Policy Advice as an Investment Problem

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I. INTRODUCTION

From the viewpoint of Public Choice theory, the logic of electoral competition makes it difficult for rational, self-interested politicians to advance unpopular policy reforms. As political decision-makers in democratic societies have primarily the aim of (re-)election in mind, ‘inconvenient’ scientific policy advice often falls on deaf ears in the political arena. Surely, under real-world conditions this simple politico-economic reasoning may not hold in general, as, for example, the transmission of economic ideas in the historical cases of Keynesianism, Reaganomics, or Thatcherism indicates. In fact, empirically observed transmission problems between academia and politics are likely to be induced by a variety of factors – for instance, there are apparent differences in the incentive structures under which politicians and scientists act. In this vein, Friedrich A. von Hayek in a lecture at the London School of Economics in February 1944 presumed:

‘Indeed it seems to me that in order to be successful as a politician, to become a political leader, it is almost essential that you have no original ideas on social matters but just express what the majority feel . . . I believe this duty to face and think through unpleasant facts is the hardest task of the economist and the reason why, if he fulfils it, he must not look for public approval or sympathy for his efforts’ (Hayek 1991, pp. 46–47).

Against this seemingly ‘natural’ division of labor, policy advisors should not be surprised if their subtle analyses meet with little response from the political sphere. Scientists facing such a dismal situation may rather wonder, ‘If It Is not Used, Why Do We Produce so Much of It?’; as Nancy Shulock’s (1999) article on ‘The Paradox of Policy Analysis’ is subtitled. In her paper Shulock asks from a political scientist’s point of view why there are tremendous investments in public

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policy analysis although the generated wisdom is rarely used by politicians and administrators. Apart from its technical, problem-solving purpose, she argues, in democratic societies policy analysis also fulfils the function to inform the public about certain issues and societal problems (see also White 1994). According to this view, policy advisors are not just ‘helping government think’ (Weiss 1992). Complementary, the ‘enlightenment function of social research’ (Weiss 1977) is regarded as a helpful tool to improve the transfer of knowledge from ivory towers to public discourses. However, instead of digging deeper into these normative considerations or the ongoing ‘Do Economists Matter?’-debate (Stigler 1976, Friedman 1986, Frey 2000), in the present paper we will take up Sherlock’s hint to explore the quantitative dimension of policy advice.

For that purpose, in the following, we will try to enrich the ‘economics of policy advice’-discourse by introducing some thoughts from the economics of innovation. The basic idea is that the ‘production’ of policy advice can be understood as an innovative activity that faces by and large the same incentive problems as investments in research and development on ordinary markets. Hence, on the market for policy advice two kinds of market failure may appear: The first is an underprovision of resources dedicated to research and development (Arrow 1962), the second is an overinvestment in R&D (Hirshleifer 1971, Loury 1979). With the help of these two effects it can be shown that in the political process the demand for policy advice is systematically ‘too low’ or ‘too high’ in terms of social welfare. The rationale for these allocative deficiencies is very simple: Using a stylized Public Choice-framework, it can be assumed that self-interested political entrepreneurs primarily deploy instruments that are expected to increase their chance of winning the next election. If we interpret the demand for policy advice (reports, expert commissions, conversations, etc.) as one of these instruments, then expert opinion is only requested whenever it seems to be ‘profitable’ in electoral competition.

The paper proceeds as follows: In Section II we will analyze the demand-side of policy advice. Applying insights from the economics of innovation, the under- and overinvestment effect in the political marketplace is presented. Section III draws attention to the supply-side of policy advice and asks in which way investments in expertise will become affected if policy advisors are modeled as self-interested, utility-maximizing agents that compete for the governmental ordering of reports. The existence of market failures raises the question of appropriate remedies. So Section IV concludes with a brief discussion of possible remedies that might be employed in order to depress overinvestment and to incite investments in case of underinvestment. The theoretical reasoning will be illustrated by the case of Germany where problems of policy advice have become apparent in recent years.
II. THE DEMAND-SIDE OF POLICY ADVICE

In the model world of the ‘old’ theory of economic policy, which was developed after World War II mainly by Jan Tinbergen, Henri Theil and Ragnar Frisch, the division of labor between politicians and policy advisors is quite simple. It is assumed that benevolent decision-makers define political goals to enhance social welfare. In search of optimal policy instruments to improve the citizens’ wealth, policy-makers ask unselfish advisors for their wisdom. As political decision-makers are committed to wise experts, Bhagwati (1990) denotes them as ‘puppet government’. Under these idealistic circumstances it can be expected that one can avoid both a socially undesirable overinvestment and a socially inefficient underinvestment in policy advice. In their efforts to maximize a social welfare function, puppet-politicians demand the ‘right’ amount of policy recommendations, which is needed as a guide to economic policy-making. Simultaneously, unselfish and wise consultants provide the ‘optimal’ quantity of policy proposals, which is in their view necessary to ‘dissolve’ society’s pressing problems. The only problem which may occur in the model world of the traditional theory of economic policy is the correct timing of the proposed measures; e.g., a lowering of taxes must be set to the right point of the business cycle. Dixit (1996, pp. 8–9) characterizes the normative approach to policy-making as follows:

‘The implicit assumption is that once a policy that maximizes or improves social welfare has been found and recommended, it will be implemented as designed, and the desired effects will follow’.

1. The Underinvestment Effect

Now suppose that politicians and their advisors live in a Downsian model democracy, wherein the traditional assumptions of ‘benevolent dictators’ and unselfish scientific assistants are relaxed. Politicians are rather presumed to maximize their subjective expected utility. To this end, they propose political programs that are likely to convince the median voter. If, as a consequence, social welfare (whatever this might be) is improved, then this, in the Public Choice view, is a mere by-product of rational politicians’ quest for ‘... income, prestige, and power which come from holding office’ (Downs 1957, p. 34). With this sort of reasoning one can explain, why policy advice often is ne-
nglected by electoral profit-seeking politicians; viz., only policy advice which is in accordance with the politicians’ median voter-strategy will be implemented.

