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Economic Affairs

Student & Teacher Supplement

Oxfam, Malthus and the Worst Prediction in Economic History

By Stephen Davies

A report recently published by Oxfam received a huge amount of attention. The report argued that world food prices will double over the next 30 years and that the only solution is 'radical reform of the world food system' which translates to mean extensive government controls over the production, supply and distribution of foodstuffs. It is surprising that they are so confident as to the level of prices in 30 years' time and even more surprising that they look to government given the catastrophic record of states in managing food supply – Communist China, the British Empire and the Soviet Union all managed to create famines that killed millions. However, it is history that tells us both where the authors of the report are coming from and why we should reject both their analysis and prescriptions.

It is true that world food prices have risen sharply over the last three years. Indeed, most of the commentary on the report states that food prices are at all-time record highs. Indeed they are – in nominal terms. In real terms, however, grain prices are less than half the level in the 1940s and are 25% less than in the 1960s.¹

The point is that food prices are volatile and short-run spikes of this kind have happened many times before (for example, during the early 1970s) due to factors such as adverse weather and bad harvests and major supply bottlenecks. This time a major cause is the insane policy of converting maize into ethanol for fuel. What matter are long-term trends.

However, the report argues that we are indeed seeing a long-term trend caused by structural constraints such as ultimate supply limits on food production and growing demand due to rising living standards (leading people to eat more meat) and rising population. Claims of this kind have been made repeatedly every time there is a spike in prices by people such as Paul Ehrlich, Lester Brown, Donella Meadows and many others. In fact we can trace this kind of thinking right back to 1798 when Thomas Robert Malthus published the first edition of his *Essay on Population*. In it he put forward the basic argument of the Oxfam report and its many predecessors, that there is an inherent limit to agricultural production and the rate at which it can increase, which means that, without checks on population growth, there is a long-term tendency for the demand for food to push up against the limits of production, leading to rising prices, declining living standards and famine.

Malthus was probably the worst prophet in human history – the long-term trend since 1798 has been for real food prices to decline and agricultural production to go up more rapidly

than population. Since 1960, for example, grain production has increased three-fold without any extra land being put under the plough. However, he was one of the greatest historical sociologists – as far as most of the past is concerned he was right and his analysis can be used to make sense of much of human history. So why has everything been different since his time? One

argument is that we are enjoying a boost to food production from the use of oil, which is now coming to an end. Leaving aside arguments about oil supply this is clearly untrue because the take-off in food production started long before any widespread use of oil, and oil-based fertilisers only account for a part of the huge increase in output since 1960.

The real reason is two-fold – sustained innovations in production and distribution brought about by the operation of the profit motive in a competitive market and the use of markets and prices (as opposed to controls) to govern the distribution of food. Every time this has been abandoned (as with the ethanol policy of the US government) the result has been disastrous. Many important innovations such as GM food are now blocked by weak-willed politicians influenced by lobby groups. The solution to the undoubted short-term difficulty we face is a mix of the following concrete policies: abandoning agricultural protectionism by the EU and the USA in particular; making it easier for small farmers in poor countries to get their products to market; removing supply-side constraints such as poor storage of grain in many countries; establishing tradable property rights in fisheries and land in many parts of the world; and, above all, by allowing high prices and the profit opportunities they indicate to lead producers to innovate, produce more and so resume the long-term downward trend in the price of food.

1. For a comprehensive review of this see the work of California-based agricultural economist Daniel Sumner at: http://blumcenter.berkeley.edu/files/blumcenter/Daniel_Sumner_Slides.pdf.

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UK Uncut Unravelling

By Tim Worstall

Many students have joined the UK Uncut campaigns to promote the case that corporations should pay more tax. Important aspects of the principles by which tax systems operate can be illustrated by unpicking the UK Uncut claims. Indeed, it is a useful case study for young economists.

UK Uncut's targets

Vodafone

The arguments about how much Vodafone should pay in tax seem to have started when Richard Brooks, at *Private Eye*, made the claim that the company had managed to persuade Her Majesty's Revenue and Customs (HMRC) to let them off a £6 billion tax bill, forcing them to pay only £1.25 billion of what was truly owed.

