Failure to Communicate?

Sound economic policy demands superior research and clear communication

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In my brief tenure as president of the Minneapolis Fed, I have emphasized the importance of policy-based economic research and clear communication about the methods and findings of that research. My first column in *The Region* (December 2009) stressed these points, as did my essay in our 2009 *Annual Report*. At the risk of overselling the message, I'm going to do so again.

That's not to say that some economic research shouldn't be purely theoretical—I've devoted many years to theory and believe that my grasp of policy and economics is stronger because of it. But at the Fed, we also have a duty to produce research that addresses real-world economic issues, and in recent times—as you're well aware—we've had a profusion of those.

I've tried to fulfill that duty in a policy paper that you'll find on the following pages (and on our Web site). The topic is optimal financial regulation through taxation of financial risk; that's a mouthful, I admit, but the idea is fairly straightforward. Basically, I suggest that governments can use taxes to curb risky investing in the same way they use taxes to reduce pollution.

Currently, government debt guarantees (bailouts and deposit insurance, for instance) encourage financial firms to engage in excessively risky investment. How? Like a factory that doesn't have to clean up after itself, financial firms with debt guarantees don't face the full risk of their investment decisions; they know that if their investments fail drastically, the government will be forced to bail them out to avoid broader systemic collapse. It's an unfortunate but inevitable reality that no legislation can truly prevent.

My proposal: a risk tax that, like an emissions tax, would provide firms with accurate price signals to undertake socially optimal investing. I'm not advocating the elimination of risk. However, I do want to ensure that firms pay for the risks borne by taxpayers. Taxes can ensure that they do—just like taxes can ensure that factories pay for the pollution that they generate. My paper explores this analogy at some length because I consider it a very useful way to address the financial and regulatory dilemmas we now face.

Shaping debate and improving policy

Now, while I think this is a great idea, I'm not so idealistic (or immodest) to believe that Washington will adopt my proposal straight away. But I do think it could shape policy discussion in coming months and years—sort of a *medium-term* impact, if you will—and I hope that a lot of our policy papers and some of my speeches will have that effect: reframing the way people view important economic issues so that subsequent policy debate will be more fruitful.

That will only be true, however, if we make our points clearly; that means we need to communicate well, often and in a manner appropriate to each intended audience. I try to do this in my speeches, and I know that our publications and Web site do so as well. Our economic staff reports, ag credit fact sheets and community affairs papers, to name just a few, all seek to communicate clearly to their respective constituents, and we constantly strive to improve each of those efforts.

And if we're successful, I also believe that in some cases our research—and our communication—can and will have a more *immediate* impact. An obvious recent example is a talk I gave in early March about the importance of maintaining the supervisory role of Federal Reserve regional banks. Proposals in Congress at that time would have stripped away that authority. I felt that doing so would seriously undermine the nation's financial stability by depriving regulators of essential on-the-ground information and expertise about small banks throughout the country. Many others, including several of my fellow presidents, expressed similar concerns about the desirability of such a change in public policy. I believe that our ideas played an important role in persuading the Senate to vote instead for an amendment introduced by Sens. Kay Bailey Hutchison of Texas and Amy Klobuchar of Minnesota that allowed for sustained supervisory authority for the Federal Reserve and its district banks over small banks and bank holding companies. The Hutchison-Klobuchar amendment was adopted overwhelmingly by the Senate on May 12.

Communication and research

Other Minneapolis Fed research—and communication about it—will, I expect, have less dramatic but perhaps ultimately more profound *long-term* effects. This will take time; good research often does. But I strongly believe that the results will justify the effort.

Let me give you an example. Economists like our own Art Rolnick, director of the Minneapolis Fed's Research department since 1985, has long been engaged in research on the short- and long-term impact of early childhood education. As Sen. Klobuchar testified in her floor speech regarding the value of the Fed's regional banks: "He has put out studies straight from the Federal Reserve because he had that information on the ground to show the kind of return on investment you get when you invest in kids early on. I do not think we would see that coming out of the Federal Reserve in Washington."

The payoff to Art's research has been enormous. From Massachusetts to Oregon to the Obama administration, policymakers are beginning to design and fund effective early childhood development programs, in part because of research like Art's that shows the public benefits of doing so are large. So research can shape policy, and policy can change our future. An essential link in that process has been good communication—and Art is one of the best communicators I know—among policymakers, economists and the public.

With that in mind, I truly hope you'll enjoy the June 2010 issue of *The Region*—not just my paper on risk and taxes, but also a great conversation with Stanford University economist Robert Hall, an expert in labor markets and recession dating, among other areas; an update on the Fed's liquidity programs; an article about China's economic transformation; and write-ups on the impact of taxes on human capital, and the interplay of cartels and productivity. You'll also find reviews of two novels about financial crises; and finally, news of a recent conference honoring my predecessor in this chair, Gary Stern—an economic model for us all. R