In Downs’ (1957) basic model of electoral ‘competition’, in which all actors are self-interested and omniscient, it is relatively easy to calculate the outcome of the next election: On the political market only two parties compete for a given number of votes. In order to take over government, each party tries to please the median voter, and, as a result, in the political market equilibrium we find identical policy programs. As a vote-maximizing party-politician has only to identify the median, no further ‘entrepreneurial’ competencies are required in this static-equilibrium world – ‘political decisions are completely determined by electorate preferences’ (Becker 1958, p. 107). Additionally, as politicians are perfectly informed, even omniscient policy advisors are out of work. According to the famous ‘determinacy paradox’, governmental advisors are useless because the

‘… grand conditions of political-economic equilibrium (whatever they may be) have already determined what will happen’ (O’Flaherty and Bhagwati 1997, p. 208).

In the course of his seminal ‘Economic Theory of Democracy’ Downs (1957) modifies the assumptions of his basic model – in part II uncertainty is introduced and in part III the effects of information costs are discussed. In this more realistic model, in which each actor is assumed to be neither benevolent nor omniscient, (i) policy advisors resume work (see Section III of this paper) and (ii) political entrepreneurs holding office are able to make use of various instruments; for instance, taxation, public spending, or legislation. Furthermore, under such conditions, politicians who are trying to maximize their subjective expected electoral profit no longer have to take citizens’ preferences as fixed and stable, but may try to influence voters’ preferences, e.g., via political marketing or the media. A further device, which we will concentrate on in the remainder of the present paper, is governments’ request for policy advice which is interpreted here in analogy to an investment in R&D.

2. As Downs (1957, pp. 115–117) acknowledges, this equilibrium solution on the political market depends on some critical assumptions (two-party system; one-dimensional issue space; left-right political spectrum; single-peaked voter preferences). For a critical survey of spatial models of voting before and after Downs see, e.g., Green and Shapiro (1994, chap. 7).

3. Or, in the words of Basu (2000, p. 168): ‘You cannot model the world as an Arrow-Debreu economy and then proceed to give meaningful advice’. In this vein, Basu (1997), Dixit (1997) and Levi (1997) discuss, in which way normative economics can play a role in the art of giving policy advice at all.

As politicians in this stylized Public Choice-framework are viewed as utility-maximizing agents, one can assume that they only make use of a political device if its application seems to be helpful to increase the chance of winning the next election. Thus, a rational and self-interested politician only has an incentive to invest in policy advice if the additional piece of information is expected to produce (non-) pecuniary private benefits in the form of power, income, or prestige. Consequently, the politician’s demand for policy advice can be interpreted as an investment decision under uncertainty. To identify re-election relevant investment projects and to estimate their future returns, politicians in their ‘competitive struggle for the people’s vote’ (Schumpeter 1942/1950, p. 269) permanently have to analyze the political market. For instance, public opinion polls are a means to reveal the voters’ policy preferences and a short-dated indicator of government popularity. If topics are not estimated as profitable regarding the median voter, then it can be expected that an electoral support-seeking decision-maker has only a weak or no incentive to invest in these less attractive policy areas.

In technical terms, it is assumed that a rational decision-maker demands additional policy advice up to the point where its expected marginal benefit equals its expected marginal costs. In other words, when a single political entrepreneur perceives that a political investment into a particular issue initiates a loss in popularity, respectively votes, investment efforts will be ceased. On the individual level, the strategy to have primarily one’s own re-election chances in mind is quite rational. Though, on the aggregate level this individual investment behavior tends to end up in a socially suboptimal underinvestment in policy advice; that is, in unprofitable policy fields the expected marginal private benefit of an investment in expertise is smaller than its expected marginal social benefit. Due to a lack of expertise, it is possible that inferior decisions in a certain political field prevent society – in intergenerational perspective – from realizing a higher welfare level. Thus, it can be assumed that systematic underinvestment in policy advice indirectly creates social costs to a society.

5. From his experience as an economic advisor in the United Kingdom, Peacock (1988, pp. 9–10) reports: ‘I hold that the demand for economic advice by governments is, in the end, based on rational calculation, in very much the same way as the demand for professional advice generally. . . . At least as perceived by governments, economic advice probably survives a cost-benefit analysis of the most rigorous kind, even though the decision to invest in such advice may often only be somewhat grudgingly undertaken’.

6. See, e.g., Nannestad and Paldam (1994, pp. 229–230) or Gallup and Rae (1940). Regarding the ‘White House Public Opinion Apparatus’, Heith (1998, p. 187) concludes: ‘Yet to be determined, however, is whether the use of public opinion during policy making represents responsive leadership, followership, or an effort to manipulate the public into supporting the president’s goals’. 
At this point one might argue that we have failed to specify the equilibrium or ‘appropriate’ advice level against which actual investments could be measured. Admittedly, for a social planner or welfare economist a well-defined reference point would be a useful tool to answer the question, how to allocate scarce advisory resources (i) in a certain policy field, or (ii) among all policy areas. Under real world conditions the determination of the ‘right’ (i.e., socially optimal) amount of investments in policy advice seems to be a ‘mission impossible’. Comparing the optimal allocation of advisory resources with the actual quantity of investments would resemble the ‘nirvana approach’ (Demsetz 1969). It should also be noted that vote-maximization is only one possible (simplifying) party motivation that, following Downs (1957) et al., often is presumed in Public Choice models for analytical purposes. Politicians could also be assumed to be purely ideological and issue-oriented (Wittman 1973), which denotes another theoretical extreme position7.

