

### **Are economic consultants worth feeding?**

Although signs forbidding citizens from feeding the economic consultants are not (yet?) a feature of our parks and public places, there can be little doubt that the species is growing and that some, at least, regard it as a pest. Of its members, many are part-time, plying their trade between what they laughingly refer to as “jobs”, but others, more hardened, seem to do little else. Is this proliferation a concern? Can we expect to see—should we hope to see—newspaper headlines proclaiming “Report shows economic consulting costs Australia billions in lost productivity” – presumably on the basis of estimates, of whatever quality, by one or more members of precisely the group at issue, and leading, undoubtedly, to a COAG process aimed at curbing the phenomenon, perhaps through a mechanism to be known as “EconomistWatch”, administered with steely severity by a special commissioner of the ACCC, or maybe through an increased tax on “Alcoponomics”?

Were the matter put to the popular vote, there can be little question as to the outcome. The perception of economic consultants in the wider community is, I am sure, mixed as best, and even among economists it may not be much better.

I will, however, seek to cast matters in a somewhat different light, and argue the case for the status quo, in which the profession of economic consultant, like that of used car dealer, insurance agent and purveyor of the more respectable forms of pornography, is tolerated, occasionally indulged, but plainly not exalted.

Let me therefore make a first, perhaps audacious, claim: economic consulting has always been with us

Even 1800 years ago, the demand to solve problems that have an economic character called forth its own supply, as can be seen from the Talmudic discussion of risk aversion, in which those competing sages, Rabbi Khisda and Rabbi Nathan ben Oshaya, each vying for community approval and peer respect, offered alternative ways of estimating damages in the presence of uncertainty and time preference – indeed, reading Nobel Laureate Robert Aumann’s brilliant exegesis of the Mishna’s analysis makes one wish the advice obtained was always as rigorous and as insightful.<sup>1</sup> And though Say’s Law (that demand creates its own supply) may have had its day, a similar mechanism – in which the pressure of economic concerns led to a search for economic solutions – ensured that economists were called on, and increasingly so, as economic growth, industrial progress and the development of giant enterprise made the problems that needed to be addressed ever more complex.

When, at the turn of the twentieth century, the Swiss Railways needed to find a way to price efficiently, who did they call on? No less an authority than Leon Walras, the pioneer of general equilibrium theory, who recommended removing the ceilings from the carriages of the third class compartment, exposing their occupants to the rigours of the Swiss winter: not, as he carefully explained, so as to punish the poor, but rather, so as to frighten the rich, thus forcing them to reveal their willingness to pay the high

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<sup>1</sup> Robert J. Aumann (2003) “Risk aversion in the Talmud” *Economic Theory* 21, 233–239.

contribution to common costs built into the first class fare – thereby actually making the poor, who could benefit from rail travel at lower fares, better off.

Equally, when AT&T needed advice on depreciation, they turned to Harold Hotelling, who developed the concept of economic depreciation (the twin of the Hotelling valuation rule) and helped write a text on “Depreciation in the Bell System”. And it was Electricite de France that induced Marcel Boiteux to do his fundamental work on optimal pricing in the presence of fixed costs, just as it commissioned Maurice Allais’ and Pierre Masse’s development of rules for efficient investment under irreversibility.

As in the theory of public utility pricing, so too in the field of industrial organisation major advances have generally come from the application of analytically alert minds to practical concerns. Moreover, and perhaps paradoxically, what distinguishes industrial organisation is the extent to which our understanding of how to analyse competition has come from work squarely aimed at defending monopoly.

The concept of “workable”, as compared to perfect, competition was developed by J. M. Clark for the American cement manufacturers, whose repeated efforts at collusion were, in the industry’s view, improperly frowned upon by the authorities. As for the theory of contestable markets—including the proper definition of cross-subsidy, the concept of sustainable and unsustainable natural monopoly, and the modelling of endogenous market structure—it was largely, if not entirely, developed by Bell Labs and its consultants in the face of the regulatory and antitrust proceedings that eventually led to the dismemberment of AT&T and of the Bell Labs with it: calling to mind (at least for those who believe, as I do, that the AT&T divestiture was a tragic mistake) Tom Lehrer’s quip about the Spanish civil war, that they may have won all the battles, but we had all the good songs.

Equally, the concepts key to understanding predatory or exclusionary conduct were given much needed clarity and focus by the consultants to IBM, in the Department of Justice’s antitrust proceedings against it that stretched from the 1960s to the 1980s, and to AT&T, in the proceedings it fought against MCI. So too was the theory of two-sided markets developed in the 1990s battles between the global payment card systems and competition authorities internationally. Overall, it would be difficult to understand the shape of the contemporary theory of industrial organisation without knowing that it emerged from heated clashes between economic consultants in antitrust courts and regulatory proceedings, as much if not more than from measured debates in scholarly journals.