There was indeed a long-running investigation by HMRC into Vodafone's tax affairs, and it revolved around a subsidiary based in Luxembourg. It was through this that Vodafone bought a German company called Mannesman, a mobile telecoms provider in that country. It received the dividends from the German operation. This is the payment, made out of profits, which goes to the owners of a company.

The way that UK company tax law works is that, if you have one of these foreign subsidiaries, then there are times when you have to pay UK tax on their profits as well as the tax that is paid abroad. These are called the Controlled Foreign Company (CFC) rules. They are there to try and stop companies piling up their profits in tax havens. But we should note, the CFC rules only require that you must pay up to UK tax rates, deducting whatever you might have already paid in taxes elsewhere. This is perfectly reasonable and is a key aspect of international business taxation. If these rules did not exist, companies could end up paying tax on their profits several times over.

This leads us to our first observation: there never was a £6 billion tax bill. This seems to have been calculated by noting that there was £18 billion of profits in the Vodafone Luxembourg accounts using a corporation tax rate for the UK of 30% (appropriate at that time) and calculating that £6 billion must be owed. However, the dividends from the German operations would have been taxed in Germany, according to German rules, the interest in Luxembourg according to their rules and tax rates and so also with the capital gains. So the maximum that could possibly be owed would not be the full 30% UK corporation tax rate but the difference between the tax already paid and that 30% rate.

This amount was the £2 billion or so that Vodafone held as a provision in its account. There was then a legitimate dispute – on which reasonable people could have different views – on whether this £2 billion should be paid by Vodafone. EU rules would suggest not though other aspects of UK tax law suggest that some tax might be due. EU rules should, in theory, be paramount as they are integral to the whole idea of the single market. However, what is clear is that a company cannot be expected to pay tax on profits in Germany and then pay tax again on those profits in the UK.

Boots

Strangely enough, UK Uncut takes the opposite position with regard to Boots – its second main target. With Vodafone, UK Uncut argues that UK tax should be paid on profits earned in Germany. With Boots it argues that UK tax should be paid on interest paid to bondholders who live abroad. Boots is largely financed by borrowing and not by share capital.

You might argue that companies are also trying to have it both ways. If Vodafone pays German tax on profits earned in Germany, then why does Boots not pay British tax on the money the company earns which it uses to pay interest to bondholders who live abroad? However, it is a long-standing and reasonable part of all international tax systems that interest paid to bondholders and banks is a cost of doing business and is not part of a company's profit: it is part of a company's costs that is deducted from revenues before profits are calculated.

Tax is still paid but it is paid by the bondholders and there is no evidence that less tax is being paid overall. Less corporation tax is being paid but whoever is receiving the interest will be paying tax where they are based. It is worth noting that, in many respects, when interest is taxed, this is a much more satisfactory way of levying taxation than the methods that are used to tax profits. Interest is taxed in the hands of the recipients according to their tax circumstances. Profits are taxed in the hands of the company and then remitted to shareholders net of tax. If those shareholders are non-taxpayers (such as charities) they cannot reclaim any of the tax that has been paid.

Arcadia and Philip Green

UK Uncut's third target is Arcadia and Philip Green. The allegation here is that Philip Green paid a huge dividend from the company Arcadia to his wife, Tina Green. Because she does not live in the UK this dividend was not taxed, meaning that HMRC lost perhaps £300 million. This, apparently, is tax dodging.

Once again, this situation is easy to defend. We do not charge UK income tax on dividends from UK companies paid to foreigners. We do not do it for foreigners who own BP shares; we do not do it for foreigners who own Rolls-Royce shares; so why should we do it for foreigners who own Arcadia shares? And the reason we do not do it is because we do not want to inhibit foreigners investing their money in the UK. Corporation tax is paid on the profits and then the recipient of the dividends may well have to pay additional income tax wherever they live though Tina Green lives in a country where no further tax is due. We do not want to prevent foreigners from holding UK shares because more capital invested in the UK means, everything else being equal, that workers in the UK are more productive. And the more productive workers are on average in an economy, the more those workers will get paid. Foreigners sending their money into the UK and investing in businesses in the UK makes us all better off. We do, however, tax the profits the companies make: and absolutely nobody has even hinted that Arcadia does not pay all the corporation tax it should. What is not paid is the additional tax on the dividends because those dividends are received by a non-resident.