However, not only on the supply-side of the political market may an underinvestment in certain policy areas arise. The individual voter also faces an investment decision regarding the acquisition of information: the rational, but ignorant voter in the Downsian model democracy does not spend costs in order to affect the political agenda, because to bring a certain issue on the political agenda in a large-scale society has the attributes of a collective good. Hence, society faces a classical free rider-problem: the community as a whole might possibly have an interest in the production of information to certain topics; however, rational, disorganized voters behave as free riders, who hope that others will bear the costs of setting up the political agenda. Moreover, research on agenda-setting suggests that often it takes time for ‘invisible’ problems to gain public attention, and to enter the policy cycle as political problems (Baumgartner and Jones 1993, Kingdon 1995, Wood and Doan 2003). Consider, for instance, the classic examples of environmental pollution (Crenson 1971, Downs 1972) and poverty (Bachrach and Baratz 1970), which were neglected for a long time by the media, the public, and the ‘classe politique’. Although the rise and fall of issues on the different agendas is influenced by a variety of factors (Neuman 1990), in our model it can be expected that latent issues (i) are more likely to pass the threshold of public perception, and (ii) are subject to sound expert advice, when politicians anticipate future electoral pay-offs.

7. A variety of (econometrically estimated) models has been developed to bridge the gap between (1) purely ideological and (2) purely opportunistic behavior that both are extreme simplifications of reality. For surveys of this literature see, e.g., Nordhaus (1989), Franzese (2002), or Mueller (2003, pp. 437–459). Nordhaus (1989, p. 7) notes: ‘The compelling feature of the hypothesis of vote maximizing is that getting elected is a necessary condition for implementing one’s program’.
The imminent undersupply of policy advice resembles the well-known underinvestment effect from innovation economics, which is used here as a heuristic. In his seminal paper Arrow (1962) demonstrates that in the absence of specification and legal protection of property rights in innovations (e.g., via patents or copyrights), one can expect that in a ‘free-enterprise economy’ a systematic underinvestment in research and development activities will arise. As long as new scientific findings show the characteristics of a public good, competitors can imitate them at little or no cost; and rational entrepreneurs will have no incentive to innovate. In technical terms, the expected marginal private benefit of an innovation is smaller than its expected marginal social benefit. As a result, a socially suboptimal level of innovations will be produced.

To cure the market failure of underinvestment, government intervention seems to be necessary and justified (Arrow 1962, Machlup 1968). For instance, the introduction of property rights and the grant of subsidies to inventors can solve the appropriability problem to a certain degree. To sum up, in our simple model the undersupply of policy advice in certain fields can be ascribed to (1) politicians expecting a low rate of return on investment; and (2) voters behaving rationally ignorant. In analogy to Arrow’s model, political entrepreneurs have no incentive to engage in political activities (e.g., propose policy innovations, demand additional expertise) as long as there is no quasi-private benefit in form of additional votes or a popularity gain that will increase the chance of winning the next election. As a result, from the viewpoint of welfare economics, in unprofitable policy fields there is a divergence between the social and private benefit of policy advice.

2. The Overinvestment Effect

Within the scope of our simple politico-economic model, there is, however, not only the possibility of a socially inefficient underinvestment in policy advice, but an analogous problem of systematic overinvestment. To illustrate the overinvestment effect we can again gain insight from the economics of innovation. In contrast to the aforementioned “public good effect’ that discourages investment in research and invention’ (Hirshleifer and Riley 1992, p. 259), it is quite possible that individuals in other settings expand their research and develop-

8. According to Arrow (1962), the underinvestment effect is even aggravated if we assume risk-averse investors and/or ‘myopic’ (political) agents who are purely driven by the realization of short-term profits.
ment activities above the socially desirable level. In their chapter on ‘Research and invention’ Hirshleifer and Riley (1992, chap. 7) present two forms of over-investment in R&D, the ‘commons effect’ and the ‘speculative effect’, which can serve as heuristics for the analysis of policy advice. According to the well-known ‘research as fishing’-metaphor, in the commons-model it is assumed that each researcher has not only the right in fish, i.e., property rights in discovered ideas. Moreover, she also has the right to fish, i.e., the right to discover new ideas in the ocean of undiscovered knowledge. As no researcher is excluded from the right to fish for new ideas, there are strong incentives to fish, which can lead, from a welfare economic point of view, to a socially inefficient over-investment in R&D.

Applied to the context of policy advice, it is highly questionable if the sketched commons effect should be oppressed in a democratic society. Because the latter would mean that only some experts or even one researcher has the exclusive right to invent policy options and to produce scientific reports. Of course, a close relationship may emerge between the government and ‘their’ advisors, which can be very efficient for the moment. Nevertheless, these ‘static’ ties might change over time or are cut indirectly by the voters’ decisions at the ballot box. As a government is permanently challenged by new national or global tasks, one can argue that there might be an appropriate variety of policy options which is required to cope with these new problems. In a dynamic respect, free entry in the market for policy advice and competition among the providers of expert knowledge seem to be prerequisites to anticipate or react to future problems. However, although it may seem attractive to store ideas for future events, players in a political commons should bear in mind that the quasi-unlimited production and storage of policy advice causes (opportunity-) costs and – possibly – is far from optimality on the aggregate level.

In addition to the sketched ‘fishing model’, one can also draw upon the ‘holy grail model of invention’ (cf. Hirshleifer and Riley 1992, pp. 262–265) in order to illustrate a socially inefficient overinvestment in R&D. In this model it is contra-factually assumed that there is a known innovation and only the first to make the discovery receives a prize in the form of a patent (the winner takes all). Consequently, one can expect that this incentive scheme triggers a ‘rush to invent’ because every researcher wants to be the first ‘discoverer’ of the inno-

9. In the words of Hirshleifer and Riley (1992, pp. 259–260): ‘... undiscovered knowledge is a common-property resource; entry into such a commons tends to continue so long as the average yield (rather than, as efficiency dictates, the marginal yield) is remunerative’. See also Loury (1979, pp. 407–408) and Barzel (1968) for an early analysis of the commons effect.
vation. To attain this goal, the single firm invests as long in research and development as the expected marginal benefit from R&D efforts equals the expected marginal research costs. However, as each innovator maximizes profits due to this calculus it can be expected that ‘each firm invests more in R&D than is socially optimal’ (Loury 1979, p. 406). That is, the perceived private returns to investment in R&D will exceed its social benefits. As the profit-maximizing participants of the innovation race ‘do not take account of the parallel nature of their activities’ it comes to a socially wasteful ‘duplication of effort’ (Loury 1979, p. 406).

