

Pro Bono Economics Annual Lecture

by Sir Gus O'Donnell, Cabinet Secretary

13 July 2010

Introduction

I was delighted to be asked to deliver the inaugural Pro Bono Economics lecture.

Let me begin by thanking Martin Brookes and Andy Haldane for their kind invitation, but much more importantly for having the vision and energy to set up Pro Bono.

Pro Bono Economics reflects a number of causes close to my heart.

First, it reflects a public sector ethos that I strongly support. I have spent most of my career in the civil service surrounded by people who are committed to making a positive contribution to society and who are often foregoing the possibility of much larger financial rewards in the private sector.

Second, economics has been my professional anchor. Having started life teaching it, and spent many more years applying it, I am as aware as anyone of the limitations of economics and the need to learn from other disciplines like psychology, anthropology and sociology in order to develop advice on public policy issues.

Nevertheless, economics remains, for me, the cornerstone of my intellectual approach to the challenges I face as Cabinet Secretary – whether that is about seeking to ensure better public policy, or in supporting the government of the day to operate smoothly. I will try to give a flavour of this in my remarks today.

Those who know me will know that I am an inveterate optimist.

There is no doubt that the global financial crisis has had terrible effects on many people in the UK and around the world. Closer to home, for this audience, the global crisis has clearly

had a significant and negative impact on the reputation of the economics profession (though we are perhaps held in somewhat higher regard than bankers).

But in both these areas my optimism wins through.

Failures in economics were, to some extent, to blame for the financial crisis. But I would argue that the impact of the crisis could have been far more severe – a depression rather than a recession – if the world had not pursued broadly sensible policies based on timely and sound economic advice.

Similarly, the best economists are embracing the opportunity to learn from past mistakes to strengthen economics as a discipline and improve public policy. To take just one example, the work of Andy Haldane, one of Pro Bono's founders, has exposed just how hopeless the risk models used by banks were before the crisis. But new versions, learning from these mistakes, should be more robust and our new regulatory structures should be more capable of preventing future crises.

For the year running up to the election I told my Permanent Secretary colleagues that we faced two crucial challenges. First we had to ensure that, whatever the election result, the civil service would be ready to support the newly elected government from day one. The second challenge would be to help that government reduce the fiscal deficit, while protecting public services as much as possible.

As always, lessons from economics – and other disciplines – have helped me in both of these challenges. Tonight I want to talk about the way in which a better understanding of the need for trust between individuals and groups has been central in thinking about how to support a coalition government. I would also like to say a few brief words on how governments are using new advances in behavioural economics to think about fiscal and policy challenges.

Trust

The issue of 'trust' goes to the heart not only of the recent credit crisis, but also to the new challenges of helping to ensure a smooth coalition.

The very words 'credit' and 'trust' carry much the same meaning and origins. The seeds of the global financial crisis were sown by a breakdown in trust – and credit – between counterparties. In seeking to repair the financial system and the wider economy, the key will be creating policies and institutions which help regain and nurture trust.

Recent economic work has shown just how important trust is. We live in a world of imperfect markets and imperfect information. We therefore live in a world of imperfect contracts – between businesses, or between business and consumers – that cannot hope to cover every eventuality or every future scenario.

Trust – the belief that the other party to the contract will treat you fairly in unforeseen future circumstances, and that if you treat them fairly today they will reciprocate tomorrow – is a crucial ingredient in allowing inevitably imperfect markets to function.¹

There is now empirical evidence to show that trust is a critical enabler of growth and development. Countries where people generally trust each other – such as in Northern Europe – tend to grow faster than those where trust is weaker.

Of course, in addition, we know that trust is essential to the legitimacy and authority of public bodies. Hence the stated commitment from all political parties to strengthen public trust in parliament and other public bodies over the coming period.

Trust is most important – but potentially most difficult to achieve – where relations between parties are likely to be characterised by self-interest rather than altruism

This is very often the nature of relations between businesses. Similarly, even for an inveterate optimist like me, it is pretty clear that self-interest – or party interest – is always

¹ This is one reason why public-private partnerships need to be more trusting if we are to ensure they are not dominated by contractual disputes.

likely to be a more powerful force than altruism when it comes to relations between political parties.

In this context, many have been surprised by the coming together of the new coalition government. How, they ask, can two parties, conditioned by decades of history to be competitors, come together in a stable and productive coalition government? And how can that be sustained?

Part of the answer can of course be found in our classical model. If self-interest is the guiding behaviour of political parties, the necessary condition for a coalition is the coming together of those parties' interests. Coalitions are, in this sense, sustained by 'mutual self-interest': as interests align, so does the willingness to work together.