All of these examples may seem remote from Australia. But I would argue that there are enduring features of our national life that have created a significant role for economic advocacy and closely associated with it, economic consulting.

There is, first of all, a predisposition, albeit varying at differing periods of our history, to view issues in a perspective that is utilitarian, and often narrowly economic.

In a celebrated article, Hugh Collins described Australia's political culture as Benthamite;<sup>2</sup> and although I believe that a too simplified and in some ways misleading characterisation, it is true that the differing strands in our intellectual traditions have found in the utilitarian calculus a common language, less restrained than it is elsewhere by an emphasis, associated with the conservative tradition, on the inherent value of institutions and processes, rather than of outcomes.

Hayek distinguished between purposive order, the *taxis*, and spontaneous order, the *cosmos*, and similarly Oakeshott contrasted society viewed as an 'enterprise association', devoted to the attainment of substantive ends, notably the satisfaction of material wants, and as a 'civil association', articulated by procedural rules and with no need or want for "starting point or appointed destination". In Australia, it has always been the directive former, the enterprise association and the *taxis*, rather than the less purposive latter, the civil association and the *cosmos*, that has marked the spirit of government.

The result, unsurprisingly, has been a prominence of economic argument in national debates. Already in 1926, writing in the *American Economic Review* about the "progress and problems of Australian economics", Herbert Heaton lamented the state of the profession in "a land where every political problem was an economic one, and every economic issue was the subject of political controversy."<sup>3</sup> Keith Hancock, in his monumental *Australia*, reported the disparaging view that the "guardians of Australian orthodoxy" had of economists as "exasperating calculators"<sup>4</sup>; but he also noted (approvingly citing Bryce) that Australia was "the country in which material interests have most dominated politics" and that in Australia, "every economic difficulty is generalised as a political issue, with the double result that it becomes more difficult to solve and more exasperating when it remains unresolved."<sup>5</sup> With the decline of rival modes of justification, such as the great ideologies and the secular and spiritual religions, that dominance of economic rhetoric has become ever more pronounced, perhaps filling the "commendable emptiness" that Donald Horne identified as following from the decline of the self-image of British Australia in the mid-1960s.

A second, connected, feature thrusting economic argument into the forefront is "the long established habit", so well described by R. S. Parker, "of institutionalising the resolution of conflicts over the allocation of values .. [in] a system of adjudication based on committees, boards, trusts, departmental agencies and similar institutional devices", thus avoiding, wherever possible, "ad hoc bargaining or trials of strength."<sup>6</sup> Having being given its independence, each such entity, entrusted with the task of deciding matters such as the basic wage, the tariff or the allocation of Commonwealth financial support between the States, could only legitimise its decisions by finding what Menzies described as "standards or policies by which to test the cases presented

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<sup>2</sup> Collins, H. (1985) "Political ideology in Australia: The distinctiveness of a Benthamite society" in *Australia: The Daedalus Symposium*, S. R. Graubard (ed.), Australia: Angus and Robertson.

<sup>3</sup> Herbert Heaton "Progress and Problems of Australian Economics" (1926) *The American Economic Review*, 16:2, pages 235-248, at page 235.

<sup>4</sup> Keith Hancock (1931) *Australia*, Charles Scribner's, New York, page 102.

<sup>5</sup> Ibid at page 276.

<sup>6</sup> R. J. Parker (1965) "Power in Australia", *Australia and New Zealand Journal of Sociology*, volume 1, pages 88-89.

to it”<sup>7</sup>, such as the various (rather incoherent) adequacy tests developed in the industrial relations courts and the Tariff Board’s notorious “economical and efficient production” standard, institutionalised by the Ottawa Agreement of 1932. Implementation of such standards in particular cases and circumstances created a clear role for evidence given by economists, often in a consulting capacity, and that economic evidence became an early and persistent feature of the system’s workings.

In the industrial relations system, for example, a long time participant could say of the economic experts called upon by the parties that “they were regarded as part of the paraphernalia, mere appendages to the drama of a wage case .. performing seals.. brow-beaten during cross-examination and frequently intimidated”.<sup>8</sup> Matters came to a head when J. O. N. Perkins, faced with a particularly robust assault, refused to give evidence in person, leading to an economists’ boycott of the proceedings that began in 1961 and only ended when the economists providing advice were forced to appear through subpoena in 1966. Even by unexact local standards, there is no evidence that the economists’ withdrawal did anything to further reduce the already low quality of the decisions taken.