To be certain, within the political realm there might be a variety of policy options, which lead to different outcomes. Thus, political entrepreneurs as well as experts do not search for the same policy innovation. Furthermore, in reality it is not easy to determine a policy’s optimal invention date. The ‘timing’ of policy inventions, however, depends on the election campaign calendar. Nevertheless, the sketched ‘holy grail image of invention’ can be applied to politics insofar as politicians joining the ‘electoral race’ have a similar goal in mind as entrepreneurs on economic markets, namely, to win the contest. Like successful innovators gain patent protection, victorious political entrepreneurs receive a temporary monopoly over government.

As stated above, there are different devices that are at the politicians’ disposal to win the electoral contest. And, it can be assumed that there is a strong incentive for policy-makers to invest in ‘hip’ (i.e., highly profitable) policy areas, which are identified through opinion polls, for instance. Thereby, politicians’ investment decisions into policy advice may lead to a divergence between the private and social optimum. In contrast to the underinvestment effect, in case of overinvestment the expected marginal private benefit of a political investor due to the acquisition of scientific information exceeds its expected marginal social benefit. Moreover, the overinvestment effect is reinforced over time if each political entrepreneur in her ‘competition for leadership’ (Schumpeter 1942/1950, chap. 22, Downs 1957, chap. 6) tries to protect her already taken irretrievable, ‘sunk’ investments in certain policy areas. According to this ‘speculative effect’, which is again borrowed from the economics of innovation/information, these political investors have a strong incentive to campaign for their views and to ‘pump’ further information into the political market. This

10. Starting with Loury (1979), the ‘patent race’-literature meanwhile is very large and widely ramified; for an overview see, e.g., Reinganum (1989) or Shy (2001, chap. 9).
11. Cf. Tullock (1965), who speaks of ‘natural monopoly’: ‘It is a monopoly simply because we can have only one cabinet, governor, mayor, president, or majority in a legislature’ (p. 464). For an elaboration of the idea of ‘bidding for political monopoly’ see Wohlgemuth (2000).
kind of push-strategy is quite rational and can be found in other spheres of life as well:

‘Professors seeking advancement are in essentially the same situation. Each professor has made a speculative commitment by investing in his own human capital. This will turn out to be profitable only if potential employers are convinced of his high worth; once again, the problem is to push the message through the noise generated by other professors trying to do the same thing’ (Hirshleifer and Riley 1992, p. 277).

3. German Labor Market Policy – A Case of Overinvestment?

To illustrate the overinvestment effect, we will have a short look at the German Social Democratic-Green government’s demand for expertise in the field of labor market policy. This issue obtained top priority on the government’s policy agenda since, after winning the 1998 election, Chancellor Schröder promised to reduce official unemployment substantially, which amounted to 3.9 million unemployed in October 1998; otherwise he and his cabinet would not deserve to be re-elected. In December 1998, Mr. Schröder invited representatives of trade unions and employers’ associations to form an ‘Alliance for Jobs, Training & Competitiveness’, which should play a key role in the Red-Green government’s fight against unemployment. To support the tripartite negotiations, a scientific advisory board, the so-called Benchmarking Group, was established. Taking into account the experiences of other countries, between November 1999 and September 2001 the five professors provided five studies about the causes and remedies for German unemployment. The Benchmarking Group’s proposals were appreciated by their political clients on press conferences and via press releases, but the recommended ‘labor market deregulation’ remained undone.

At the beginning of the election year 2002, approximately 4.3 million persons were officially unemployed. Moreover it turned out that some sub-units of the Federal Labor Office had sugarcoated their job placement figures. Not surprisingly, parts of the German mass media as well as the Christian Democrats (CDU/CSU) and the Free Democrats (FDP), which were in office from 1982 to 1998, reminded Chancellor Schröder of his ambitious election pledge13. In

12. ‘With inhomogeneous beliefs, individuals with differing opinions will tend each to believe that revelation of new information will favor his own speculative commitments. Hence, a group of such individuals might willingly cooperate in making expenditures far in excess of the social value of the information to be acquired’ (Hirshleifer 1971, p. 573).

13. Note that ‘by far the most important issue in the 2002 campaign, as in 1998, was unemployment. In a poll conducted a few weeks before the election, more than 80% of respondents considered unemployment the most important problem in Germany’ (Helms 2004, p. 145).
February 2002, the government established the Hartz Commission, named after its chairman Dr. Peter Hartz, a member of the management board of the German car manufacturer Volkswagen AG. The committee consisted of politicians, managers, two social scientists, two management consultants, and representatives of trade unions and employers’ associations. The fifteen appointed members should have made proposals how the German labor market institutions (especially the headline-catching Federal Labor Office) could be reformed in order to reduce the persistently high unemployment14.

As requested by the Schröder administration, the Hartz Commission presented its final report ‘Modern Services on the Labor Market’ in August 2002 – one month before the German federal election. Shortly after being re-elected for a second four-year term, the Red-Green government in November 2002 appointed another commission which consisted of twenty-six members. Among them were several economists, social scientists, managers, management consultants, politicians, public officials, and representatives of labor unions and employers’ associations. The Rürup Commission, labeled after its chairman Bert Rürup, a professor of Public Finance & Economic Policy, was concerned with the rebuilding and financing of the entire German social security system, which is closely interrelated with the national labor markets.

Labor market reforms are difficult tasks – not only in Germany with the idiosyncrasies of its political system (federalism, bicameralism, election rules, veto players), the historic event of German reunification in 1990, and the institutional interdependence between labor markets and social security systems (see, e.g., Berthold and Fehn 1996, Saint-Paul 2000). Yet, at the end of 2002 German labor market reform gained momentum: Government and opposition selected some of the Hartz Commission’s proposals to enact a couple of laws that, among other things, intensify unemployed persons’ incentives for job search. Needless to say, the reform bills are quite unpopular from the viewpoint of unemployed voters, trade unionists and left-wing Social Democrats.

