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Unintended Consequences- Advice for Politicians and Policy Analysts

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Far too often, political policy makers are surprised by the consequences of their policy action; a simple policy decision with seemingly obvious consequences can lead to damaging unintended consequences. The careful study of economics reveals the causes of unintended consequences of policy decisions. The economy is not a simple machine that can be adjusted to obtain a certain outcome; it is a subtle social system driven by consumers, producers and investors who can anticipate outcomes and adjust their behaviour accordingly. Any policy maker who does not understand this subtle feedback mechanism will make serious errors. This essay explores some examples of policy errors: for example, US housing policies that encouraged excessive lending; trade policies that wasted resources;

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and industry regulation that was based on 'rent-seeking'. The essay emphasises the importance of high-quality, accurate policy analysis.

There is only one difference between a bad economist and a good one: the bad economist confines himself to the visible effect; the good economist takes into account both the effect that can be seen and those effects that must be foreseen …

Yet this difference is tremendous; for it almost always happens that when the immediate consequence is favorable, the later consequences are disastrous, and vice versa. Whence it follows that the bad economist pursues a small present good that will be followed by a great evil to come, while the good economist pursues a great good to come, at the risk of a small present evil.

—Frédéric Bastiat

Predicting the consequences of economic and social policy changes is fraught with traps for the unwary. In this paper I will demonstrate, using examples, how policy makers often fail to understand the economic consequences of their interventions. There are three layers of complexity in dealing with policy formation:

1. Members of the public, without professional training in policy-related disciplines, often do not perceive consequences that are readily predicted by professionals. Discussion in the media is often confusing and misleading.
2. Competent policy analysts may be able to anticipate what appears to the public as 'unintended consequences', but still have difficulty with more complex issues. The economy is not a machine, requiring simple adjustments to obtain a certain outcome; it is a subtle social system driven by bureaucracies, consumers, producers and investors who can anticipate outcomes and adjust their behaviour accordingly. Because of this complexity, policy analysts can be unsure of the size of aggregate responses. Often the data are poor, so that careful prediction can only indicate a range of possible outcomes.
3. Applying more sophisticated analysis and careful data collection can reduce the lack of precision, but this complexity is impossible to eliminate altogether.

These three layers of complexity can be illustrated with two examples.

Example 1: Australian commodity exports to China

Australian commodity exports to China were booming until 2008, but prices went into sudden decline as the international crisis intensified because Chinese exports fell, reducing the demand for commodity inputs. The Chinese government faced a decline in its manufacturing sector causing serious economic and social dislocation. What was surprising to many experienced observers was the size of its fiscal stimulus which led to an infrastructure boom from 2009 through 2012. Having observed the stimulus, shrewd Australian policy analysts would have considered the Chinese government's policy options and its political process and alliances, monitored political commentary and attempted to predict the longevity of the infrastructure boom. This would have given more accurate predictions of the strength and longevity of the Australian commodity cycle, its impact on the Australian economy and federal and state tax revenues.

My discussions with international commentators indicated that the Australian government and its policy advisers were far too optimistic about long-run commodity exports to China and the downside risks for commodity exports. This optimism led to large planned increases in mining capacity and mining revenues. But recently, as Chinese demand has declined and commodity prices have fallen from very high levels, we have witnessed the cancellation of several large Australian mining projects. There has been little analysis of this failure of proper risk-management practices in flagging potential downside risks associated with a rapid expansion of mining investment. International commentators have been critical of Australian policy analysis in this area and its lack of professional rigour.

Example 2: taxi licence plates

In this example, I will examine in depth a simple case of a hypothetical policy decision concerning the restriction of the number of taxi licence plates in a city. This example is often used in beginning economics principles texts. Variations of the scenario have occurred in Australian and overseas cities. I will explore its implications, the people who are affected and their lobbying efforts, then analyse the political and economic machinations surrounding the decision and the economic forces that play out over time.

Suppose that taxi owners who employ drivers have to buy a licence plate from an authority in order to provide a service in a given area or city. If the owners successfully lobby for the authority to restrict the number of new licences, the result after many years, especially with increasing population and demand for taxis, would be a dramatic rise in taxi fares, although the drivers would continue to earn only minimum, competitive wages. The reason is simple: the restriction on the availability of taxi services is controlled by the fixed number of plates. The economic rents from restricting the services flow to the owners of the plates, so that the price of the plates reflects the expected present value of the rents. Often regulators are sensitive to the higher fares and impose fare ceilings, particularly for the disabled or disadvantaged. The taxi owners could respond by increasing waiting times for the lower priced taxis, or otherwise rationing their 'availability'.

