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Institute of Economic Affairs

WELCOME

… to the **first EA of the new academic year.**

Three of the main articles in this issue take a **very clear look at the future**.

Our cover story (p10) asks whether **Bitcoin – or other digital money – provides a realistic alternative to the current monetary system**.

On page 20, we take **a critical look at the student loans system** – something that's sure to loom large for you in the months ahead.

And, on a much more positive note, we meet author and journalist **MATT RIDLEY** (p18) to discuss why he sees **the world as a much better place than ever before** – and why life on the planet will **continue to get better.**

Elsewhere, we meet one of the **current greats of economics**, Professor **JOHN TAYLOR** (p30) and, on page 38, we pay tribute to Professor **GARY BECKER** – a **truly remarkable and innovative thinker** who died earlier this year.

Another sad death I would like to note is that of **JOHN BLUNDELL**, former Director General of the IEA. Under his leadership, the IEA established its **student/teacher programme** with a large grant from the Templeton Foundation. John will be remembered by many teachers, and there is a longer tribute to him on the IEA blog: **www.iea.org.uk/blog/john-blundell-rip**

Throughout this issue, you'll see we've highlighted **films and interviews** you can watch on **ieaTV**. We're adding **insightful new material** all the time, so be sure to check it out at **www.iea.org.uk/tv**

In the meantime, I hope you find this latest edition of **EA truly stimulating**

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IN THE DOCK: Market failure

IEA Editorial and Programme Director **PHILIP BOOTH** on why "market failure" is a false indictment...

If somebody were to start an engineering textbook by saying that the maximum theoretical speed of a perfect car was the speed of light[1] and that a car that travelled at any speed lower than that was a "failed car" or suffered from "car failure", you would probably think that it was an unhelpful way of presenting the topic – and you would be right.

Yet, a common approach in economics teaching is to lay out the preconditions of a so-called perfect market (full information, no transactions costs, no externalities and so on) and then to look at how markets, in practice, deviate from that textbook model. We then call those deviations "market failures" because they imply that all opportunities for welfare maximisation have not been taken[2]. This is despite the fact that it is impossible to have a perfect market, just as it is impossible to have a "perfect car".

Because markets are deemed to fail according to the textbook model, the concept is then used to justify different forms of government intervention. For example, consider this statement by the former regulatory body for financial markets, the Financial Services Authority (the body that presided over financial regulation at the time of the financial crash) made in 2003:

"In meeting our objectives in a manner consistent with the principles of good regulation, we have adopted a regulatory approach based on correcting market failure…There are, however, numerous cases where unregulated financial markets will not achieve the best outcome due to some form of market failure, making action on our part necessary."

The word "necessary" is especially interesting in this statement because all markets suffer from the problem of market failure as defined in the textbooks – just as all cars travel at less than the speed of light – and thus there would

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[1] This analogy is not original – I believe it was first suggested by David Friedman.

[2] This can all be related to the textbook model of perfect competition and the assumptions that underlie it. However, I shall follow a slightly different track in this article.

appear to be no limit on the extent of regulatory intervention that the FSA believed it needed to use to try to perfect the market. The market failure doctrine is not simply a problem in economics textbooks, it is used to determine public policy.

Government failure?

In some A-level syllabuses, the concept of market failure is balanced by that of "government failure" – the idea that, for various reasons, the government might not be able to perfect markets through regulatory intervention. However, though this provides balance, it is not a helpful phrase to use. We cannot expect governments to perfect markets – it is simply beyond their capacity. As such, governments do not fail if they do not perfect markets. The lessons of public choice economics tell us that regulators may act in their own interests, or may get "captured" by the industries that they are trying to regulate so that the actions of regulators do not contribute to increasing overall welfare and improving market outcomes. Regulators might be risk averse and over-regulate markets or they may have cognitive biases that lead them to regulate markets through "rule writing" which simply raises costs without improving outcomes. Furthermore, Austrian economics suggests that, if a market is "imperfect" in some way, governments and regulatory bureaus simply cannot know what the outcome of a perfect market would have been had it existed.

For these reasons and others, governments cannot perfect markets and the concept of "government failure" is just as unreasonable as that of "market failure".

Achieving better outcomes, not perfect outcomes

The obsession with the market failure approach to policy analysis is relatively new and can probably be ascribed to Pigou. The obvious example, coming from Pigou, is the idea of the optimal tax to deal with pollution. If a factory owned by one individual pollutes the air or land of other individuals, the argument goes that the problem can be solved with an optimal tax on the factory's activities to bring marginal social costs into line with marginal social benefits. Again, this is reflected in A-level and undergraduate economics syllabuses. However, we do not know what that tax should be. How can a government minister know the social cost caused by a pollutant? People's preferences for different economic goods are only revealed by the prices they pay in market transactions. Different people will have different preferences. Some people might have a strong preference for clean air; others might prefer dirty air if allowing more pollution allows them to be a little bit more wealthy in other ways. The government could only have the information to work out the optimal tax if it had all information about the costs and benefits of all potential uses of economic resources. If it had that information, then centrally planning the economy more generally would work. And yet we know that central planning is a catastrophe.