The purpose of this case study is not to assess whether the initiated policies are suitable for reducing unemployment and/or job creation; and it remains to be seen how the reform debate continues. In retrospect it can be acknowledged that particularly the appointment of the Hartz Commission, among other things, fulfilled the function to prepare and legitimize these policies. However,

14. Although the commission dealt with a major part of Germany’s present economic malaise, there was not one professional academic economist in this commission. Leaving possible ideological or partisan motives aside, one potential reason for this astounding fact could be the current state of the (inter)national economics profession, which has been recently criticized by, e.g., Frey and Eichenberger (1993), Frey (2000, pp. 17–19), or Blaug (2002) for its decreasing practical policy relevance due to mathematization and formalism.
it should also be noted that the bulk of the ‘brand-new’ instruments as proposed by the external experts has been widely discussed in public and scientific debate across Europe, at least, since the mid-1990s (see, e.g., Buttler et al. 1995, Lindbeck 1996, Siebert 1997, Profit and Tschernig 1998). Consider, for example, the proposals of the Hartz Commission such as ‘activating’ labor market policies, special programs to tackle youth and long-term unemployment, or qualification measures to enhance the employability of workers. This paper certainly is not the ideal forum to evaluate the Hartz Commission’s policy recommendations in detail, which mainly focus on one part of Germany’s unemployment problem – the matching of jobless persons to vacancies. But, as far as we can see, during the last decade the core of mainstream economists’ policy recommendations to improve German labor market performance has hardly changed on this applied-economics level (see, e.g., German Council of Economic Experts 2002, Berthold and Fehn 2003, EEAG 2004, chap. 2). And also economists who favor a Keynesian strategy such as the Memorandum Group (Arbeitsgruppe Alternative Wirtschaftspolitik) or the Institute of Economic and Social Research (WSI; associated with the trade unions) are not tired of convincing politicians of their alternatives to the ‘neo-liberal’ mainstream.

By the way, for years the research findings and reform proposals of the two camps (i.e., neo-classical vs. Keynesian views) have been also published in newspaper articles, popular scientific books or (free downloadable) academic papers. As a special service, members of parliament and their research assistants are free to borrow this expertise from the German parliament’s library. Moreover, several graduated economists, as in-house advisors, work on labor market problems in the Federal Ministry of Economics & Labor and the Federal Labor Office; the latter has an Institute for Employment Research of its own. In addition to this internal expertise, the government receives annual reports by the German Council of Economic Experts, permanent suggestions by the scientific advisory board to the Federal Ministry of Economics & Labor, and periodic surveys provided by the leading national economic research institutes and international organizations (e.g., European Commission, OECD, International Labor Organization). In short, the Social Democratic-Green government as well as its conservative predecessors could choose from an opulent menu of policy options or take a look at best practices in neighboring countries.

Against this background, in a series of official inquiries members of the CDU/CSU-opposition in the German parliament (Bundestag) asked for more detailed information on the governmental ordering of ‘new’ expertise in the field of labor market policy. According to the Schröder administration’s account, the expenses of the Hartz Commission added up to 630 000 Euro; for the
Rürup Commission the government provided one million Euros in the fiscal year 2003. Moreover it turned out that between January 1999 and August 2001 the government had ordered 51 reports, which were largely concerned with labor market issues; these studies amounted to a sum of about 4.8 million Euros (data source: German Bundestag 2001, 2003a). Given the vast amount of internal and external expertise, the question arises, for what reason the German administration ordered this additional publicly financed expertise. In slight modification of Shulock’s (1999) ‘Paradox of Policy Analysis’ an impartial observer may ask: ‘Why do they demand so much of it, if they already know the answer(s)?’

The case at hand underlines the well-known fact that there are other uses of policy advice than its instrumental, problem-solving function (cf., e.g., Kirchgässner 1988, p. 46). According to Shulock (1999) one possible explanation for the ‘Paradox of Policy Analysis’ is the enlightenment function of expert advice in public discourse: Policy-making in modern democracies is a complicated and time-consuming task. Hence, expert opinion not only helps policy-makers to cope with societal problems; even if it is not used by politicians, policy advice is a channel to inform the public about recent developments in certain policy fields. In the light of our simple Public Choice model, also another explanation seems possible: Press conferences on the appointment of expert commissions or publishing press releases about ‘new’ reports and ‘innovative’ problem solutions are, among other things, useful tools to demonstrate political responsiveness and to enhance (re-) election chances – in this way, the demand for expert opinion shows the public that something is done to ‘solve’ pressing societal problems (e.g., unemployment). The Schröder administration’s attempts to produce good news in ‘bad times’ can be interpreted in this way. By the same token, the speculative effect, i.e., the speculative function of information in the competition for media attention and opinion leadership, can be exemplified by means of the German case: After receiving a huge body of expertise, in June 2003 the government mounted an information campaign labeled ‘Teamwork for Germany’ in several German newspapers and the World Wide Web. Ten million Euros were budgeted in the fiscal year 2003 to communicate the government’s reform efforts on the labor market to the public (cf. German Bundestag 2003b).

To summarize, the presented case study shows that something has been overlooked in the political economy of policy advice. Of course, expert opinion still is an indispensable resource in the policy-making process in which internal and external expertise serves as an intermediate good, for instance, to produce labor market policies. We surely do not pretend to know the socially optimal amount of advice in this policy field for the first and second Schröder administration in absolute terms. Yet, taking into account the already existing stock of
internal and external expertise, the added value of the purchased ‘new’ expertise seems to be rather low in terms of substance. From the viewpoint of Public Choice theory, it is not surprising that rational politicians tend to invest in those policy fields where the expected electoral pay-off appears to be relatively high. But one should never forget that investments in policy advice or political marketing are not for free. The German government’s demand for external expertise in the field of labor market policy recently has triggered off a public debate about the national policy consulting branch. Up to now, for time and secrecy reasons, the Schröder administration refuses to disclose a complete official listing of contracts in either policy field (cf. German Bundestag 2004a, b).