But this simple story may not end there. Assume that a reforming regulator observes the high prices of taxi fares and long waiting times in the city. There is much public grumbling about the service. Given the high price of plates, the regulator decides to increase the supply by auctioning off more of them, generating extra revenue for the city. The increased number of licences makes their price fall, the taxi service improves and cab fares decline. Existing holders of plates are incensed because the restriction on the supply was imposed long before they bought the plates at inflated prices. They argue that they are only earning a normal return on their investment in the expensive plates.

Shrewd taxi owners could have foreseen attempts to increase plate numbers and tried to lobby at the outset for various legal and contractual devices restricting any attempt to reverse the policy. Once the licensing scheme has been introduced, it creates powerful vested interests to protect their investment through lobbying.

The only beneficiaries of this scheme are those who owned the plates when the original policy, restricting plate numbers, was introduced. They understood the implications and that fuelled their lobbying. The losers were: first, the taxi customers who paid inflated fares over the period when the number of licence plates was restricted; and secondly, the naive new licensees who did not anticipate the deregulation of the supply. If new owners had begun to suspect that sooner or later the supply would be increased, then the value of the plates would have been lower, reflecting the expected impact of decreased rents with increased competition.

A shrewd policy analyst should readily see the possibility of reactions by other vested interests. For example, if drivers were able to form an active union, then they would be able to bargain with the owners to share the monopoly rents generated by the scarcity of plates. The division of the rents would depend upon the strength of the union's bargaining power. If this were achieved, the owners and drivers would lobby jointly to restrict the number of plates, as any increase in supply would decrease the wages of the drivers and the value of the owners' assets. The prevalence of worker–management rhetoric in the media would then obscure the true situation – that the taxi customers would be the victims of the gouging by the owner-driver coalition.

The principal lesson to be drawn here is that once the system is created it is difficult to change.

Political economy

There are many other examples of policy failures that appear to have large, attractive benefits for one sector or group in the economy, and have negligible costs for individual members of the rest of society. This asymmetry, where a few gain a lot and large numbers suffer small individual losses, provides incentives for the gainers to lobby hard, whereas the losers cannot be bothered to make the effort. Much of the lobbying that takes place in our society has this characteristic. Indeed, it happens under governments of both persuasions, although the vested interests may be different. Some economists complain that a policy decision is inefficient, in that the gainers could have compensated the losers and there would have been a surplus. (The surplus is a measure of the loss or inefficiency.) Reflection should reveal that this political compensation mechanism does not occur, because the analysis ignores the political costs of coalition formation with a dispersed group of losers. Even worse, it may be more productive to find one's own rent-seeking scheme to promote, rather than oppose those of others. And so schemes are piled on top of schemes!

A well-functioning political system will try to reduce these lobbying and associated rent-seeking activities, as they are socially wasteful redistribution schemes. But even the most sophisticated society cannot eliminate them any more than an engineer can banish friction. It appears that the more sophisticated the society, the more subtle the rent-seeking machinations of lobbyists and vested interests. The great danger is that left unchecked, lobbying and political rent-seeking can become so entrenched and pervasive that it can lead to lower growth in standards of living or – in the extreme – economic stagnation.

The following is a brief summary of a number of policy failures that have occurred in the United States and Australia. I have chosen the United States because it has a large literature exploring policy failures.

The US airline industry

The post-World War II, highly regulated US airline industry restricted entry, inflated fares and made flying a luxury form of transport. Major beneficiaries were established airlines and airline unions, which shared in the rents generated by competition created by the impediments to regulatory supply. When airlines were deregulated in 1978 under Democratic president Jimmy Carter, the entry of new competitors reduced fares significantly. Existing airlines with high unionised labour costs went bankrupt. As part of the airlines' reorganisation, union power became circumscribed by competition. Since then, airlines have provided cheap, economy class air travel to the great benefit of the general public.

The Australian car and truck industry

The Australian car and truck industry was born in the post-World War II period. Sheltered by very high tariffs and other trade restrictions, it was promoted as an infant industry that would eventually grow up and compete in international markets. Competent policy analysts had long predicted that it would fail because of the crippling costs due to inefficient production runs in a small domestic market. Companies in the United States, Europe and Japan had much larger runs and reaped economies of scale and scope. Many billions of dollars of assistance and elevated prices over decades have not saved a struggling domestic industry. Car industry lobby groups often try to argue that subsidies to the industry are offset by positive externalities to other industries. These arguments seldom hold up after close scrutiny.

The US housing industry

More recently, the US housing market has suffered a major decline in prices. This has caused borrower defaults and a sequence of credit losses for banks, pension funds and other investors, not to mention the personal tragedy suffered by many who have lost their homes and thereby their life savings. The broad reasons for the crisis are now well known, but the details are more complex. We will focus on US government policies that induced the original risky lending policy and led to widespread speculation in the housing market.