There is a better way of dealing with these problems. Instead of focusing on market imperfections and government regulation and taxation to correct those imperfections we might think about which set of institutions and policies generally produces the best result – not a perfect result but the best result. In the case of externalities we might want to consider the set of policies that will lead to the parties causing harm and the parties who are harmed coming to an agreement that leads to better outcomes.

Let us take land-use planning as an example. At the moment, people in the South East of England tend to oppose more development because it reduces their environmental amenities, leads to more road congestion and so on. On the other hand, people regard new houses in the South East as incredibly valuable compared with other uses for the same land such as farming. Land with planning permission for building is worth about 100 times land with planning permission only for agriculture. So there is a conflict: builders want to build and existing residents want to prevent building. There is a social cost from building more houses but a huge potential welfare gain too.

Since 1948 we have resolved

IT IS IMPOSSIBLE TO HAVE A PERFECT MARKET, JUST AS IT IS IMPOSSIBLE TO HAVE A PERFECT CAR

KEY LESSONS

- No market will ever be a "perfect market" as defined in the textbooks
- Markets cannot be perfected by government action – it is simply impossible
- As such, both the terms "market failure" and "government failure" are unhelpful
- Economists should look at how markets are impeded from increasing welfare and suggests ways in which those impediments can be removed
- This will often involve extending markets rather than regulating them, though in some situations governments may well be involved in facilitating this process

this conflict by giving powers to regulators in local government to take decisions about development using a bureaucratic process that is influenced by interest groups. This leads to some perverse outcomes, one of which is that houses that might have a minor impact (minor social cost) on nearby villages do not get built even though the private gains might be huge. If only those who gained could compensate those who lost, there could be much better outcomes.

Instead of this process of regulators trying to dictate who should and should not have permission to build, what if we were to bring those parties that gain together with potential parties who might lose? Builders, who gain hugely from turning agricultural land into building land, reflecting the value their customers put on new houses, could use some of that gain to directly compensate those who lost their environmental amenities[3]. This could be done at a very local level as the number of people affected by housing developments is normally quite small. Localities that valued their environmental amenities highly might refuse compensation, and the builder can build near people who value their environmental amenities less.

Good, better, best – but not perfect

There are many more examples of how we might improve economic outcomes by looking at the institutional framework rather than to extend markets so that economic agents have a good chance of taking into account the costs and benefits of different courses of action. As in the planning example, this might involve better definition of existing property rights so that

THE LESSONS OF PUBLIC CHOICE ECONOMICS TELL US THAT REGULATORS MAY ACT IN THEIR OWN INTERESTS, OR MAY GET "CAPTURED" BY THE INDUSTRIES THAT THEY ARE TRYING TO REGULATE

looking to regulators to pull levers, but what is the general approach that should be taken?

We should do two things. Instead of saying: "this is a market failure, we should give power to a regulator to pull the lever marked 'X' to perfect the market" we should look to improve institutions, parties can work out a solution in a way that best takes account of costs and benefits. The outcome may not be perfect, but it will be better. Secondly, so-called market failures are not generally failures of markets. They normally involve incomplete markets. In the planning example, under current law, there is no market in environmental amenities. If I get some benefit from the farmland at the back of my house, is that a property right of mine or not? Under our current land-use planning regime, it is in a kind of limbo. On the one hand the farmer cannot simply build on his field without permission. On the other hand, he cannot be stopped from building once he has permission. In lots of areas (for example, land-use planning, fishing rights, environmental pollution) the problem is that property rights do not exist in the relevant resource so nobody has an incentive to use the resource efficiently or come to agreements with others to compensate them for the "social costs" of their actions.

Failure to treat this subject properly is a major impediment to economics being useful in solving public policy problems.

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[3] In fact, the cost might be borne by the owners of the agricultural land the price of which will go down reflecting the extra cost to the builders of providing compensation.

DECONSTRUCTING the ARGUMENT

IEA Senior Research Fellow KRISTIAN NIEMIETZ critiques DANNY DORLING's *All That is Solid: The Great Housing Disaster* (Penguin Books)

Let us start with the good aspects of Danny Dorling's *All That is Solid*. The book is quite good in describing the symptoms of the UK's housing crisis, and of the social problems that follow from it. Dorling's critique of the 'Help to Buy' scheme is spot on, and his attack on the bedroom tax is well worth a read. Those parts of the book are solid. But they are all that is solid.