II. THE SUPPLY-SIDE OF POLICY ADVICE

We will now focus on the production of policy advice. Closely examining the conditions on the supply-side is insofar important, as it can be considered whether producers of expertise will equilibrate or even aggravate the previously discussed tendencies towards under- and overinvestment. In the following, the suppliers of policy advice are subdivided into two sorts: external and internal advisors. External advice is typically given by professors and scientific staff, who are affiliated with a university. Moreover, as has been extensively analyzed in recent years, a good deal of external advice is given by research institutes or think tanks (see, e.g., McGann 1994, Stone et al. 1998). The second kind of suppliers, the so-called in-house advisors, can be found on the various levels of government bureaucracy. Complementary to this institutional categorization of advisory supply, for analytical purposes it seems worthwhile to differentiate between two types of behavioral assumptions: (1) the benevolent-technocratic advisor, and (2) the self-interested utility-maximizing advisor. Since these policy consultants are introduced here as Weberian idealtypes, they certainly never appear in their pure shape in the real world. Nevertheless, the classification of idealtypes is a useful tool to keep the argumentation clear and to generate empirically testable hypotheses.

1. The Benevolent-Technocratic Advisor

The benevolent-technocratic advisor lives in the model world of the traditional theory of economic policy-making, as described in Section II above. This type of advisor receives his orders by the government which has defined the political targets that allow the maximization of social welfare (e.g., full employment,
economic growth, or whatever). Afterwards it is the social engineer’s task to 
find the adequate instruments to achieve the politically defined aims. In real-
world politics, this sort of advisor is said to be at work in the progressive era 
(from the mid-1880s to the end of World War I) in the United States and ac-
cordingly has been called the ‘progressive neutral expert’ (Nelson 1987, 
pp. 52–54). Whether benevolent-technocratic advisors are external to the po-
litico-administrative system, e.g., as a university professor in a commission of 
experts, or inside bureaucracy as an in-house advisor – in any case they are al-
ways ‘looking out for the national interest’ (Stiglitz 1997).

Under the heroic assumptions of the traditional analysis of policy-making, 
advisors will equilibrate tendencies towards under- and overinvestments in pol-
icy advice. As a result, it can be expected that an external advisor pinpoints po-
litical fields which may be crucial for society’s future welfare but that are cur-
rently not on the political agenda. In the same manner, an internal advisor 
informs his superior of political fields in which expert opinion is more or less 
needed. To be sure, the impact of ‘neutral experts’ on government’s investments 
in policy advice crucially depends on the advisor’s freedom to choose relevant 
topics. It can be argued that the smaller an advisor’s leeway to put issues on the 
political agenda, the more the quantity of supplied advice will equal political 
demand. Put differently, benevolent-technocratic advisors produce expertise 
only up to the amount that has been ordered, i.e., the production process is 
‘technically’ efficient. Finally, if we not only assume that advisors are benevo-
lent-technocrats but also politicians and bureaucrats behave as benevolent 
agents, then at every point in time the welfare-maximizing amount of policy 
advice is produced.

15. Later on, this kind of advisor seems to be still alive: ‘Given the uses of political economy as a 
source of effective Presidential power; . . . and given the statutory responsibility for maintaining 
prosperity in an economy that, by its nature, cannot be self-regulating, one finds it hard to im-
agine a future President spurning professional economic advice . . .’ (Heller 1966, p. 13–14).
16. For example, the German Sachverständigenrat (Council of Economic Experts) can relatively 
freely choose its topics, but the council is not allowed to recommend specific measures of eco-
nomic and social policy (Law on the Appointment of a Council of Experts on Economic Devel-
opment of 1963). In the United States the Council of Economic Advisors gets its orders from 
the president, especially, the council prepares the ‘Economic Report of the President’ (Employ-
ment Act of 1946). In France the Conseil d’analyse économique gets its orders from the prime 
minister, who also is the chairman of the council (Décret 97–766 of the french prime minister 
of 1997).
2. The Self-Interested Utility-Maximizing Advisor

According to the economic theory of politics, it is highly questionable whether scientists in ivory towers or government offices primarily pursue the public interest, social welfare, or something like the truth. Consequently, Public Choice scholars like Frey (1983), Friedman (1986), Peacock (1988, 1992, 1994), or Kirchgässner (1988, 1999) have introduced the *homo oeconomicus*-assumption into the political economy of policy advice. From this point of view, it can be saucily assumed that policy advisors — on average — are not different from politicians, voters, bureaucrats, or lobbyists; that is, they first of all try to maximize their subjective expected private utility. Put into the above-described Downsian model democracy, selfish policy advisors are not primarily interested in social welfare, but in their personal well-being. Suppose, for example, the case of a university professor who sometimes gives external advice. From her point of view, a utility-maximizing strategy might take a variety of variables into account. Being a member of a council or writing reports is expected to be profitable, because (i) a salary or royalty will be paid, (ii) scientific staff can be hired, (iii) one’s reputation in academia or in public is raised, which might be helpful to acquire further orders of reports, or to become a member of further councils, and so forth.

On the other hand, a professor who considers to advise governments has to take into account some features that may diminish her subjective expected utility. Advising political actors may cost a lot of time. In addition, giving advice may damage the advisor’s scientific reputation, for instance, if reports only reflect the principal’s (ideological) opinion. Against the background of a careful cost-benefit-analysis, the utility-maximizing advisor has to solve a trade-off between utility-increasing and utility-decreasing variables. In this vein Peacock (1988, p. 5) remarks:

‘The economists I have known, including myself, who have found themselves in this position place great weight in their own utility function on maintaining their reputation with their peer group. It is not solely a question of professional pride but of enlightened self-interest. To acquire the reputation of compromising on scientific matters might have undesirable side effects on future job opportunities …’.

