

## **Evidence-Based Policy Making: Just a Myth or a Must?**

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### **Abstract**

Using experiences gleaned from her years as a Commissioner at the United States Securities and Exchange Commission and from her present position overseeing two of the major U.S. statistical agencies, economist Cynthia Glassman explores the importance of seeking and using evidence in policy making. She illustrates the real and serious consequences that can occur when policy makers do not have a solid, evidence-based foundation on which to base their decisions, and she outlines some current efforts to expand the information frontier in the United States.

### **Remarks**

Good afternoon. At the outset, I would like to thank our Turkish hosts. I would also like to thank the OECD for organizing this forum and, in particular, Enrico Giovannini, the OECD’s Chief Statistician and the Director of the OECD’s Statistics Directorate, for the invitation to participate in this panel. I am delighted to be here.

When I first learned the topic of this session, I thought to myself... how obvious. The answer to the question “Is evidence-based policy making a myth or a must?” is clear; that is, it is a must. This view no doubt reflects my background and training. As we say in the United States, where you stand usually depends on where you sit. At present, I sit at the head of two of the key federal statistical agencies in the United States—places whose sole purpose is to gather and compile data about the U.S. economy and the American people.

I am also an economist by training. These days, the profession of economics is largely—if not entirely—about evidence-based analysis. We have come a long way from the era when economists, like Thomas Malthus, theorized about the growth of population and the growth of the food supply. Today’s economists go out and get the data, then test the hypothesis.

I have also learned through years of working in policy and economics that there can be real and serious consequences when policy makers do not have a solid, evidence-based foundation when they make policy. I would like to illustrate this with three stories, one drawn from the history of the Bureau of Economic Analysis, one of the agencies that I oversee, and the two others from experiences from my prior role as a Commissioner at the U.S. Securities and Exchange Commission.

For those of you who might not know, the Bureau of Economic Analysis (BEA) is the agency in the United States that produces the National Income and Product Accounts. The most well known number from these accounts is the gross domestic product or GDP. The accounts produced by BEA are among the most important tools that we have for

understanding the mechanics of the U.S. economy. However, it is easy to forget how recently this body of evidence came into existence and what it was like before we got monthly and quarterly statistical updates on the state of the economy.

BEA recently published a fascinating account of its history and the birth of the National Income and Product Accounts in the United States.<sup>1</sup> The desperate need to understand the workings of the U.S. economy during the Great Depression was the motivating force in producing these statistics. Before then, well-meaning policy makers did make economic policy, but there was no systematic means of knowing whether the policies made matters better or worse for the economy as a whole.

As Rosemary Marcuss and Richard Kane aptly described it in their article, during the early 1930s, “[n]either the public nor elected officials understood the workings of the economy that seemed to be perpetuating the crisis, nor did they know quantitatively its scale and scope.” In hindsight, we now know that “Asset values had plummeted, the banking system was breaking down, deflation was reversing the gears of the economy, and sales were insufficient to keep businesses going. Farm income, on which one-fourth of the population depended, had fallen by a half.” The income statistics that the Department of Commerce began to produce in 1934 were a huge step forward in providing evidence on which to base policy. Imagine how much better policy could have been if decision makers had had data to help them disentangle the various economic forces at work in a timely manner.

This story illustrates the consequences of realizing in the middle of a crisis that you need more information than you have at hand. My second story illustrates some of the same principles on a more micro scale. It also dramatically demonstrates how all of us—personally and professionally—make evidence-based decisions, and just how problematic it can be when we find out too late that we did not have enough of the right information when we made choices.

Prior to my appointment as Under Secretary for Economic Affairs, I was one of the five commissioners at the U.S. Securities and Exchange Commission (SEC). While I was at the SEC, there was a series of corporate reporting scandals that highlighted how important accurate financial reporting is to our capital markets. Investors, creditors, regulators, and other market participants rely on getting accurate, timely and comparable financial information from public companies. The efficient allocation of capital depends on financial reports that provide a realistic picture of firms' past performance and future prospects.