The US government provided long-term lending incentives for home ownership, including tax deductible interest payments, indirect subsidies through government-sponsored agencies (Fannie Mae and Freddie Mac), and indirect subsidies to large banks with high credit risks ('too big to fail'). Coupled with the Federal Reserve Board's low interest rates (after the September 11 attacks), the housing industry flourished. Politicians and bureaucrats allowed a shadow banking system to grow rapidly outside the banks' normal prudential supervisory system. The boom was seen to be beneficial in boosting the wealth of a stagnating middle and working class. The housing bubble increased wealth temporarily, but resulted ultimately in a housing crash that dragged house prices back to trend, destroyed home owners' and pension fund wealth, and induced a government bank bailout with increased taxpayer liabilities. The consequent financial crisis increased inequality of income and wealth. The highly levered middle class lost substantially on housing and the long-term unemployed lost many months or years of income. In contrast, there is evidence that the wealthy were better informed and avoided severe losses.

The housing policy interventions were short-run, political fixes that did not address the real causes of the initial income stagnation. That was caused by a number of factors, including the character of technological innovation, inadequate training, an inflated financial system, and the long-term decline of employment in manufacturing in the Western world. What is worse, some policy analysts fear that the causes of the crisis have not been addressed adequately, and a second crisis could occur in the medium term. Given the weakened state of most Western government balance sheets due to slack fiscal policies and demographic factors, the implications are troubling.

The Australian housing market

A similar situation has arisen in Australia, where incentives such as negative gearing and first home buyer grants, coupled with the limited supply of available land for housing (itself a feature of increasingly restrictive zoning laws), have led to very high house prices. A number of economists, myself included, are concerned that high prices could suffer serious falls if there is a major recession triggered by a decline in commodity export revenues. The consequences of high personal debt, coupled with falling house prices, would have potentially serious consequences for the Australian banking system and for federal and state government balance sheets. This is an example of long-term adverse consequences stemming from politically attractive short-term policies. Given the immediate political incentives faced by governments, long-term costs are heavily discounted or even ignored. When the long term eventuates, governments panic.

Popular 'sacred cows'

Another trap for policy analysts is falling for popular 'sacred cows'. Invariably, these emphasise short-term benefits and downplay the long-run costs. They often rely on incomplete or faulty research. The media and vested interests seize on these policies, parading them as simple panaceas for 'major social and economic problems'. Politicians – those that are weak and overly susceptible to pressure from vested interests – can be easy prey. This process of capture, superficial policy analysis and premature implementation is compounded by the frenetic 24-hour news cycle with political spin doctors trying to score cheap debating points over opponents. The consequences are invariably expensive failures.* Let me give an example where all these failings are apparent to the experienced policy analyst.

* See Foster, C 2005, *British Government in Crisis*, Hart Publishing, London for an analysis of the Blair–Brown government's flawed policy process. Ironically the Rudd government imported this process from the outgoing Blair–Brown government. The incoming Labor government had been warned of the UK failings outlined in this book. The consequences are now only too obvious. Liberal governments have had their own sacred cows. The Liberal Country Party government in the 1950s and 1960s encouraged manufacturing using heavy tariffs that drove up domestic prices on some manufactured goods. The Hawke–Keating government reduced tariffs and protection, which reduced consumer prices on cars, textiles and footwear.

For the last two to three decades, governments in the United Kingdom, the United States, Australia and elsewhere have believed that there is an obvious connection between increasing the amount of education obtained by the population and higher economic growth and standards of living. Although education is important for the functioning of a modern society and economy, the scale and allocation of resources between primary, secondary and the various subsections of tertiary education requires careful analysis. As some researchers have observed, there is no obvious correlation (in the relevant ranges) between per capita education expenditure and economic growth rates. Furthermore, the method for determining the allocation of funding is of prime importance. It should be carefully crafted, allowing market incentives to operate on the demand and supply sides. Decentralised mechanisms have long proved superior to centralised, top-down bureaucratic control. Government intervention should focus on clearly identified market failures. This is particularly true in education, which requires subtle matching of types of education to individual ability and demands for training, skills and education. Furthermore, as our economy evolves, education in particular disciplines is a risky investment: the demand for certain types of training can be high in some periods, but then decline markedly within a few years. These cycles can be driven by technological changes, international trade booms and busts, or merely the supply of trained people in an area expanding sufficiently to reduce a tight labour market.* The system should encourage the demanders and suppliers of education to understand these risks fully and to act on them.†

Another trap for the unwary occurs when politicians and the public are presented with tables of rates of return for different types of degrees or training. These tables are based on calculations of the

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* For example, see the New Zealand study, Mahoney P, Park Z & Smyth R, 2013, *Moving on up: what young people earn after their tertiary education*, Ministry of Education. Note that historical data does not imply that high returns for education in certain disciplines will continue into the future. That requires a careful analysis of future supply and demand characteristics of the particular labour market.