Also on the plus side, various passages are unintentionally funny, especially when Dorling speculates about the motives of his political opponents. Dorling is the type of left-winger who genuinely imagines his opponents to think and act like the villains in a Batman comic. The coalition parties, for example, "want the children of the rich to be given more space in the city, and they want the children of the poor to go" (p187). Those who do not share Dorling's idolisation of squatters are likened to "the Victorian regressive who believed that hunger was a far more effective weapon than the overseer's whip" (p283), and to "the 1930s eugenicists who believed a national health service would only help the weak to survive and breed" (ibid).

There are enough bedrooms for everybody

As for the bad parts, it would be wrong to claim that the book fails to identify the causes of the under-supply of housing. It is worse. This book categorically denies that there is an under-supply. "[O]ne of this book's central premises [is] that the fundamental problem in Britain […] is not a shortage of homes" (p108). Dorling says that building new

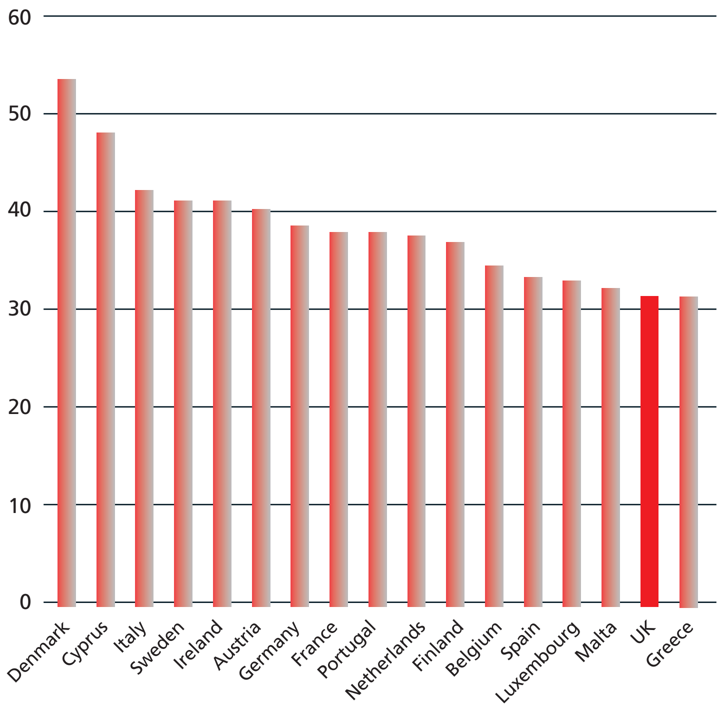

Figure 1: Residential floor space (in m2) per capita, 2008
Source: Entranze/Enerdata (2014) http://www.entranze.enerdata.eu/

homes might become necessary in the future, if high levels of net immigration continue for a long time. But, for now, it is wholly unnecessary, because "everyone in Britain could be adequately housed within the existing housing stock" (p100). The problem, Dorling believes, is purely a distributional one:

ALL THIS HOUSING SPACE THAT DORLING WANTS TO REDISTRIBUTE IS SIMPLY NOT THERE

"[T]his book is [...] concerned not with an absolute lack of housing, but with the problem of how that housing is distributed" (p.65). Or: "What is reducing the chances of [...] the badly housed, most is not government's failure to ensure that houses are built, but rather other people's overconsumption of housing" (p209). And elsewhere: "We have already built enough homes. We have more bedrooms than we have ever had before. But a few have been taking far more than their fair share" (p313). Dorling's solution, then, is not to build new homes – an option he repeatedly dismisses – but to redistribute the existing housing stock: Kick the rich out of their homes, and put the poor into them.

For the first two thirds of the book, Dorling simply repeats his assertion that there is an abundance of housing which is just poorly distributed. It is only then that he provides the 'evidence' for this claim, on which his whole book depends, in the form of a graph which shows the number of rooms per capita. This number has gone up from around 1 in 1911 to 2.5 in 2011.

So Dorling measures housing supply by the number of rooms. This might work for some countries, but definitely not for the UK. In a major international study of housing markets and housing conditions, Evans and Hartwich (2005) show a British peculiarity: when European countries are ranked by the number of rooms per dwelling, the UK comes out on top of the list. But when they are ranked by average room size, the UK comes out at the very bottom. Dorling's supposed abundance of rooms is simply an artefact of the fact that British homes tend to be subdivided into lots of exceptionally small rooms.

Too many bedrooms, not enough square metres?

So, if we are interested in housing space, why not measure it directly? Figure one shows the average residential floor space per capita in Western Europe. The UK comes second to last. All this housing space that Dorling wants to redistribute is simply not there. Irritatingly, Dorling himself briefly alludes to the fact that 'lots of rooms' does not automatically mean 'lots of space' (p195), but then chooses to ignore this distinction.