If this type of consultant enters the market for policy advice, then we can no longer expect that under- and overinvestment effects become equilibrated. On the contrary, an amplification of these two effects is likely to arise. Since in the Downsian model democracy ‘governments never undertake any policies unless they expect to win votes (or at least not lose votes)’, as Downs (1965, p. 85) put it, a support-seeking government concentrates its activities on relatively profit-
able policy fields. Due to the fact that the demand for expertise depends on this simple calculus, competition on the market for advisory products also leads to a concentration of consulting in these highly profitable policy areas. Consider, for illustration, again the German case: in recent years one can observe a mass production of reports on labor market issues, while in other fields like education, family policy, poverty, or gender the production of reports seems to be relatively smaller.

Up to this point we were concerned with external advisors like university professors or think tanks. However, in the political sphere a lot of advice is also generated ‘in-house’, e.g., by professional experts in government agencies. Because the careers of in-house advisors crucially depend on the relationship to their superiors, it is not likely that they will equilibrate investments into policy advice. Rather, a single in-house advisor who is eager to signal his loyalty and compliance can be expected to bring his production of policy advice in line with his superior’s policy agenda. This pattern of behavior is quite rational from an individual advisor’s viewpoint, but aggravates socially inefficient tendencies towards an under- and overinvestment in policy advice. The microeconomics of internal labor markets offers a simple rationale for this kind of outcome. Since the politician cannot accurately assess an in-house advisor’s productivity, she must rely on proxies for an expert’s performance. One measure of performance is the quantity of advice given on a certain topic (Dur and Swank 2003). That is not to say that quality does not matter in public bureaucracies. But, under this incentive scheme an in-house advisor tends to produce information (reports, memos, PowerPoint presentations, statistics, etc.) in abundance, in order to signal his principal to be a good performing agent which is crucial to get promotion.

In summary, if we endogenize policy advisors into Public Choice analysis and reject the idea of benevolent-technocratic experts, then we cannot expect that competition among external advisors leads to an equilibration of politicians’ investments in policy advice. The same holds true for in-house advisors in public bureaucracies who compete for promotion and, in doing so, produce a considerable quantity of expertise. As competition among advisors does not

17. After interviewing about 60 government economists from 1972 to 1976, Allen (1977, p. 86) concludes: ‘The government economist typically is not a highly independent researcher and analyst, free first to pick many of his subjects and entirely free then to broadcast generally the results of his labors. He is a member of an organization, commonly devoting the bulk of his time to topics specified from on high’.

seem to serve as an adequate mechanism to remedy market failure, it appears useful to search for institutional antidotes.

IV. OUTLOOK: SOME INSTITUTIONAL REMEDIES

As mentioned above, under real-world conditions the determination of the optimal quantity of policy advice is a mission impossible – or, in Hayek’s (1974/1989) words, a ‘pretence of knowledge’. Nevertheless, it seems reasonable to search for institutional safeguards which may be able to cope with the described effects. That is, we look for some constitutional rules for the policy advice game. As Popper (1962/1976) has already pointed out, it is not due to the individual scientist’s behavior that may cause problems of scientific research, but due to the formal and informal framework in which science proceeds. Popper argues that it is necessary to set adequate incentives to make the scientists’ self-interested behavior socially beneficial. In other words, in an appropriate environment of formal and informal rules it can be expected that the research process systematically leads to a selection of superior theories (cf. also Kirchgässner 1999).

1. Remedies against Underinvestment

Applying Popper’s approach to the problem of underinvestment into policy advice, a well-chosen set of rules for scientific research seems to be instrumental in raising the quantity of expertise and assuring a production of various policy options. Thus policy issues likely to be underrepresented in the public debate get a greater chance to appear on the political agenda. One example of a rule, which works against the underinvestment effect can be seen in the freedom of research that is granted, for instance, to scientists by article 5 (3) of the German constitution. This constitutional right contains not only scientists’ independence from political pressure and the freedom to choose certain topics and methods; it also protects researchers, who criticize prevailing opinions. At first glance, this argument might sound a little bit naive and simple. However, the guaranteed freedom of science creates an environment that encourages policy advisors to encounter well-established rent-seeking coalitions that have been formed by politicians, consultants, and special-interest group leaders.

In the same direction works the statutory right of the various advisory councils of the German ministries to select the topics of counseling by themselves19.

19. See, e.g., § 7 of the statute of the scientific advisory council at the German Federal Ministry for Economics and Work.
Consequently, these councils can produce expertise in fields which have yet to be perceived or requested by policy-makers. To that extent, one can argue, that the institutional protection of scientific independence increases the probability of producing scientific information also in such policy fields in which a relatively small political demand for expert knowledge currently exists. Beyond this, an additional remedy for the underinvestment problem might be seen in the creation of incentives for rationally ignorant voters to engage in public discourse. For example, the introduction of direct-democratic elements like referenda and initiatives on the national, regional, or local level offers individuals more opportunities to take part in political discussions. Direct democracy also enables citizens to express their political preferences for or against particular policies between polling days and to bring alternative topics on the political agenda (see, e.g., Bohnet and Frey 1994, Feld and Kirchgässner 2000).

Whereas the introduction of direct democratic elements in most countries calls for institutional reforms, there remain other devices with which the public debate can be directly influenced. For example, in democratic societies pluralistic mass media represent a wide spectrum of political opinions, which are more or less critical of governmental decisions. On the political left, in this sense, the *taz – die tageszeitung* (a daily newspaper) in Germany, the *WoZ – Die Wochenzeitung* (a weekly newspaper) in Switzerland, or the French newspaper *Le Monde diplomatique* provide their readers with ‘alternative’ – albeit often biased – views on pressing policy issues and international developments. Or consider the traditional ‘letter to the editor’ and ‘chat rooms’ in the World Wide Web with which magazines and newspapers offer interested customers a forum for public communication and debate.