When information provides a misleading picture, the results can be devastating, as we saw in those corporate reporting scandals. The misleading information reported by those companies resulted both directly and indirectly in a serious misallocation of resources.

- Investors in those companies paid a huge opportunity cost by investing in companies with unrealistic, inflated values;
- Competitors made business decisions on a distorted playing field;
- Creditors did not price credit appropriately for the real risk taken; and
- Employees tragically made career and retirement investment decisions based on a false picture of their employer's financial prospects.

The impact did not end there. As I learned in my new position, the inflated profits contributed to a level of Gross Domestic Income calculated by BEA that was higher than

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<sup>1</sup> Rosemary D. Marcuss and Richard E. Kane, “U.S. National Income and Product Statistics: Born of the Great Depression and World War II,” *Survey of Current Business*, Bureau of Economic Analysis, Vol. 87, no. 2, February 2007 (<http://www.bea.gov/scb/index.htm>).

Gross Domestic Product. The difference in these two measures raised questions by policy makers about why the GDI numbers were growing faster than the GDP numbers. Not knowing the answer led to challenges in determining monetary and fiscal policy at the time. In retrospect, now we know that the discrepancy was due, in part, to the same misleading financial information.

My final story illustrates the consequences of choosing not to look for evidence. Does this happen? I suspect it happens more often than I would hope. In fact, I have some evidence. Two economists, Alan Blinder and Alan Krueger, conducted a study entitled “What Does The Public Know About Economic Policy, And How Does It Know It?” They found that “On a variety of major policy issues (e.g., taxes, social security, health insurance), ideology is the most important determinant of public opinion, while measures of self-interest are the least important. Knowledge about the economy ranks somewhere in between.”<sup>2</sup> This suggests that many people are simply not out there seeking the facts before making important decisions.

While at the SEC, I made it my mission to try to instill more economic analysis into the Commission’s rulemaking and enforcement initiatives and to show the value of empirical data in framing rules designed to protect investors and maintain the integrity of the markets in the most efficient, effective way. Routinely I would ask: What are the objectives of the rule? Will the rule meet the objectives? Does it go far enough – or does it go too far? Does it meet the spirit as well as the letter of the law? Does it make sense? Are there likely to be unintended consequences? Are the costs commensurate with the benefits? Does it create unrealistic expectations? What are the regulatory alternatives? Within the Commission ranks, I became famous – or perhaps infamous – for consistently asking these questions. But they were, and they are, important. Too often, regulators – who, particularly at the SEC, are more likely to be lawyers than economists – tend to promulgate a rule and see how it works rather than try to ascertain its effects in advance. To me, that is putting the cart before the horse.

I asked all these questions when we were first presented with a mutual fund governance proposal requiring funds to have at least 75% independent directors and an independent chair. I particularly wanted to know how the performance and costs of funds with inside chairmen compared to that of funds with independent chairman. But, at least at that time, no internal studies were forthcoming, and the rule was promulgated over my dissent. It was, however, struck down by a unanimous court. Why? Because the Commission had failed to give adequate consideration to the costs of, and alternatives to, the measure. Recently, the agency sought public comment on two internal studies. As a result, the agency now has the benefit of public input on the studies. I do not know what the outcome will be, but I am encouraged that any decision will be informed by the evidence.

What are the lessons that I draw from these three stories? First, there are plenty of examples of situations where policy is made without the benefit of evidence, or enough evidence. There are always reasons why this happens. Sometimes you do not know what information you need until you are in the middle of an event. Other times you rely on evidence only to find out that it was a lot less reliable than you thought. Sometimes you know exactly what information you need, but it is not available and you must make do with the incomplete information that is available.

