

THINKING LIKE AN ECONOMIST

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Overview

- We will explore a little of the philosophy and caste of mind of the economist and argue (a) that there are a lot of diverse ideas and (b) they are relevant directly to public service reform and prevention
- Economics can provide guidance how to, and a systematic way of, thinking about decision-making by all actors
- Economics criteria should play a role but need not trump other criteria like social justice or human rights but they should be factored-in to decisions
- Link to evidence, knowledge and more or less complex chains of cause and effect
- Main focus will be on a number of key concepts from economics which we will relate to an illustration

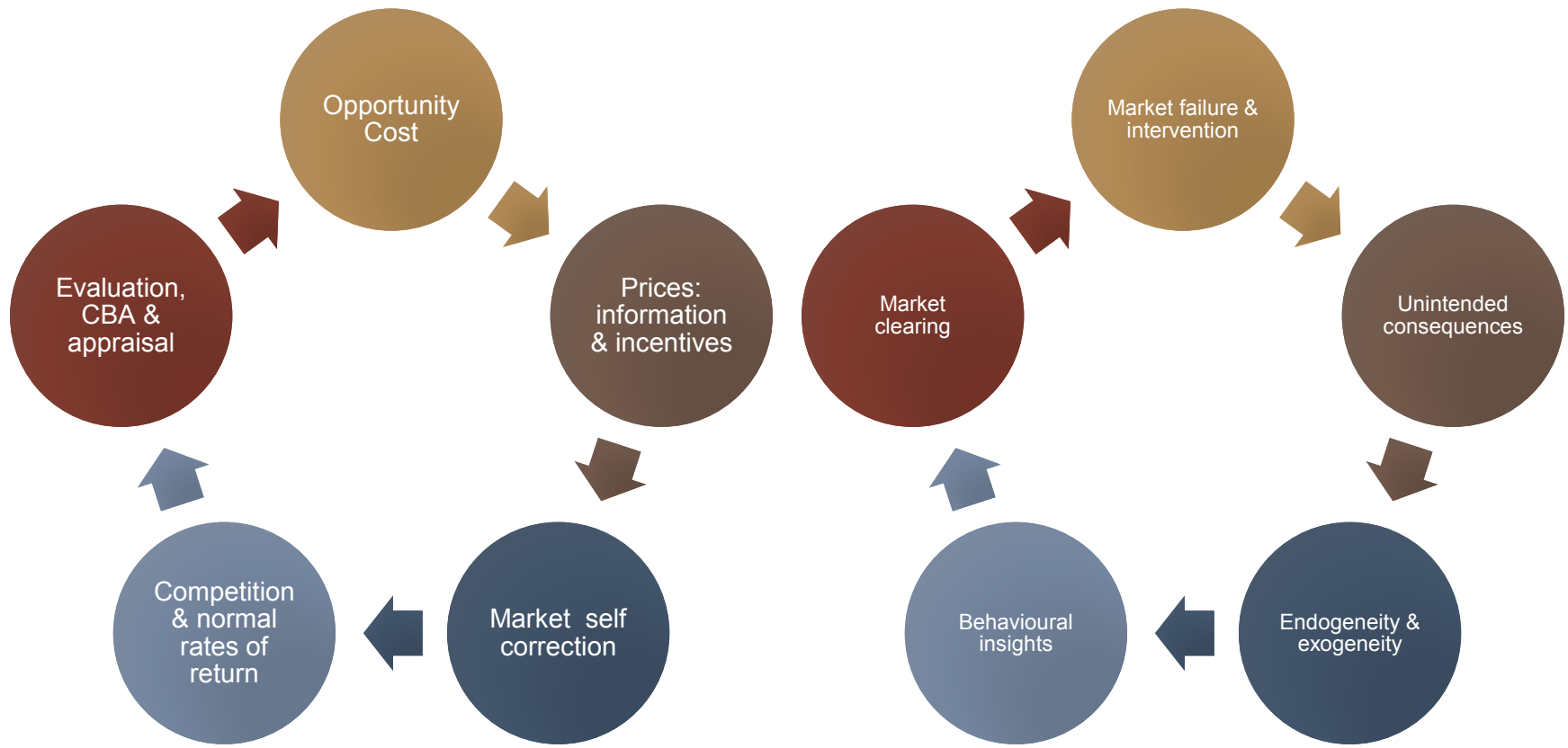
What is Economics?

- City of Glasgow Bank, 1888 – nothing new under the sun
- Material decision making at all scales
- Ubiquity of scarcity and rationing –relevant to *all* human endeavours
- In defence of economic efficiency
- Verbal, graphic and mathematical reasoning
- Conceptual and empirical – a strength but the pitfalls of forecasting
- Mainstream and heterodox economics

Prevention and Disinvestment Illustration

- Prevention is ‘spending to save’
- Reducing long term ‘failure’ demand
- Dealing with causes rather than symptoms
- There is consensual support for the aims of prevention
- In current funding climate, however, a ‘decisive shift’ to prevention can often require an element of **disinvestment**
- How do you decide:
 - (a) What preventions are to be prioritized?
 - (b) How would you rank areas or programmes for disinvestment?
- How can economic ideas help make these difficult decisions?
- We will look briefly at 10 ideas of clusters of ideas

Key Concepts



Opportunity Cost

- Trading choices off like guns and butter or housing (health) versus general consumption?
- No such thing as a free lunch
- What was the best alternative use of the resources required to do X?
- What will not happen as a result of doing X?

