most powerful ideas in economics are the foundational ones, the biggest value from our discipline can come from being the first economist in the room. This sometimes be a lonely role, but is often a critical one.

That can mean applying economics to policy problems that people think of as non-economic. To be part of a non-economic unit can be to bring a completely different perspective into the conversation, which may allow organisations to think in terms of cost-benefit analysis rather than a less robust framework.

Lesson five: use the best evidence. In building the case for change, it's important to recognise that the evidence in some cases may be very strong and in other cases may be very fragile.

One example of this is nutritional epidemiology. For many years, newspapers and television and radio have traded off stories along the lines of 'people who consume food X have health outcome Y'. That might well be nutrients and cancer risk. It might be a particular vegetable associated with longevity. It could well be a particular beverage associated with mental wellbeing.

The problem, as health writers Peter Attia and Bill Gifford point out, is that 'our food choices and eating habits are unfathomably complex', so observational studies are almost always 'hopelessly confounded' (Attia and Gifford 2023, p300). Most likely, a study that looks at people who consume a certain kind of food is going to tell it tell you a lot about those kinds of people, and very little about that type of food.

For example, nutritional epidemiology once suggested that people who consumed moderate amounts of alcohol had better health outcomes than those who consumed no alcohol, or a lot of alcohol. This turned into a recommendation that people should have one glass of red wine a day, that would be protective for your heart.

But then a more rigorous form of evidence came along. This used the fact that on a random basis, a small portion of the population have a genetic intolerance to alcohol. Using that approach, known as 'Mendelian randomisation', researchers could compare non-drinkers with drinkers. In those studies, non-drinkers appear to have better health outcomes than moderate drinkers (Biddinger et al 2022).

Why might the nutritional epidemiology results have been wrong? Well, one reason was that it turned out that some of the non-drinkers were former alcoholics. Moderate alcohol consumers also appeared to have better health behaviours in other regards. They tended to exercise more, they tended to have better mental wellbeing. It looks now as though the low-quality evidence was driven by the kinds of people who had the discipline to consume small amounts of alcohol every day, rather than by the causal effect of alcohol on health (Zhao et al 2023).

By establishing the Australian Centre for Evaluation, the Australian Government seeks to get more randomised trials into public policy – to move up the evidence hierarchy. As evidence improves, we're able to make better policy decisions. As economists, great use of evidence is one of the signatures of what we do.

Lesson six: consider expected value. Expected value is unfamiliar to most non-economists. Non-economists very free frequently think about things that will happen or won't happen. But economists are comfortable in the world of probabilities, and the world of risks in thinking about things that are unlikely to happen but aren't zero probabilities.

When we insure our homes, we're not buying a policy based on the assumption that our house is going to burn down in the next year. We're buying a policy that we believe is good value because the cost of the home burning down would be catastrophic if it were to happen.

So too we should use expected value calculations when thinking about risks to humanity. If you ask artificial intelligence researchers about catastrophic risk, the median researcher believes the probability that the long-run effect of advanced AI on humanity will be 'extremely bad (e.g., human extinction)' is 5 percent (AI Impacts 2023; see also Leigh 2021).

Those who don't think in terms of expected value might say that 5 percent is a small number. Those who do think about the expected value, think of the value of the world multiplied by 5 percent and come up with a very big number. If we can reduce the catastrophic risk of artificial intelligence risk from 5 percent to 1 percent, then that would have a huge expected value payoff for the for the world. The 2023 Bletchley Park declaration is impressive for its breadth of signatories, though critics have noted that it is light on detail.

Lesson seven: think in magnitudes, not just in signs. One of the things that struck me when I moved from academia to politics was the tendency of people to ask 'will it happen or won't it happen?', or 'will it go up or will it go down?'.

However, the size of those effects are incredibly important. Thinking about the impact of having that daily glass of red wine on your health, I can reassure you that it is a very small impact compared to the risk of taking up smoking. If we're considering the impact of tax changes on behaviour, then fundamentally the most interesting question is not will a tax have a deadweight cost, because they normally do, it's how big is that deadweight cost. In the case of insurance taxes and income taxes, both have a deadweight cost. But the deadweight cost of insurance taxes, according to most economists, is much higher than the deadweight cost of income taxes.

To focus on magnitudes is again to effectively use evidence. And by moving the conversation from up or down to big or small, we're making an important economic contribution to improving the conversation.

Lesson eight: channel a libertarian. Economics has origins in free market thinking. In 1776, Adam Smith wrote 'It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest.' Early French economists continued the focus on market efficiency, coining the term 'laissez faire'.

In the same spirit, it can often be useful in any public policy conversation to ask: 'what is the market failure?'.