But this mutual self-interest is a necessary but not sufficient condition for stable coalition. This is something that we, in the civil service, discovered ourselves as we prepared for the post election period.

As part of our preparations we ran a number of scenarios based on possible election outcomes. When the first exit polls came in, it quickly became apparent we were looking at what, for a small group of us, had become known as "Scenario 4".

The good news was that we had practiced handling a result that was very close to the real one. The bad news was that, under our scenario, no stable government had emerged.

Civil servants role-playing senior politicians in a hung parliament scenario had been briefed with the manifestos of all parties, and so had the ability to identify clear areas where the interests of parties could be aligned. Nevertheless, the discussions broke down.

So why, in the event, did the politicians do so much better?

I believe it was because, in our role-played negotiations, there was one vital ingredient which was not possible to simulate – and on which, in fact, the founding and sustaining of a coalition rests. That ingredient is 'trust'.

The coalition came together not just because of an alignment of party interest, but because politicians – contrary to the expectations of many – were able to develop the necessary level of trust in each other. And just as trust was essential to underpin the formation of the coalition, so the strengthening of that trust over time must also be essential to ensuring the coalition is sustained.

The mistake we, in the civil service, made when role-playing post-election scenarios was – unusually for civil servants – to worry too much about the substance, and not enough about the process. That is, we concentrated on the zero-sum game of who would get which policies, and not enough on the positive-sum game of how to establish a process that would build mutual trust and hence reinforce a cooperative approach to policy development.

Once again, economics has a lot to offer us here – and recent work, particularly in understanding the critical role of sustaining trust in business, has a new resonance for those of us seeking to support the coalition government.

The Coalition Agreement is the programme for government. Interestingly it is not just a ‘compromise’ document, seeking to find the lowest common denominator between the positions of two parties. Often it strives to find the common ground that combines the agreed strongest features of both parties’ election manifestos. In other areas, where the parties do not agree, the Coalition Agreement provides explicit room to disagree.

In this way the Coalition Agreement is, in essence, a contract. It is a crucial document, providing a clear guide to civil servants in supporting the government of the day.

But, as we have seen, all contracts are incomplete and imperfect, unable to predict every event or issue to come. As the economic analysis tells us, this is where trust must step in to fill the gap.

Hence when, as is inevitable, difficult decisions not covered by the agreement arise, they must be dealt with in a way that is perceived as fair, builds trust and strengthens the coalition government further.

Game theory too has critical lessons here.

PARTY A	PARTY B	PARTY A	PARTY B
Not cooperate	Cooperate	3	0
Cooperate	Not cooperate	0	3
Not cooperate	Not cooperate	1	1
Cooperate	Cooperate	2	2

Consider this basic grid showing how two parties – A and B – might cooperate. Economists and game theorists will recognise the Prisoners Dilemma.

Of course, if this were a once-only game, neither side would have an incentive to cooperate; because regardless of what Party A does, Party B would be better off not cooperating, and vice versa. But such mutual non-cooperation produces a poorer overall outcome and erodes trust.

By contrast, for repeated events over time, if both parties consistently pursue a policy of mutual cooperation, aggregate benefits are maximised, and trust is strengthened.

Coalition, of course, is not a once-only game: it is a five year commitment. So the message for the coalition is clear: wherever possible, ensure the coalition parties are held to a ‘cooperate-cooperate’ approach. That is the bottom line for civil servants supporting the new government.

In some respects, this is nothing new for us. As many people have noted, in one sense every government is a coalition of different interests. Indeed, we should not simply assume that this government is a coalition between two political parties – it is also a coalition of different groups within and across parties which form around different issues. This is in the very nature of all elected governments.

But coalition government places a greater emphasis on the machinery to support collective decision-making, and ensure that no actions are taken that might – deliberately or inadvertently – erode the trust which is essential to the coalition.

A new word has entered the vocabulary of the civil service: “coalitionising”. It’s not a particularly elegant word, but it describes a vital element of the civil service’s role in fostering trust.

This is partly achieved by ensuring that almost all departments have a mix of ministers from the two coalition parties. It is also supported by the Cabinet Committee system – with a wide range of committees chaired by a minister from one of the coalition parties, and a deputy chair from the other.

Last week, for example, there were no fewer than seven different cabinet committees, bringing Ministers of both parties together to resolve key policy issues, including the new coalition committee – jointly chaired by the Prime Minister and Deputy Prime Minister.

Alongside the cabinet committee structures and mixed ministerial teams, in some instances further mechanisms are locking the two parties into agreed courses of action. The Coalition Agreement itself – as the contractual representation of the coalition – is an example of this. But there are others.