Small houses in the wrong place

The supply side problem of the UK housing market is vastly greater than this graph suggests. The housing stock is inadequate in total, but much of it is also in the wrong place. For more than three decades, the UK has been building fewer new homes per 10,000 inhabitants than any other country in Europe (Eurostat, 2010). The spatial distribution of the housing stock therefore does not reflect the southward shift of economic activity which has taken place in the same period, it is still built around the economic geography of decades ago.

Dorling is also wrong to treat supply side issues and distributional issues as entirely separable. In reality, constraints on the total supply can also

- Dorling claims that there is no undersupply of housing in the UK. There are more than enough homes, they are just poorly distributed. The basis for this claim is that there have never been so many rooms per person in the UK.
- The solution, therefore, is not to build more houses, but to redistribute the existing housing stock through state rationing.
- Yet the only reason for this apparent abundance of rooms is simply that British houses have been subdivided into ever-smaller rooms.
- Looking at floor space rather than the number of rooms points in the opposite direction.
- There is a lack of supply, and it is exacerbated by the fact that much of the existing housing stock is in the wrong place.
- The reason is that over the past three decades, the UK has built fewer new homes (per 10,000 inhabitants) than any other country in Europe.
- All of the literature points to planning constraints as the main impediment to development. Rather than redistributing the shortage, we should therefore liberalise planning, and give way to a sustained construction boom.

lead to a more inefficient use of that supply. In the UK, the same planning constraints which prevent the construction of sufficient numbers of houses also prevent older people from downsizing, and freeing up some of the housing space that is already there. As The Economist (2014) explains:

If old people could be persuaded to sell up, the young would benefit. Many want to. According to polling by Demos, a think-tank, 58% of older people are keen to move and one in four is interested in the idea of a retirement property. But they have few options. Britain has just 106,000 purpose-built owned retirement homes. […] Britain's planning controls […] make it extremely difficult for developers to build the sort of housing that older people would like to move to.

FOR MORE THAN THREE DECADES, THE UK HAS BEEN BUILDING FEWER NEW HOMES PER 10,000 INHABITANTS THAN ANY OTHER COUNTRY IN EUROPE

Conclusions

Dorling's attempts at economic reasoning simply do not stack up. He claims that "[o]ld rules that worked so well in the past and that still work well elsewhere today include rent controls" (p70), apparently oblivious to the fact that rent controls have failed wherever they have been tried. In the UK, rent controls were introduced in 1915 and liberalised in 1989. During that period, the share of households renting privately fell from 89 per cent to 9 per cent; it has since recovered to 18 per cent. Rent controls are rejected by virtually every economist currently alive, including economists such as Paul Krugman who position themselves firmly on the political left. Dorling also claims that markets only work when we can opt out of them entirely, which is why housing could not be left to the market. By that standard, we should also have state rationing of food, clothing, and other goods for which we do not have the 'none of the above' option.

What is perhaps most frustrating about the book is that it completely ignores the whole empirical literature on the determinants of housing market performance (for an overview, see Niemietz, 2012, pp.74-80). This is a well-researched topic, but is ignored.

In a sense, though, Dorling has no choice. Most of that literature points to building constraints and supply-side issues as the problem and these do not fit the conclusion at which Dorling wishes to arrive. In housing markets, demand curves really do slope downwards and increases in supply do reduce prices.

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Niemietz, K. (2012) Redefining the poverty debate. Why a war on markets is no substitute for a war on poverty, Research Monograph 67, London: Institute of Economic Affairs.

Bitcoin is very much in the news these days, and opinions about it are divided.

Its proponents see it as the money of the future with far-reaching implications, not just for money, but for the broader social order and especially the balance of power between the individual and the state. Sceptics see it as a modern day tulip mania, a bubble that is bound to burst.

So what is all the fuss about?

Bitcoin is the most successful of a new type of currency known as crypto-currency, a form of anonymous computer currency based on the use of strong cryptography to control the creation and transfer of money.

It was invented in 2009 by an anonymous programmer using the name Satoshi Nakamoto. Its key innovation is that it is completely decentralised and has no central authority or organiser whatsoever.

Bitcoin is a type of e-cash system in which there is no central body to authorise or track transactions; instead, these tasks are carried out collectively by the network itself.

Transactions are carried out using a digital 'coin' that uses public-key cryptography. When a coin is transferred from A to B, A adds B's public key to the coin and digitally signs the coin using a private key. B then owns the coin and can transfer it further. The network collectively maintains a public list of all previous transactions and before any coin is processed, it is checked by the network to ensure that the user hasn't already spent it. This prevents a user from illicitly spending the same coin over and over again.

Nakamoto explained the thinking behind Bitcoin in an email announcing its launch on February 11, 2009:

"The root problem with conventional currency is all the trust that is required to make it work. The central bank must be trusted not to debase the currency, but the history of fiat currencies is full of breaches of that trust…

Bitcoin's solution is to use a peer-to-peer network to check for double-spending…the result is a distributed system with no single point of failure."