There are two other complaints in this story. The first is that Philip Green 'gave' the company to his wife and that this is the tax dodge. But this is not true. The company which owns



Arcadia is called Taveta. And when Taveta bought Arcadia, at least as far as it is possible to tell from the records, Tina Green owned Taveta. So what we have, on paper at least, is a woman who owns a company which then buys another company and she sends her husband in to run it. It is very difficult indeed to see that this is a tax dodge.

However, the main complaint seems to be that they are man and wife – they are not just any two potential owners of a company, they are really the same persons. Because Philip Green pays UK tax then his wife should too, it is suggested. Twenty-five years ago wives were taxed as appendages of their husbands. Now they are taxed independently. There seems to be little desire to turn the clock back when that point is made explicitly. It would be amusing to see some of the young protesters in UK Uncut trying to explain to some of the young women in UK Uncut that in order to get £300 million from Tina Green all those young women should lose their economic and tax individuality – that is the logic of their argument.

The economic theory of taxation

Companies do not pay tax, not a single penny. Corporations, of course, hand over the cheque to HMRC but the burden of the tax on profits is borne by the company's owners and sometimes by workers and customers. Shareholders are not anonymous fat cat capitalists – they are future pensioners. Indeed, many pensioners today are suffering greatly because of the fall in the value of pension funds arising from the relatively poor performance of the UK stock market in recent years.

There have been a number of attempts over the years to work out exactly who bears the burden of corporation tax and in what proportion. Joseph Stiglitz (who went on to win the Nobel Prize for Economics) pointed out in 1980 that it is theoretically possible for this burden upon the workers to be greater than 100%: that the amount the workers lose from their wages is higher than the total amount of corporation tax that is raised. Mike Devereaux at Oxford University has calculated that this is true in the UK today – the burden of

corporation tax falls on employees and is greater than 100%. Other estimates are lower. For example, the Congressional Budget Office in the USA estimates that the burden of corporation tax falling on workers is around 70%.

We need to note here that this is not a case of the company trying to impose the corporation tax bill on the workers. These are costs that arise naturally from the system. Average wages in an economy are determined by average productivity in that economy and labour productivity can be increased by adding capital. If capital is mobile and the amount of capital employed in a given country is reduced because of the cost of corporation tax then the amount of capital being employed will fall and this will lower the wages of labour.

This is the mechanism by which the burden of corporation tax gets passed on to the workers: not because anyone is trying to, but because there will be less capital invested, leading to lower average productivity and thus lower average wages.

The second thing about the economics of taxes is that all taxes have deadweight costs. This means that by having a tax we will make sure that some valuable economic activity which would have happened will not happen. This leads to lower economic growth.

There are lots of sensible changes that could be made to the UK tax system to make it more efficient and economically coherent. But the starting point for understanding tax paid by companies should be that corporations do not pay tax, ever. The corporation tax burden is borne by workers and owners. We should tax those owners in a consistent way and not in an arbitrary way. Corporation tax reduces growth more than any other form of tax in common use. Far from demonstrating in shops to try to get companies to increase the tax they pay, we should be demonstrating to reduce the burden of taxes on companies.

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The New Paternalism¹ – Unravelling ‘Nudge’

By Glen Whitman

For many years, people have been telling other people what is good for them – and manipulating or forcing them to do it. Today the ‘new paternalism’ seeks to make people better off *by their own standards*.

New paternalism has many names, and arose from behavioural economics, which studies how people deviate from the pure rationality of mainstream economics. Real people have cognitive biases, including lack of self-control, excessive optimism, status quo bias, and susceptibility to framing of decisions. The new paternalism is informing policy in Downing Street which has a ‘nudge’ unit to try to find subtle ways of changing our behaviours in ways government feels are best for us.