Furthermore, non-governmental organizations call attention to perceived grievances like enduring poverty, child labor, the violation of human rights, or the discrimination of minorities. Remember also spontaneously arisen protest movements, which oppose to phenomena like ‘environmental pollution’, ‘nuclear threat’, ‘global capitalism’ or ‘neo-liberal globalization’. A critical survey of the ‘globalization and its discontents’-phenomenon, which has gained media attention in recent years, gives for example Stiglitz (2002). The winner of the 2001 Nobel Prize in Economics was a member of president Clinton’s Council of Economic Advisors from 1993 to 1997. Afterwards he worked three years as Chief Economist and Senior Vice President of the World Bank.

The media, NGOs, and social movements may help to raise political participation and to increase the demand for expertise by the political establishment. Moreover, scientific expertise is not fixed to the ivory towers of science – policy relevant knowledge is also dispersed among the public. For example, Sonnert and Holton (2002) call scientists who make use of their competence and knowl-
edge to observe, criticize and affect governmental policy-making ‘citizen-scientists’. This type of scientist is engaged in NGOs, points to current and imminent societal problems, and fulfills insofar a bridging role between science and society. In summary, there exist some mechanisms that work against an underinvestment into policy advice, but there is obviously a need to set up or strengthen the more explicit institutional safeguards like freedom of science or direct democracy. A more institutionalized sort of participation of NGOs in the formal political process might also be an idea to boost the demand for policy advice.

2. Antidotes against Overinvestment

To mitigate the overinvestment effect, one could establish the mandatory rule that the government has regularly to give an account of its advisory budget. In this way, citizen-voters and opposition parties may be able to control the government’s expenditures on policy advice. In addition, one could set up a mandatory monitoring of the government’s demand for policy advice by independent institutions that can help to communicate the actual demand for expert knowledge into the public arena. For example, in Germany, institutions, which might serve as independent monitors are the Bundesrechnungshof (Federal Audit Office) or the Statistisches Bundesamt (Federal Statistical Office). Transparency and increased public perception of the market for policy advice may possibly be able to attenuate overinvestment tendencies.

Another measure could be lowering the attractiveness of consulting activities. For example, a university ‘prohibits consulting, or at least restricts the time allowed for it’ (Dixit 1996, p. 97). To be sure, there is evidence that there is a close-knit relationship between research, teaching and the capability to give profound policy advice. Indeed, it seems intuitively clear that there might be a severe problem when a scientist’s incentives to engage in consulting are much more high-powered than her incentives for teaching and research (see also Faria 2001). Although it is sheerly impossible to determine the optimal mix of teaching, research, and consulting it seems reasonable to keep in mind Dixit’s (1996, p. 97) recommendation:

‘Some consulting will be allowed if that makes it easier to ensure that the professor gets enough utility from the whole bundle of activities to be willing to work for the university, that is, to satisfy the professor’s individual rationality (participation) constraint. But this calculation will involve comparing the average product of consulting time and the marginal reward for teaching and research.’
To conclude, the present paper proposes an analytical framework for dealing with the quantitative dimension of policy advice. But, as we have seen, there are no simple remedies against an over- or undersupply of expertise. On the other hand, the problem of inefficient allocation of advisory resources is an important but until now neglected aspect that needs some sort of institutional ordering. Although the proposed remedies are only a first step to cope with asymmetric investments into policy advice, it is by no means futile to search for appropriate rules that may help to equilibrate investments. Needless to say that changing the rules of the policy advice game, again, is likely to be subject to serious implementation problems in the political sphere. In a next step, a careful quantitative analysis seems to be reasonable in order to test the hypotheses derived from the model. Improvements of this research may also be gained by a more in-depth comparison of policy advice in various countries. There may be, for example, different institutional settings or ‘cultures’ in which (economic) experts try to influence politics (see, e.g., Frey and Eichenberger 1993, Wyplosz 1999), or diverse ways in which ‘economists do economics’ (Medema and Samuels 1996). In any case, our approach is a first attempt to set up a theory with which it is possible to give an explanation for the quantity and structure of scientific policy advice.

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POLICY ADVICE AS AN INVESTMENT PROBLEM

SUMMARY

From the viewpoint of Public Choice theory, the logic of electoral competition makes it difficult for rational, self-interested politicians to advance unpopular reforms. As political decision-makers have primarily the aim of re-election in mind, ‘inconvenient’ scientific policy advice often falls on deaf ears in the political arena. This implementation problem has been widely discussed in political science, economics, and related social sciences. Complementary to this qualitative dimension, the present paper uses insight from the economics of innovation to analyze the quantitative dimension of policy advice. It is assumed that additional expert opinion is only requested whenever it increases a politician’s chance to become re-elected. This simple politico-economic reasoning, it will be argued, induces a systematic under- and overinvestment in policy advice, which is inefficient in terms of social welfare. After discussing the advisor’s role in this framework, the paper concludes with a brief presentation of possible remedies to dilute these undesirable incentive effects. The theoretical reasoning will be illustrated by the case of Germany where problems of policy advice have become apparent in recent years.

ZUSAMMENFASSUNG


RÉSUMÉ

Du point de vue de la nouvelle économie politique, la compétition entre les voix d’électeurs empêche les hommes et femmes politiques de réaliser des réformes. Puisque ceux-ci visent avant tout leur propre réélection, les conseils scientifiques, demandant souvent des mesures peu populaires, ne sont pas pris en considération par les décideurs politiques. Ce problème soi-disant d’implémentation a souvent été discuté dans la littérature économique et politique. Le présent article ajoute une discussion de la dimension quantitative et structurelle du conseil politique. Pour ce faire nous nous servons des connaissances venant de l’économie des innovations. Nous supposons que les conseils scientifiques ne sont suivis que lorsqu’ils augmentent les chances du politicien d’être réélu. Ce comportement mène cependant en certains domaines de la politique à un sur- ou sous-investissement systématique en conseil, ce qui est inefficace d’un point de vue de l’ensemble de la société. Après avoir étudié le rôle du conseiller en politique dans le cadre de ce comportement d’investissement, nous discutons une série de mesures qui pourraient servir à contrecarrer ces fausses incitations. Les considérations théoriques sont illustrées à l’aide du cas de l’Allemagne, où ce genre de problèmes est devenu particulièrement évident au cours de ces dernières années.