IT IS ALREADY WIDELY USED IN THE KREUZBERG AREA OF BERLIN AND IS RAPIDLY GROWING IN POPULARITY AROUND THE WORLD

MINING BITCOINS

Bitcoins are created in a process known as 'mining'. This process uses computer power to search for solutions to pseudo-random number computational problems in a way analogous to a gold miner looking for gold. Finding solutions is not easy, but when a Bitcoin 'miner' hits upon a solution, he is rewarded with Bitcoin he can spend. The solution is then verified by the network. The process is designed in a way that ensures that the amounts produced are almost exactly known in advance. Anyone can mine for Bitcoin, but the rules are constructed so that the total amount 'mined' can never exceed 21m.

BITCOIN AS TRANSACTIONS MONEY

The first Bitcoin trade occurred on April 25th, 2010 and the first Bitcoin price was three cents. Early prices and quantities were low but once it got going, the market price rose strongly and went from peak to peak, after each of which it fell back. The last big peak was almost $1,200 late last year and it is now trading at about $450. Thus, the price has risen enormously since the market started but has also been very volatile.

One source of demand for Bitcoin was the online illegal drugs market Silk Road, famously described as the "Amazon.com of illegal drugs". This market used Bitcoin as its currency and operated on the dark web, making it difficult to shut down. Silk Road was finally closed down in October 2013 after its owner became careless, but within a short time a new Silk Road 2.0 was operating and providing the same service as its predecessor. And doubtless, should Silk Road 2 fail, Silk Road 3.0 would soon arise in its place.

Bitcoin is being used for ordinary legal transactions as well. It is already widely used in the Kreuzberg area of Berlin and is rapidly growing in popularity around the world. Reasons for using Bitcoin include it having lower transactions costs and being

IS BITCOIN IN A BUBBLE?

The price of Bitcoin has risen from 3 cents on April 25th, 2010 to about $450 today – an annualised rate of increase of about 300 per cent. It is therefore difficult to deny that Bitcoin is in a bubble. However, it is a bubble unlike the tulip one. At the height of the tulip mania one could reasonably say that a tulip was not worth a fortune in Amsterdam real estate and hence the market was over-priced. With Bitcoin, on the other hand, there is no 'natural' benchmark to tell us whether it is over-priced or not. The reason is because Bitcoin has no other use-value – unlike a tulip. This, in turn, means that whilst the price of tulips was never going to fall to zero, the price of Bitcoin might – and eventually probably will. However, if it becomes widely used for transactions, its value may hold.

Table one: **BITCOIN and the FUNCTIONS of MONEY**

Function	How does BITCOIN measure up?
Medium of exchange	Bitcoin can be used quite widely but is by no means universally accepted
A store of value	Bitcoin's value fluctuates widely, though this may change if the demand for Bitcoin becomes more stable. Bitcoin does not have a tendency to systematically fall in value like government money
Means of deferred payment	The fluctuating value of Bitcoin makes it difficult to use as a means of deferred payment
A unit of account	Bitcoin can easily be used as a unit of account or be converted into other units of account

cheaper for retailers than credit cards. There are also Bitcoin ATMs, which exchange dollars for Bitcoin, and companies are starting to pay their employees in Bitcoin. Even some universities now accept fees in Bitcoin. You can also use Bitcoin to donate to organisations that the government does not like, such as Wikileaks.

IN THE LONGER RUN, BITCOIN IS ALMOST CERTAIN TO FAIL – AND THIS IS NO BAD THING

More generally, it is interesting to consider whether Bitcoin fulfils the functions of money as normally understood by economists. Bitcoin certainly has at least some of the characteristics that are required of money: it is scarce, divisible, portable and acceptable (at least to some extent). But, does it fulfil the functions of money? This issue is considered in *Table 1.*

RISKS TO BITCOIN

Bitcoin is however vulnerable to threats. One source of threats is cryptographic. Modern cryptographic systems depend on the assumption that an attacker would need a very long time – decades in fact – to decrypt a message, and it has been argued that this could change in the face of future advances in technology (for example, the development of quantum computers) or in mathematics (such as new algorithms). Major advances in computing technology are surely inevitable, but Bitcoin automatically corrects for improvements in cryptographic technology or computational power. Routine improvements in computational power should therefore pose no problem.

Nonetheless, in the longer run, Bitcoin is almost certain to fail – and this is no bad thing. The pioneers in any industry are rarely the ones who last longer term: who remembers Betamax from the early days of the video industry? Bitcoin might have been the first successful crypto-currency, but it is not yet clear whether being the first mover in this area is an advantage in the longer term. After all, major design flaws in the Bitcoin model are set in concrete and competitors can learn from them. The crypto-currency market is also an open one and a considerable number of new competitors have already entered the field. Most of these will probably soon fail, but, as competition in the market develops, no-one can predict which crypto-currencies will be best suited to the market and achieve long-run success. My guess is that Bitcoin will eventually be displaced by other crypto-currencies with superior features.