While the economists’ contribution to the industrial relations system added little lustre to the profession, the same cannot be said of the Tariff Board. At the most microscopic level, it was a commission to help prepare a brief seeking assistance for a producer of printed cotton piece goods that tweaked the young Max Corden’s interest in the structure of the tariff and through that, in the effective rate of protection: a commercial acorn from which sprang one of Australia’s most significant contributions to the theory of international trade.<sup>9</sup> From the mid-1960s on, Alf Rattigan and Bill Carmichael, senior members of the Board, ran hard with the notion of effective protection as a way of reforming a tariff structure that was as irrational as it was costly. Their decision to do so, and the rigour and determination with which it was pursued, not only brought myriad economic benefits but, importantly for this story, gave economic analysis extraordinary legitimacy as a guide to decision-making.

It is on that fertile ground that economic consulting in Australia developed, with its growth accelerating as structural reform created a slew of issues of analysis and implementation and opened new areas – such as the field of trade practices and more broadly, competition policy – to the systematic use of economic evidence. If economic consulting could take some of the space thus created, it was also because academic economics seemed to pull back from a direct interaction with industry and public policy which, at least according to some observers, had been far more

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<sup>7</sup> R.G. Menzies (1962) in J. G. Crawford (1968) Australian Trade Policy, 1942-1966, Canberra, at page 467.

<sup>8</sup> Jim Robinson, advocate for the employers in the 1960s, cited in Blanche d’Alpuget (1977) Mediator: A Biography of Sir Richard Kirby, Melbourne University Press, Melbourne, at page 190.

<sup>9</sup> Of this work, Corden says “I do remember that I was paid, and also was taken out to dinner at a high-class (or so it seemed at the time) restaurant in a hotel that the firm’s owners also owned.” As for the work itself, it “made me aware of the importance of vertical relationships among products, and specifically that a tariff on an input reduces protection for value added of the final product. In my later lectures and writings my examples of effective protection always came from the textile industry. I believe that this consulting work started me off on the ‘effective protection road’.” Max Corden, (2005) “Effective Protection and I”, *History of Economics Review*, volume 42, pages 1-11, at pages 1 and 2 respectively.

pronounced in earlier periods.<sup>10</sup> The academics' retreat may have been a "trahison des clercs" – a betrayal of the intellectuals, in Julian Benda's famous term – but as one group of economic clerics withdrew, market forces ensured that other flogging parsons took their place.

The outcome is that the "exasperating calculators" appear to have triumphed. Every day, newspaper headlines tell us of this study or that, "showing" that the economic consequences of pursuing a course of action are (in the case of benefits) staggeringly large or (in the case of costs) remarkably small. There is, to the best of my knowledge, no other country in which economic studies are the stuff of broadsheet and tabloid, of morning TV and serious news commentary. Shocking policy decisions continue to be taken, at no lower a rate than in the past; but the economics profession, and even more so the economic consultants, can get a warm glow from the sense of doing well by doing good. But how merited is the sunshine?

James Fenton, a marvellous poet, once wrote that "It would be very odd to go to a concert hall and discover that the pianist on offer *wasn't any good at all*, in the sense that he couldn't actually play the piano. But in poetry this is an experience we have learned to take in our stride."<sup>11</sup> It is difficult to escape the thought that he could have been writing about economic consulting.

This is not to disparage the very good work that many do. The risk, however, is that the oracular and magical—the semblance of rigour, the mumbo-jumbo of the economist's art, the lure of what might be termed 'number envy'—can so readily give substance and credibility to arguments that, stripped of the arcane, are nugatory. Misused, economics can end up doing as much harm to the quality of public debate as its proper use can do good.

Consider, for example, the slew of studies telling us that curing major afflictions in our society – violence against women, child abuse, aboriginal disadvantage – would yield large economic gains. Perhaps; but surely no sensible person would become a proponent of child abuse, a justifier of aboriginal disadvantage or adopt a tolerant attitude to violence against women were the economic gains found by cost-benefit analysis to be smaller or even entirely negative?

Stanley Engerman and Robert Fogel, using techniques far more rigorous than those of the studies I have referred to, showed long ago that slave agriculture was highly efficient, so that abolishing it imposed economic losses. That hardly means, nor did they ever suggest it to mean, that slavery was a desirable feature of American society.<sup>12</sup>

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<sup>10</sup> Alex Millmow (2007) 'Does academic economic opinion matter any more?,' paper presented at the Governing by Looking back Conference, hosted by the Research School of Social Sciences, ANU College of Arts & Social Sciences, Canberra, Dec 12-14.