† See Wolf, A, 2009, *An adult approach to further education*, Hobart Papers 168, Institute of Economic Affairs, London for such an approach applied to adult education.

salaries received by graduates in previous decades. Vested interests like to use these tables to justify moving educational funding from a low rate of return discipline to one with a higher rate of return. This analysis is misleading. First, salaries capture much but not all of the returns to education. The deeper understanding of society that comes from studying history or literature may not earn as high a return as an MBA, but it can produce a more subtle mind. Second, past returns are no guarantee of future returns in a discipline. Disciplines come into and out of demand for various economic, political and social reasons. Careful estimates of future returns are more reliable. Third, if a discipline is earning a high return, expanding the number of graduates may rapidly satiate a limited market, driving down the return, so that the eager, new graduates face dismal job prospects.

An additional distortion occurs when vested interests lobby for tougher credentials for a profession or trade. The lobbying for longer and more rigorous training comes only after there are some perceived failures. Vested interests feed the media with horror stories of the inadequacies, which leads to damaging consequences. Increased standards in training raise barriers to entry, restrict the supply of new entrants and drive up the financial rewards for incumbents, who invariably are exempted by 'grandfather' provisions from the more demanding training and standards. Another group that benefits from this lobbying is the associated educational suppliers who see an increase in demand for their services. These credential races are so common that few even reflect on the waste of resources.

Tragically, many of these policy practices have been observed in Australia. Increasingly, federal governments have interfered in the educational system, trying to influence the scale, quality and type of education. There is a perception that 'more' education is the goal. Precisely what this is trying to achieve is not clear. Sometimes the increase in the tertiary education sector is justified by appealing to equity; other times to economic growth, or policy clichés such as 'the knowledge economy'. Far too often, policies are working at cross-purposes. Market incentives are so distorted that unintended consequences abound. For example, Commonwealth funding has been based on the number of tertiary students graduating. This provides clear incentives not to fail students and for institutions to lower quality. Not surprisingly, governments are now worrying about quality, devising complex and costly quality indicators and incentives.

Quality education is very important for the economic and social health of a society – that is self-evident. But when you look closely at education policy and careful empirical research, you become aware that political slogans about education expenditure and reform can be misleading (especially for parents and prospective students) and very socially wasteful.

Conclusion

Using a series of examples, I have illustrated the unintended consequences that can flow from public policy decisions. The examples have been chosen to illustrate a number of dangers that flow from the consequences of ill-conceived or poorly implemented policies. I have outlined the importance of the political process in policy formation. What are the lessons that we can draw from these examples?*

First, policy makers should be very clear about the objective of the policy and study it carefully because social and economic issues are complex. It is only too easy to have an ambiguous objective, or one that addresses an artificial issue promoted by vested interests.

Second, the process of policy implementation is fraught with snares for the unwary. Careful analysis will reveal many of those potential consequences, which require discussion during policy planning. It is better to take longer at this stage to adjust the implementation procedures, rather than to make the adjustments after the policy has been introduced. Consequences that have been ignored can appear after implementation and create the embarrassing impression that the policy makers are incompetent.

Third, policy debates should be open so that serious critics can explore the contents and the implementation procedures. History provides many examples of embarrassing fiascos that an open, honest vetting process would have avoided.

Fourth, honest vetting of policies assumes a cadre of highly professional experts in the relevant areas. It is important that these

* The lessons apply to any organisation. Private companies and non-profit organisations suffer from these all-too-common ailments. For example see, Finkelstein, S, 2003, *Why smart executives fail: and what you can learn from their mistakes,* Penguin Books, London.

professionals be allowed to develop independently in universities, public service departments and think tanks. Indeed, I am continually surprised and delighted by examples where ordinary citizens with relevant knowledge and skills have contributed constructively to policy analysis. Of course, an open system will attract the usual one-issue cranks, but their arguments will not survive careful analysis.

And finally, even detailed policy analysis and implementation can give rise to complex and subtle policy failures. It is crucial that such cases are given forensic treatment by independent experts. The report should be public so that lessons can be learned. Attempts to conceal failure are a sign of weakness in the policy process. Concealment increases the possibility that the failure, or a variation on the failure, will be repeated in the future. Analysts should learn from their mistakes – this is necessary for high quality policy formation and implementation.