The ideal – the gold standard in this area – would be one or more crypto-currencies that were able to achieve stable purchasing power through elastic but fully automatic supply schedules that accommodate demand changes, and which also have the ability to maintain state-of-the-art security. Such crypto-currencies would also avoid the boom-bust cycle to which Bitcoin is prone. The purchasing power of Bitcoin varies according to demand arising for various different reasons – including speculation. A currency the supply of which was designed to stabilise its purchasing power is more likely to become generally acceptable.

BROADER IMPLICATIONS OF BITCOIN

Bitcoin and associated innovations also have broad implications. Bitcoin has no regard for international borders and can be used by anyone with access to the internet. As one blogger put it:

"As long as my encrypted [Bitcoin] wallet exists somewhere in the world, such as on an email account, I can walk across national borders with nothing on me and retrieve my wealth from anywhere in the world with an internet connection."

This gives Bitcoin great potential as an internationally mobile store of value that offers a high degree of security against predatory governments. Indeed, Bitcoin now

New Private Monies – a bit-part player? can be downloaded for free at *www.iea.org.uk/publications/research/new-private-monies-a-bit-part-player*

fulfils the role once met by bank secrecy – the ability to protect one's financial privacy.

In this context, it is useful to note that the designers of crypto-currency sought to create, not just a new currency, but a new anarchist social order, a crypto-anarchy in which:

"the government is not temporarily destroyed but permanently forbidden and permanently unnecessary. It's a community where the threat of violence is impotent because violence is impossible, and violence is impossible because its participants cannot be linked to their true names or physical location."

There is no easy way in which the government can prevent the use of Bitcoin to evade government control. The combination of anonymity and independence means that governments cannot bring down Bitcoin by conventional methods, although they may occasionally catch individuals and organisations that are careless. They cannot bring Bitcoin down by taking down particular individuals or organisations because the system is not dependent on any individual or organisation: there is no single point of failure. They could shut down any individual sites they wanted, but the Bitcoin community would carry on.

For a long time now, individual freedoms have been subject to more and more exceptions: there were exceptions to counter money laundering, terrorism, offshore financial centres that offered low tax rates and payments to whistle blowers and organisations on government blacklists. We have gone from a situation where privacy – including financial privacy – was respected, to one where it is now openly repudiated.

Strong cryptography offers the potential to swing the balance of power back toward the individual. Censorship, prohibition, oppressive taxes, financial repression and repression generally, are being undermined as people increasingly escape into the cybersphere where they can operate free from government harassment.

If this sounds extreme, it was perfectly normal a century ago. As AJP Taylor put it:

"Until August 1914 a sensible, law-abiding Englishman could pass through life and hardly notice the existence of the state, beyond the post office and the policeman... He could travel abroad or leave his country for ever without a passport or any sort of official permission. He could exchange his money for any other currency without restriction... Substantial householders were occasionally called on for jury service. Otherwise, only those helped the state who wished to do so."

So is Bitcoin the money of the future? Probably not. But crypto-currencies might be •

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Why they don't tell you 23 THINGS about CAPITALISM

MARK PENNINGTON critiques **PROFESSOR HA JOON CHANG**'s *23 Things They Don't Tell You About Capitalism* (Penguin Books)

Professor Ha Joon Chang has become something of a hero to those who champion heterodox economic theory and who rail against the supposed intellectual hegemony of 'neo-liberalism'. His books are often recommended pre-reading for economics students, especially his best seller *23 Things They Don't Tell You About Capitalism*. However, throughout *23 Things*, Chang misrepresents his opponents' views and spends much of his time knocking down "straw men". If students wish to understand the case against open market policies, a better book would be *One Economics, Many Recipes* by Dan Rodrik (2007: OUP). Readers should think twice before taking Chang's popular books too seriously.

Do "free" markets exist?

One of the first 'myths' that Chang sets out to correct is the very idea of a 'free market'. He argues that the 'free market' doesn't exist because all markets are embedded in political and institutional relationships and require rules in order to function effectively – laws to enforce contracts, for example.

Anyone who has even cursory familiarity with Nobel Prize winning 'free market economists' such as Ronald Coase, James Buchanan and F. A. Hayek – none of whom are cited or mentioned in *23 Things* – would know that they have never denied that markets depend on institutions and rules.* Indeed, much of their work involves explaining the institutional context in which markets can operate successfully.

There is legitimate scope for disagreement on the appropriate extent of the market and the precise role of the state. All economists can do is to use their theoretical tools to offer some general guidance about the effect of drawing the boundaries one way or another. In *The Constitution of Liberty*, for example, Hayek sets out a range of government actions, including basic social security measures, educational provision and environmental controls which he judges compatible with the basic principles of a liberal market economy. Some economists would see Hayek as having gone too far, others not far enough, but there is no contradiction between the way that Hayek argues for specific policies and his overall defence of the free market. Most free market economists are not anarchists.