Fixed Term Parliaments and ending the ability of the Prime Minister to seek a unilateral dissolution of Parliament is a stark example of imposing discipline in an area that is critical to the coalition to ensure that neither party can ‘cut and run’.

Further legislation will take forward two of the political reform priorities of either party, hand in hand – the review of boundaries to ensure smaller numbers of more equal constituencies and a referendum on voting reform.

This process of ‘coalitionising’ requires an investment of time and discipline. But the dividend is significant – not just in reinforcing trust across the coalition, but most important of all, ensuring the quality of decision-making and the strength of the policies introduced.

Two months into this brave new world, therefore – as we learn the lessons of trust – we have, so far, a stable coalition which has surprised many with the speed with which it has acted on a very wide range of issues.

Behavioural Economics and Wellbeing

Keeping a coalition government on track is a new and fascinating challenge for all of us. But, of course, the real test for any government lies in what it achieves.

So I would like to say just a few words about how some of the more recent thinking from economics – and other disciplines – can help governments, including the coalition government, to address some of the challenges we face. And of course the number one challenge is to reduce the budget deficit.

Behavioural economics

The first is that governments need to tap into that rich vein of thinking which is growing up around the concept of behavioural economics.

Long experience in policy making – and recent experience in financial markets – teaches us that individuals and organisations do not always act rationally or respond to incentives as we would expect. People are easily fooled, make mistakes and often make decisions they later regret.

In addition, one particular area of recent study is the development of our understanding of altruistic motivations, as distinct from, and perhaps opposed to, self-interest. We need, as

economists and policy-makers, to answer Richard Layard's question: "why should I feel responsible for other people?"

These motivations can be strong: in some cases stronger than the motivation of self-interest. For policy makers, considering how public policy can foster and utilise these motivations – to 'nudge' people's altruistic impulse – may again be key to addressing some of our biggest policy challenges, including on aid, community cohesion and the environment.

For example, why would someone – particularly someone relatively cash rich and time poor – spend their limited time sorting their household waste into 'recyclable' and 'non-recyclable' bags? Clearly the right tax, regulatory and other frameworks could help ensure this kind of behavioural change – in line with our concept of the individual as a rational self-interested being. But it seems unlikely that those who diligently sort their household waste today do so for any financial return, or to avoid any financial penalty. There is clearly a wider motivation at work – a more altruistic impulse to 'do the right thing'.

As policy makers we need to draw on the increasingly rich and sophisticated understanding of incentives and motivations in addressing some of our knottiest policy problems – preparing ourselves to understand how and when we should inform, educate, 'nudge' or compel people towards behavioural change.

Personally I am delighted that governments are showing a real appetite to embrace behavioural economics – eager to understand how new developments in thinking can be used to help government departments come up with better, cheaper ways of helping citizens and businesses. I am equally delighted by the way that the civil service is responding: rising to this challenge just as they are rising to the new ways of working under coalition government.

In the UK, alongside the work of the Better Regulation Executive, which is charged with reducing the burden of regulation on businesses and citizens, a new unit in the Cabinet Office is being brought together to harness some of the best ideas and thinking from behavioural economics and translate those into practical solutions around key policy challenges such as public health and environmental behaviour.

I will be chairing a cross departmental group overseeing the work , and we will be drawing on outside experts like Richard Thaler, Paul Dolan and David Halpern.

Happiness and Wellbeing

Another area of study, closely linked to both altruism and self-interest, is the growing literature and analysis on happiness and wellbeing.

By broadening our understanding of how people are motivated, we simultaneously broaden our understanding of what their ultimate goal might be. So we come to a wider definition of ‘utility maximisation’ than traditional monetary models have tended to allow. Instead, the concept of ‘wellbeing’ – which I would argue is broader simply than just ‘happiness’ – has grown in currency and given rise to a prolific and energising area of study.

Once again the self-interested question for the policy maker is: what’s in this for me? The answer, of course, is that these questions go to the very heart of what government is actually for, and how we can measure its success.

This is not easy. Some argue for measures that track happiness – or people’s perceptions of their happiness. Others, such as Amartya Sen, have emphasised, people’s capabilities.²

Even if we could derive good measures for individual wellbeing, we would then need to resolve the problem of how to aggregate them, and track them over time. This raises quite profound ethical and political issues about what government and society values.

For example, should we care more about reducing misery and worry less about turning fairly happy people into even happier ones? A politician might be more attracted to a policy plan that maximised perceived well being in the run up to the next general election than to one with a higher aggregate value spread more evenly over the life of a parliament.

² The happiness versus capabilities debate is a lengthy one that I fear this busy civil servant hasn’t come close to resolving. I recommend reading *Capabilities and Happiness*, edited by Bruni et al. When you have read that, please tell me who’s right.