You do not have to be a libertarian to ask this question. Even economists who favour an expansive role for government should think about where the market failure exists. A valuable example is John Quiggin's book *Economics in Two Lessons* (Quiggin 2019), a response to Henry Hazlitt's book *Economics in One Lesson* (Hazlitt 1946).

Hazlitt argued that economics can be boiled down to one simple lesson: market prices represent the true cost of everything. Quiggin offers a second lesson: market prices often fail to reflect the full cost of our choices to society as a whole. Quiggin then explores two-lesson economics by looking at market failures in a range of policy issues, including climate change, unemployment, monopolies and inequality. Quiggin is no devotee of Ayn Rand, but he nonetheless asks the libertarian question 'what is the market failure?', and in the process produces a valuable book about economic policymaking.

Lesson nine: remember equity. If you accepted lesson number one – consider wellbeing – then it likely follows that you care about equity. One of the best cases for redistribution is that most economists believe there is a declining marginal utility of income. To form this view, you need to simply believe that another dollar buys less happiness for a billionaire than for somebody who's sleeping rough. If you believe that, then it follows that redistribution can raise overall happiness. In a nutshell, you have the case for a progressive income tax and a targeted social safety net (for which Australia's is the best example in the world). Reducing economic inequality has the potential to boost overall societal wellbeing.

By considering equity too, we can ensure that we're not making the mistakes that flow from only looking at averages. If Elon Musk walked into a bar, the average wealth would be over a billion dollars. But each drinker wouldn't become a billionaire. To simply look at averages is to miss the distributional consequences. To miss the distributional consequences is to miss the welfare consequences. Even the most free market economist should focus on distribution, because to focus on distribution is to come back to the roots of economics in boosting wellbeing.

Lesson ten: incentives matter. Much of policy involves using the power of incentives to shape behaviour. Subsidies may be used to encourage firms and individuals to purchase goods and services with positive externalities, such as solar panels and electric vehicles. Taxes can be used to deter the consumption of goods and services with negative externalities, such as tobacco and alcohol. Performance-based contracts shape incentives to private providers in markets such as infrastructure and health care.

Incentives can work in unexpected ways. One example (possibly apocryphal) is the 'cobra effect', said to have occurred under British colonial rule in India. Supposedly, the British government placed a bounty on cobras to reduce their population. In response, locals began breeding cobras to collect the reward, resulting in an increase in the cobra population.

The Australian Government has sometimes been surprised by citizens' response to incentives. In the May 2004 federal budget, the Australian Government announced that the parents of babies born on or after 1 July 2004 would be eligible for a $3000 'Baby Bonus'. Asked how the policy would work, the government confirmed that parents of a child born at 11:59 pm on 30 June 2004 would receive no payment, while parents of a child born at 12:01 am on 1 July

2004 would receive $3000. The responsible minister confidently stated that this 'introduction effect' would not affect the timing of births. However, Gans and Leigh (2009) found that more babies were born on 1 July 2004 than any day in the previous three decades. In total, around 1000 births were shifted from June 2004 to July 2004 so that parents could receive the payment. Policymakers ignore the power of incentives at their peril.

Conclusion

Over the past two decades, I have served as a policy-focused university economist, then as an economically-focused member of parliament. Drawing on that experience, here are my ten lessons for economic policymakers:

1. Focus on wellbeing, not just dollars.
2. Think comparative advantage.
3. Ignore sunk costs.
4. Optimise, subject to constraints.
5. Use the best evidence.
6. Consider expected value.
7. Think in magnitudes, not just in signs.
8. Channel a libertarian.
9. Remember equity.
10. Incentives matter.

How might these lessons be applied? An economist asked to devise a creative arts policy might recognise that the objective is maximising social wellbeing, not merely the incomes of those in the sector (lesson one); ensure that it creates incentives for artistic collaboration (lesson ten); and evaluate the program using a randomised trial (lesson five). An economist developing an industrial policy might focus on existing strengths (lesson two), be willing to abandon unsuccessful projects (lesson three), and take moonshot risks with high expected payoffs (lesson six). Or an economist crafting housing policy might start by asking 'where is the market failure?' (lesson eight); acknowledge that certain policies are politically unfeasible (lesson four), opt for approaches with larger magnitudes of effects (lesson seven) and begin with approaches that help the most vulnerable (lesson nine).

Finally, economists would do well to engage with the Economic Society of Australia. The Economic Society does a great deal to strengthen the intellectual conversation about economics, but also to build the social ties. In that sense, it embodies a couple of my rules. To be an effective economic policymaker isn't just about being bold in ideas. It is also about improving your utility and your wellbeing through engagement with your fellow economists.

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