To suggest that there is no such thing as a 'free market' because there is no strictly objective way to define the boundaries of the state and the market is equivalent to saying that there is no such thing as democracy because no 'pure' form of democratic organisation has ever existed or is ever likely to exist. We don't have, for example, electronic popular voting on every single political issue. We elect representatives using various systems of voting at regular elections.

Chang on free trade, markets and development

Summarising his work in *Kicking Away the Ladder and Bad Samaritans*, Chang tries to debunk the claim that free trade and open markets are the key to prosperity in

* Editor's note: I regularly drink coffee out of a mug with a quotation from Coase: "Without appropriate institutions no market economy of any significance is possible."

developing countries. He claims that, historically, free trade was rarely – if ever – practised by developed nations such as Britain and the US. To the extent that they prescribe free trade for today's developing nations, therefore, free market economists and their political supporters are guilty of a 'do as I say, not as I did' hypocrisy. What the developing world needs is the freedom to pursue the protectionist industrial policies that Chang himself favours. The economic success stories of East Asia owe their prosperity to high levels of state intervention and not to 'neo-liberalism', he argues.

TO PUT IT MILDLY, CHANG OFFERS A HIGHLY SELECTIVE VIEW OF THE EVIDENCE

To put it mildly, Chang offers a highly selective view of the evidence. But, firstly, few if any free market economists have ever claimed that Britain or the US were historical paragons of free trade. At most they have suggested that, relative to previous historical eras, nineteenth century America and especially Britain benefited from a broad package of market-oriented policies of which free trade was a part. Similarly, such economists have been foremost in attacking the residual protectionism that exists in the developed world today – for example, the European Union Common Agricultural Policy.

Secondly, Chang misrepresents the place of free trade in the overall package of institutions and policies supported by free market economists. The classical liberal case has never been that international trade is the engine of development *per se* but that free trade offers an *extension* of the benefits provided by good domestic policies such as improvements in the security of property rights, largely private ownership of industry and a broad reliance on competition rather than central planning. Free trade is especially important for smaller countries in extending the benefits of good domestic policies. However, countries can often grow to a reasonable level of prosperity from a situation of extreme poverty simply from good domestic institutional reforms. The fact that Britain and the USA had varying degrees of protectionism in place during industrialisation does not imply that it was the protection that caused the growth – this is elementary. Nineteenth century America was a large country that benefited from the creation of an enormous internal free trade zone.

Significantly, Chang fails to mention any empirical literature that shows protectionism causes development relative to other factors. Douglas Irwin and Stephen Broadberry have shown convincingly that the sectors of the US economy that were supposed to benefit most from 'infant industry' protection did not experience strong growth. The US overtook Britain in the nineteenth century largely by increasing labour productivity in the service sector – and not through gains in protected manufacturing sectors. Similarly, high growth in Argentina and Canada in the late nineteenth century was largely due to growth *outside* protected industries. Protection in Britain – notably the Corn Laws – slowed industrialisation.

Reading Chang's book one is left with the impression that Europe and the United States during the Victorian era were models of Keynesian interventionism, even though they had government expenditures between 5 and 10 per cent of GDP, minimal regulation and virtually non-existent welfare states. Europe and America of today, by contrast, are depicted as practitioners of rampant *laissez faire* – even though government spending runs at between 40 and 60 per cent of GDP alongside escalating regulation.

Chang's analysis of East Asian development is no more impressive. Though it is true

THE MARKET… ACCORDING TO CHANG

"The free market doesn't exist. Every market has some rules that restrict freedom of choice"
23 Things: 1

"If there is nothing sacred about any particular market boundaries that happen to exist, an attempt to change them is as legitimate as the attempt to defend them"
23 Things: 8

"Recognising that the boundaries of the market are ambiguous and cannot be determined in an objective way lets us realise that economics is not a science like physics or chemistry, but a political exercise. Free market economists may want you to believe that the boundaries of the market can be scientifically determined, but this is incorrect"
23 Things: 10

that South Korea and Taiwan pursued protectionist policies during the 1960s and 1970s and experienced strong growth, their performance was eclipsed by that of Hong Kong and Singapore which operated much closer to a free trade model. China post 1978 meanwhile, though it is far from a *laissez faire* economy, has undergone one of the most significant economic liberalisations in world history – a liberalisation that has promoted unprecedented economic growth. Not surprisingly, Chang is quick to claim that the continuing existence of industrial policies and active government involvement in the financial sector are the cause of this growth. Yet, as Jasheng Huang has shown, the growth that started the Chinese economic boom had little to do with such policies – it was the result of a huge boost in agricultural productivity following Deng's massive programme of rural privatisation in the early 1980s. Insofar as the Chinese have developed successful industrial companies (such as Lenovo) these have been Chinese in name alone and have tended to be foreign or Hong Kong owned or registered. Far from China's system of financial controls being the cause of their success it has been the ability of entrepreneurial start-ups to exit from these restrictions and to re-enter China on the more liberal terms granted to 'foreign investors' that has been critical.