The primary lesson that I take away from these stories is that we must always strive to find the best evidence we can in order to make informed decisions. All of these stories reinforce my opening presumption. Evidence based policy is a must because making policy with no evidence or bad evidence has real and serious consequences. These stories show

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<sup>2</sup> Alan S. Blinder and Alan B. Krueger, “What Does the Public Know about Economic Policy, and How Does It Know It?,” NBER Working Paper No. 10787, September 2004.

how serious the consequences can be if decision makers—from people making economic policy to ordinary people planning their retirement—do not have complete information. This is also why I find it troubling when smart people—people who should know better—choose not to go out and look for the evidence when it is in their power to do so.

This search for more and better evidence about how the U.S. economy works is something I deal with every day. The core mission of the bureaus that I oversee—the Bureau of the Census and the Bureau of Economic Analysis—is to produce solid, impartial statistics. And, it is data like that produced by these two agencies that forms the foundation on which analysis that informs policy can be built.

I would like to tell you about three areas where we at the U.S. Department of Commerce are currently working to push against the information frontier and improve our understanding of the economy. Two of these are at the Bureau of Economic Analysis and the third is a cross-cutting effort at the Department level.

Last September, BEA, with support from the National Science Foundation, published a preliminary satellite account on investment in research and development. Satellite accounts are supplementary estimates that do not change the official national accounts. However, by remaining consistent with the broader economic accounts, while adding new information and formats better suited to answering particular analytical questions, these accounts provide a “laboratory” for economic accounting research into specific industries and markets.

This particular satellite account was developed to explore the effect of investment in research and development on U.S. economic growth. What we have learned from this preliminary account is fascinating. It appears that R&D may have accounted for a substantial share of the resurgence in U.S. growth in recent years.<sup>3</sup>

A vital next step in this effort to explore the role of intangibles in the U.S. economy is currently underway at the Bureau. They are working on a prototype health satellite account, which we hope will provide insight into the role of health care spending in the U.S. economy.

This is a really big deal. The increasing cost of health care is the number-one long-term budget issue confronting the U.S. government. Health care spending currently represents 16 percent of U.S. GDP. It has doubled as a share of GDP over the last ten years and it is expected to continue to increase. We know that some of the data that we are now using to measure health care is inadequate. Preliminary research indicates that our measures of health care inflation are likely overstated. If this is the case, we could be looking at an overstatement of overall inflation and an understatement of overall economic growth and productivity because the sector represents such a large share of our economy. Getting the best evidence we can in this area is critical not only for health care policy, but also for monetary and fiscal policy.

Another policy-sensitive area where we are pushing against the frontiers is in the area of innovation measurement. This is an area that I know is also of high importance at the OECD and within the European Union.

We have begun by looking at what evidence is already available. We have examined metrics across our entire statistical system. We have talked to colleagues at the European Union and the OECD to see what they have discovered as they struggle with similar questions. But, we are also taking a next step and asking what data do we not collect that

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<sup>3</sup> Bureau of Economic Analysis, “Preliminary Study Shows Research And Development Contribution To Economic Growth,” Press Release, September 28, 2006 (<http://www.bea.gov/newsreleases/general/rd/rdspend06.htm>).

we should collect if we want to really understand the impact of innovation in the U.S. economy.

In February the Secretary of Commerce convened an Advisory Committee of CEOs and academics to “advise the Secretary on new or improved metrics on innovation in the economy.” I must point out that it is very rare for a member of the President’s Cabinet—the most senior group of policy makers in the United States—to take an interest in data collection at the technical level that this exercise requires. But, Secretary Gutierrez personally recruited CEOs from America’s top-tier companies for this effort. As decision makers, they believe—and this is a quotation from the first meeting of the Advisory Committee— that “If you cannot measure it, you cannot manage it.”

This is the type of person who believes that evidence-based policy is a must.

Ultimately, I believe that this forum is about finding the evidence. We are all here to compare notes about how we go about measuring progress in our economies and our societies. I look forward to our discussion this afternoon.

Thank you.