<sup>11</sup> James Fenton, "Some Mistakes People Make About Poetry", *N.Y. Review of Books*, March 25, 1993, quoted in by X. J. Kennedy in Stephen Kuusito, Deborah Tall and David Weiss (editors) (1995) *The Poet's Notebook: Excerpts From The Notebooks of Contemporary American Poets*, W.W. Norton, New York, at page 131.

<sup>12</sup> Stanley Engerman and Robert Fogel (1974) *Time on the Cross: The Economics of American Negro Slavery*, Boston: Little, Brown and Company.

True, one might say, but don't those studies tell us how much we should spend so as to cure those ills? Obviously not. It is no more than elementary economics to note that what matters, in selecting among courses of action, is not a comparison of total costs and benefits, but of costs and benefits at the margin. That eliminating a condition entirely would yield a benefit of say \$10 billion is irrelevant, if spending the first billion to achieve that goal secures \$3 billion of those benefits, but going from that \$3 billion to the potential \$10 billion costs \$7.1 billion. In that event, it is not efficient, in a cost-benefit sense, to spend just over \$8 billion to cure an ill valued at \$10 billion. Rather, society should, if this is indeed an economic problem, live with \$7 billion worth of child abuse. Economics is a harsh mistress in these respects, and only the reckless invoke her lightly.

Matters are then made all the worse by the many technical issues that beset studies of this type. For example, if one counts the costs of afflictions such as binge drinking or exposure to the sun, why wouldn't one also count the utility derived by those who engage in them? How can it make sense, in assessing social costs, not to consider the savings society obtains when those suffering from the condition being studied die young? If human life is to be valued in terms of the loss of human capital, how can one ignore the fact that Australia faces a highly elastic supply of migrants, so that replacement costs for human capital are very low, and especially so for the relatively poor and unskilled who are generally over-represented among the victims? And if all of the policies recommended by these studies—amounting to a program for the eradication of all afflictions—were to be implemented, wouldn't the costs be far greater than those individual studies present, or have scarcity and the tyranny of upward sloping supply curves been abolished? How is it then that each week further recommendations to move up those supply curves are issued, as if no other policies had already been as ardently advocated and endorsed?

These are, of course, quibbles. Counsels of perfection count for little when deadlines loom, clients await, and bills must be paid. And in any event, we are not here to bury economic consulting but to praise it. If, economics, and hence economic consulting, are to be part of the theatre of Australian public life, let us embrace that role with brio.

Ours may not be the theatre at its grandest, of Shakespeare, Chekhov or Ibsen. But our part in the pageantry of persuasion is surely no worse than a David Williamson, appealing to our hopes and fears, our emotions and embarrassments, and in the process highlighting wrongs, perhaps helping avert even greater harms and—who knows?—occasionally inducing a move in the right direction. A country that argues over issues on the basis of the utilitarian calculus may have its faults, not least a certain dullness, but is blissful to those used to societies in which differences are played out in more divisive, ultimately much more menacing, ways. If economists and economic consultants are to be its sorcerers disguised as bean-counters, witchdoctors wielding spreadsheets and equations, one can only say that mankind has seen far worse. These are vices we can afford to tolerate.

No one knew this better than the early 19<sup>th</sup> century classicist, Thomas Love Peacock, whose glorious satire, "Crotchet Castle", features the delightfully named Scottish economist, Mr MacQuedy. Mr MacQuedy's enthusiasm for the newly founded discipline of political economy – which he terms "the science of sciences" – knows no bounds, and he regards its disciples as "the modern Athenians". This earns him a

harsh rebuke from his dining companion, the Reverend Doctor Folliot, who summarizes economics as “premises assumed without evidence, or in spite of it; and conclusions drawn from them so logically, that they must necessarily be erroneous”.

Readers of contemporary economics journals would have to concede that the Reverend Folliot, whose views are driven by his passions for Kant (who he clearly does not understand) and for wine (which he understands all too well), has a pretty good point. But the spirit of Mr MacQuedy triumphs, not least through song—for it is in “Crotchet Castle” that we find the reforming economist’s hymn, to be engaged after a fine meal and a drop or two of excellent claret. As we rededicate ourselves to the lofty—millennial?—goal of ensuring that at least in this country, no economic consultant, actual, aspiring or potential, will live in poverty, much less be short of a feed, let us all—functionary and freebooter, courtier and critic, analyst and advocate—stand respectfully to attention, raise our glasses, and intone its immortal words:

After careful meditation,  
And profound deliberation,  
On the various pretty projects which have just been shown,  
Not a scheme in agitation,  
For the world's amelioration,  
Has a grain of common sense in it, except my own.