Thanks to advances in research and better multi-disciplinary work we are closer to knowing how to address some of these issues in a rigorous way. But research must continue, and I hope that funding – from research councils and other sources – can be found to support this important work.

Whilst all of this work implicitly recognises some of the limits of more established measures – including GDP – none of it should detract from the importance of more traditional cost-benefit analysis in policy making. In these more difficult fiscal times as we scale back public spending, it has never been more important to do so in a way that minimises adverse long-term impacts on society as a whole, whatever measures we use.

Pro Bono Economics

At the launch of Pro Bono Economics last September I appealed to both the self-interest and altruistic impulses of economists. I suggested that Pro Bono could enhance your own personal wellbeing by giving you valuable experience of addressing social problems, and allow you to perform a useful social function.

My own experience, working with St Basil's in Birmingham, has certainly lived up to this. I visited the St Basil project in February to see their work helping homeless young people to find and keep a home and develop their skills. It was a hugely rewarding experience, and has helped me understand much more about the public policy issues around homelessness.

It has also tested some of my own economics and analytical skills. By providing specialist housing advice St Basil's has seen a reduction in the number of young people needing emergency homeless accommodation by 92%. But, it is proving very challenging to establish precisely how much difference the charity is making because of the absence of knowing in sufficient detail what would have happened if it didn't exist: we lack a control group.

Luckily, like other Pro Bono projects, I am ably supported in trying to resolve this knotty issue by a Government Economics Service economist – in my case Lottie Murphy from the

Treasury. I would like to pay tribute to Dave Ramsden and Vicky Pryce as the heads of the GES and to Government Chief Economists across Whitehall, for their support for Pro Bono, which has been key to ensuring that Pro Bono is the strong and growing organisation it is today.

Governments in the UK and elsewhere are increasingly recognising the key role of civil society in achieving policy ambitions. The coalition government, with its focus on Big Society, is no different. In the introduction to the Coalition Agreement, the Prime Minister and Deputy Prime Minister state:

“we share the conviction that the days of big government are over... we believe that the time has come to disperse power more widely... to recognise that we will only make progress if we help people to come together to make life better”.

Pro Bono is a great example of bringing together the passion, expertise and commitment of civil society, with the rigours and disciplines of the economics profession.

The work which Pro Bono supports sees economists helping charities in a range of ways: sometimes helping to find quick wins by cracking open the data they already have; sometimes by showing – or even challenging – evidence that the work of the charity is having the impact intended.

Take the case of St Giles Trust. Rob Owen, their inspiring Chief Executive, has developed a ‘Through the Gates’ programme to offer intensive support to former offenders as they make the difficult transition from custody to community. This really is ‘behaviour change’ work in one of the hardest possible fields.

The Pro Bono team, working with Frontier economics, helped St Giles to carry out a serious evaluation of whether they were actually succeeding in reducing re-offending rates. The good news is that they are: their clients have a 40% lower re-offending rate against the national average.

Is this helping Rob Owen run St Giles? Absolutely. He described the economics work as 'dynamite', having impact at every level of government and helping St Giles to be selected for the first Social Impact Bond.

On the strength of cases like this Pro Bono is growing. It is now involved in around twenty projects, covering a vast spectrum of real world issues, in regions all around the country and, increasingly, with an international flavour. I know that there are more details available this evening, and I would encourage all of you to consider whether you could support Pro Bono's work.

Conclusion

Let me conclude. The strength of economics, and its value to policy makers, rests on its ability to grapple with, and understand, the motivations and behaviours of people and organisations. Recent work – on behavioural economics, on wellbeing, and on trust – has enriched our understanding of human behaviour. This work can help to give our profession confidence as we seek to support policy makers in addressing the major challenges which the global financial crisis has exposed.

I feel encouraged about the way in which the profession is rising to these challenges, and by the willingness of government to engage with new ideas.

This is, indeed, a good time to be an economist. Yes, we are facing huge challenges; and we will face even greater challenges over the months ahead. The same is true of civil servants. But if we stay anchored in our core values and show the innovation needed to meet these challenges, economists and civil servants can both emerge as parts of stronger professions in the months to come.

Of course, ultimately, it is only when we test our elegant economic models and our innovative policies in the imperfect reality of everyday life, with the unpredictable motivations of different people and with the humility that our professions must always adopt, that we see whether our work is genuinely making a difference.

That is why the work of Pro Bono is of such importance. As an economist and policy-maker wishing to satisfy both my self-interest and altruistic tendencies, I thank Pro Bono for the work they do and the opportunities they are giving me.