Prices as information and incentives

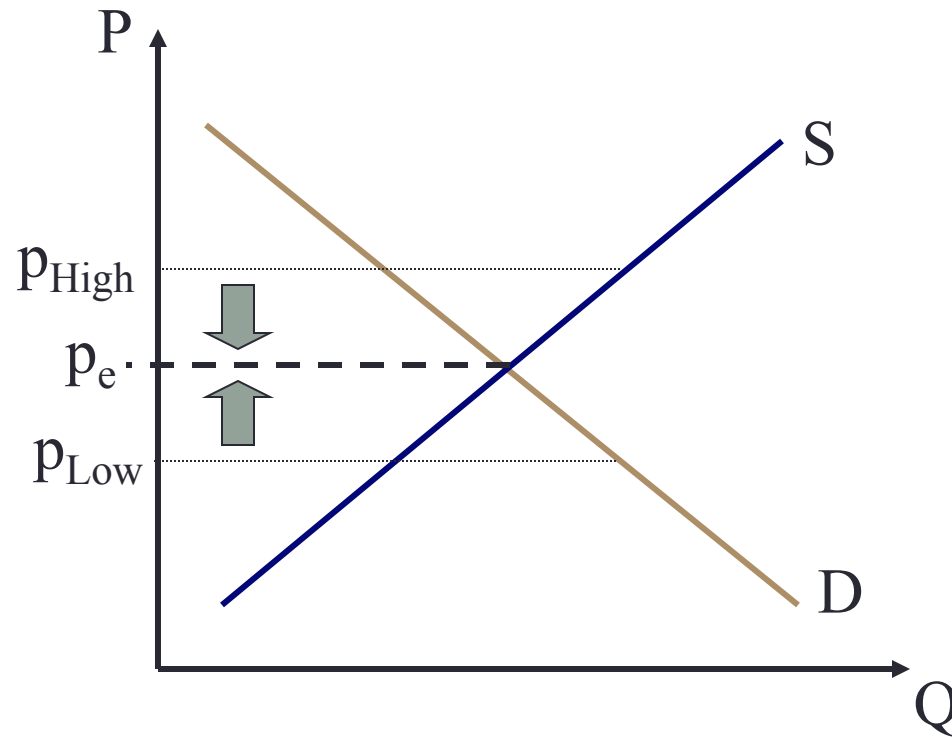
- Price signals as information to help make decisions
- Prices as incentives that influence decisions
- Prices on their own, and within limits tell us a lot

Markets can self-correct

- If (and it is a big 'if') markets work properly they adjust themselves (provided there are clear and enforceable property rights)
- If Demand exceeds Supply, prices rise and markets clear
- If supply exceeds demand, prices fall until $D=S$
- The most that can be sold or consumed in a given market is where $D=S$
- Price signals and the automatic adjustment function – is a very powerful mechanism that is hugely influential for policy frameworks and suggests little role for economic planning (Austrian view is that the complexity of markets makes planning infeasible)
- But like many aspects of economics – it is an empirical question

Automatic adjustment towards Equilibrium

- Equilibrium occurs where there are no net pressures for price or quantity to change
- This only occurs where $D=S$ (market clears) because if $D>S \Rightarrow \uparrow P$ and if $S>D \Rightarrow \downarrow P$



Competition and Rates of Return

- Why are competitive markets so valued by economists?
- Competition disciplines markets and cuts cost
- Ethical basis – pareto optimality criterion
- Promotes the interest of consumers
- Contestability and the threat of competition
- Regulating anti-competition
- The downside of competition
- Normal and abnormal rates of return
- Economic rent and land value taxation

Unintended Consequences

- A sociological idea from yesteryear but economics is replete with their identification
- Many 'attractive' policy ideas fall foul:
 - rent controls
 - bedroom tax
 - help to buy

Market Failure & Intervention

- Markets can fail because of:
 - market power
 - information problems
 - spillovers
 - public goods
 - chronic volatility
- What market failure is not
- Are state responses and interventions appropriate and efficient?

Appraisal, Cost-Benefit Analysis, Evaluations

- Distinguish ex ante economic appraisal of an intervention from ex post economic evaluation
- Cost-benefit analysis versus cost-effectiveness
- Defining and measuring benefits and costs
- Time, investment and discounting



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THE GREEN BOOK

Appraisal and Evaluation in Central Government

Note explaining changes made to the Green Book in July 2011:

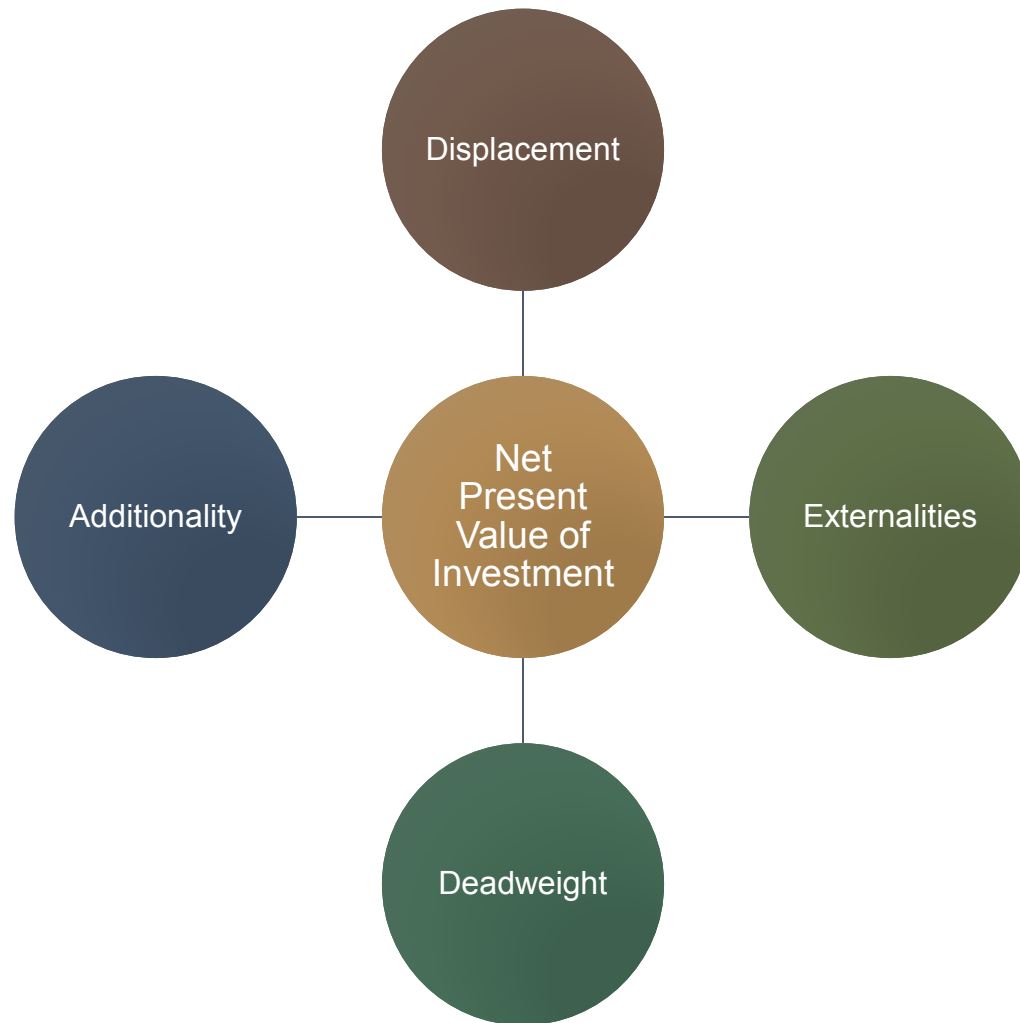
This is the 2003 edition of the Green Book. However, pages 57-58, which deal with the valuation of non-market goods have been updated alongside the release of a Green Book discussion paper on this subject - Fujiwara and Campbell (2011), Valuation Techniques for Social Cost Benefit Analysis: Stated Preference Revealed Preference and Subjective Well-Being Approaches.

The changed text on pages 57-58 has been highlighted in red within this updated document. Because of the changes there is some duplication of paragraph numbers, and there is some change to the sequence of footnotes in this section.

Treasury Guidance

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Evaluation Core Ideas



Behavioural Insights

- Rational maximizing selfish economic man?
- Bounded rationality
- Heuristic Biases and cognitive bandwidth
- Loss Aversion
- Mental accounting
- Non-selfish goals
- Hyperbolic discounting/ 'present bias'
- 'Nudge' and the 'behavioural insights' unit

A Note on Endogeneity

- Applied economists develop models to explain and/or predict outcomes
- A key problem is endogeneity and the elusive search for causal relations
- Data is often secondary but new techniques (panel and instrumental variables) help
- Increasing interest also in experimental methods, natural experiments and random controlled trials

ASSUMPTIONS



INPUTS



ACTIVITIES

OUTCOMES



IMPACTS



Concluding Thoughts

- Economics and decision-making
- Returning to prevention and disinvestment
- Enlightened scepticism but many important and useful ideas
- Thinking like an economist will not necessarily make you dismal or grow the size of the pizza but it might help make real decisions

Further Reading

- Ha-Joon Chang (2014) *Economics: The User's Guide*. Pelican: London
- Avinash Dixit (2014) *Microeconomics: A Very Short Introduction*. Oxford University Press: Oxford.
- Le Grand, J, Propper, C and Smith, S (2008) *Economics of Social Problems* 4th Edition, Palgrave Macmillan: Basingstoke) ch 4
- Glennerster, H. (2009) *Understanding the Finance of Welfare (2nd Edition)*. Policy Press: Bristol
- Poundstone, W (2008) *Priceless*. Hill and Wang: New York.