The proposals of the new paternalism might seem modest. But, if you dig deeper, you will find a wide-ranging policy agenda at work. In articles by the main academics working in the field, you will find policy proposals from mild to downright intrusive. New paternalists present their position as the reasonable middle ground between rigid anti-paternalism and intrusive ‘hard’ paternalism. However, it carries a risk of placing us on a slippery slope from soft paternalism to hard. The slippery slope risk must be counted among the relevant costs of new paternalist policies.

The paternalism-generating framework

Humans are vulnerable to *framing effects*. Choices turn on factors such as the order in which options are presented and which option is designated as the ‘default’. Indeed, nudge adherents use this fact to justify their own policies. However, this observation also shows how nudging can lead us down the slippery slope of ever-more intrusive regulation. People exhibit *extremeness aversion*: a tendency to avoid positions that are presented as extremes. The new paternalists exploit this by presenting their position as a middle ground. The danger is that the middle ground can easily shift. Once, banning smoking on airplanes seemed like the reasonable middle ground. Now that policy is seen as the *laissez-faire* position and smoking bans in bars and restaurants represent the middle ground. Full-blown smoking bans have come to pass in some US cities.

Also, paternalism is presented as inevitable. The new paternalists frame the debate as being not *whether* there should be paternalism, but *how much*. This makes it very difficult for people in the political debate to argue against paternalism in principle.

Thirdly, new paternalists present their agenda as existing on a continuum and define the continuum in a way that elides crucial distinctions – such as the difference between private and public and between voluntary and coercive. We all subscribe to voluntary paternalism (for example, joining clubs where certain types of behaviour are banned). However, the new paternalism involves the state taking over the role of voluntary organisations and civil society in helping to influence behaviour.

Choosing among preferences

Ultimately, politicians cannot prove that someone is acting irrationally, rather than simply having preferences that politicians would prefer them not to have. There is nothing *per se* irrational about strongly valuing the present relative to the future, or enjoying food more than good health.

Behavioural economists point to inconsistent behaviours. For instance, people make long-term plans but then succumb

to the desire for short-term gratification. They also make different choices in different emotional states.

Assuming that these actions do reveal irrationality, *that fact does not license a third party to choose among competing preferences*. If a person is more patient when thinking about trade-offs in the distant future, but less patient when thinking about trade-offs near the present, which level of patience is the ‘correct’ level? Yes, people may behave inconsistently but this does not mean that the government knows which choice is best for us.

Policy temptations and political myopia

Policy-makers have short time horizons for various reasons. Given this, it can be quite rational for policy-makers to ignore the long-term effects of their choices. But, it is worse than that. Policy-makers also have problems with self-control and difficulty working through cause and effect. Consequently, they tend to focus on the problem-of-the-moment and succumb to policy temptations that promise short-term political gains.

By definition, slippery slopes happen over time. A proposed policy seems like a good idea now, but will open the door to worse policies in the future.

The new paternalists encourage us to adopt promising paternalistic interventions and worry about future proposals as they come – emphasising present benefits while downplaying future costs. This is exactly the kind of error that new paternalists think demands correction – ignoring the fact that politicians succumb to exactly the same problem. *The slope risk must be counted among the costs of the initial intervention*.

New paternalists imagine policy-makers acting only when the benefits outweigh the costs. In reality, they face a stream of temptations. So they use rules of thumb. They display *extension neglect*: the tendency to focus on ‘prototypes’ instead of measuring the true degree and extent of a problem. Even worse, policy-makers will be influenced by special interests that will support policies for financial reasons or have a moral or ideological agenda.

Conclusion

Real people are susceptible to cognitive biases that can lead to poor decisions. But no one is immune to bias. The same cognitive defects that they wish to correct by ‘nudging’ also exist amongst politicians. I recommend a slope-resisting framework – one that stresses private options and opportunities for self-correction. That doesn’t mean we will never adopt any new paternalist policies but we will hopefully stand a better chance of not slipping down the slope.

1. A longer version of this piece appeared at Cato Unbound www.cato-unbound.org.

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