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“Politicians and Economists: A Troubled Relationship”

2006 OXONIA Inaugural Lecture

By Professor Lord Desai (LSE)

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In delivering the 2006 OXONIA Inaugural Lecture Lord Professor Desai first considered the differing objectives of politicians and economists, before examining how they have interacted in relation to two major UK policy problems – productivity and macroeconomic stability. He argued that they have worked together well to produce a framework for macroeconomic management, but thought that a solution to the productivity problem will require politicians to express their dissatisfaction with current theories to their economic advisers.

Lord Desai began by asking what the problems of economists are as they think about policy, and how they are received by politicians. He argued that economists have a very simple view of themselves – they are perfect. They think that politicians don't understand economics, and are short-termist and short-sighted. In the UK, economic influence on policy has been greater than in any other country, including the US. This is because of the structural role of the Treasury, and also because many politicians believe that they know something about economics. Economic journalism, which has recently increased tremendously, has also made a difference. Politicians certainly have different objective functions from economists; they regard full employment, low inflation, and the like, as intermediate objectives, working towards the end of getting re-elected. There is one final test of economic policies; can the policies get a government re-elected? On this criterion, monetarism was a success for the Conservatives. A politician acts on a 24-hour horizon. The next day, he or she has to get up in Parliament and defend a policy, or fight off bad headlines. But, when economists do offer advice, politicians can think for themselves, and don't

always act along predictable lines. Some economists feel that there should be an overriding constitution which interest groups can't affect, so that the big long-term interests of society will be taken into account. For instance, Hayek seems to think there's a law beyond society that governments shouldn't be able to alter. But who is to know what the long-term interests are? The long-term interests are the product of a dialogue. They change, because people decide they want different things. And politicians are the agents for expressing these changes – whether they are good agents is another question, of course.

The Problem of Productivity

Lord Desai noted that, during the 41 years that he had been in the UK, some problems had stayed constant. One constant unsolved question is: what can be done to improve growth? How do we raise the productivity of British industry? Planning along French lines has been tried, so have large firms (under Harold Wilson). It's been thought that productivity will rise with increased demand. But the same problem remains, and Gordon Brown's speeches are similar to Harold Wilson's. One response is that it doesn't really matter, because the British economy has grown at approximately 2½ per cent per annum. We're all better off; real income has roughly quadrupled since 1960s. But British economic debate is still being conducted with some sense of urgency, some sense of searching for a holy grail. The problem remains because we don't really have a theory of what causes growth, and we also have the wrong measure. We should realise that productivity is not the issue in a capitalist economy – profitability is. In one sense, productivity is the dual of profitability. We have the productivity hang-up because we still think of the economy as a factory; the amount produced tells us something about the economy's efficiency. We think about the economy as a one-good economy, which tells us nothing at all about how an economy works. Why should tax policy really affect productivity? We're driven by politicians who actually think that when talking about productivity they're talking about something real. They don't want to talk about higher profitability, because that is slightly dirty. But if an economy has enough profitable firms, that economy will be healthy. We don't think like this because profitability doesn't enter into our concepts. If we want to think about profits, we have to go into 'the underground of economics', because no serious, respectable economist would worry about profitability.

The Problem of Macroeconomic Stability

Lord Desai felt that one important problem in the UK economy has been solved in the last four decades: how can low unemployment, low inflation, low interest rates and stable exchange rates be combined? In the 1960s, it was felt that Keynes had solved the problems. Nobody realised that the Keynesian description was very good for a closed economy, but less useful for an open economy chancellor. The advice the chancellor was getting from the Treasury and everybody else was to ignore the open economy problems. What the Treasury

was saying at the top level was ‘Don’t worry about the budget deficit, worry about unemployment. And if inflation is too high, it’s because we haven’t exploited returns to scale. If we just spend more money, output will go up.’ The problem was that even the best minds that we had couldn’t model the economy in a way that a politician could usefully act on. By contrast, in the last decade macroeconomics has become the duller subject on earth, because there’s nothing to debate about. How come, since our exit from the ERM, the macroeconomic environment has become so benign? What’s been happening is that economists have been searching for a better way of modelling the economy; modelling has been revolutionised in the last four decades. Quarterly data wasn’t available in 1965, and there was only one model of the British economy, at Oxford, at that time. By the 1990s, we had abandoned naïve Keynesianism and monetarism, and the idea came that governments needed a credible policy structure, understood by markets. The search for an anchor, along with developments in economic theory, allowed us to construct a sensible policy framework; statutory independence of the central bank combined with a fiscal rule (‘the golden rule’). These combine to make a credible economic strategy. In the 1960s policymakers didn’t know that this was the best way to frame economic policy. After a lot of mistakes, we now have convergence on macroeconomic policies around the world. The reason that economic theory has developed to produce macroeconomic stability is largely due to the politicians. Economists were very happy with the theories they were teaching in classrooms. It’s only because they were driven by politicians to go and find something better that they did so; this would have not happened without the political influence. We might have to wait for politicians to ask us to construct a better theory of profitability before we can properly address the ‘productivity’ puzzle.

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