CHANG SEEMS TO ASSUME, IMPLICITLY, THAT POLITICIANS DO NOT SUFFER FROM THE SAME BOUNDED RATIONALITY THAT EVERYBODY ELSE SUFFERS FROM

Is it their fault that they are poor?

Perhaps the worst misrepresentation of free market economics in *23 Things* occurs in chapter 15 where Chang claims that 'they' – the 'free market economists' - attribute lack of development in poorer countries to the absence of entrepreneurial spirit. From Peter Bauer in the past to William Easterly in the present, free market economists have argued that entrepreneurship is a *universal* aspect of the human condition. In poor countries, productive entrepreneurship is held back by poor institutions. Social and political institutions need to channel entrepreneurship towards voluntary exchange and positive sum games rather than rent-seeking activity focused on the predatory transfer of wealth. The primary obstacle to the poor in much of the developing world is the absence of secure title to property and a maze of regulatory restrictions which confine people to the 'informal sector' and which benefit predatory elites. Chang offers no account of how these obstacles would be addressed by protectionism and regulation. Indeed, protectionism gives more power to the elites in poor countries and entrenches their position.

Chang's very bounded rationality

In chapters 16 and 19, Chang asserts that free market economics rests on the view that actors are fully rational and that individuals always know what is in their best interests when deciding to buy, sell and invest. However, drawing on Herbert Simon he argues that people often do not know what they are doing because the limitations of the human brain make the world too complex to fully understand. Thus, there are often advantages from restricting individual choice in order to reduce the complexity of the problems people face. One way to do this is to rely on administrative hierarchies, such as firms, which operate on internal command and control procedures. The existence of corporate firms which 'plan' their activities demonstrates, according to Chang, that so called 'free market economies' are to a significant extent 'planned' – and that the existence of such hierarchies demonstrates that 'planning' is often superior to more decentralised structures.

Similarly, rules and regulations that limit choice can result in better decisions. Just as consumers who have limited attention spans often simply buy well-known brands rather than investigate unknown products, rules and regulations can reduce the complexity of the choices people face and limit the things that may go wrong. From this Chang concludes that we should see greater government regulation not as an inhibitor of economic growth but as a way of reducing uncertainty.

Unfortunately for Chang, 'free market economists' have already anticipated these arguments. Indeed, the development of the idea that firms are important for planning within hierarchies was cited in Ronald Coase's Nobel prize acceptance speech. The foundational paper was published nearly 80 years ago! Hayek and Vernon Smith have done more than anyone to examine bounded rationality and the role of hierarchy and rules as social ordering mechanisms. The key issue is not whether there should be planning but who plans what and how is it decided?

More subtly, Chang misses the point that, under bounded rationality, *there is uncertainty about what types and levels of hierarchy and which rules are desirable*. Market competition plays a key role in determining how much hierarchy, and what rules we should have. As Coase said in his Nobel address: "To have an efficient economic system it is necessary not only to have markets but also areas of planning within organisations of the appropriate size. What this mix should be we find as a result of competition". (716).

Chang may not believe that these things are best determined by competition but in *23 Things* he gives no explanation as to why and, more seriously, no indication to his readers that his points have already been considered in some depth by 'free market economists'.

In a market economy voluntary co-operation enables people to develop a range of competing institutional structures and to discover which are best suited to different tasks: big firms, small firms, owner-managed firms, joint stock companies, partnerships, mutuals and cooperatives all compete for workers, sales and investment capital. By contrast, government planning is imposed on all. The scope for learning is diminished because we do not have price signals to indicate which models are successful and which are unsuccessful. When governments plan, they have to determine the right model in advance. Chang seems to assume, implicitly, that politicians do not suffer from the same bounded rationality that everybody else suffers from.

The financial crisis

Not surprisingly, Chang argues that the financial crisis was caused by intrinsic problems in financial markets and that certain complex financial products should be banned.

There are many different views of the causes of the financial crisis. However, it is certainly arguable that the major lesson is not the need for more regulation but for greater competition between different forms of regulation in order to reduce the risks arising from the bounded rationality of regulators. As Jeffrey Friedman has shown in some detail, the problems that afflicted the financial sector arose in large part from the inability of policy-makers to comprehend the combined effects of the maze of inter-connecting regulations that have accumulated over the last fifty years. Regulators are as subject to bounded rationality as anyone else but, with their unique powers of coercion and immunity from competition, they have the capacity to do enormously more harm. Before the crash, central banks kept interest rates at excessively low levels; regulators induced government-backed mortgage companies to relax lending requirements for low income families; international capital regulations encouraged banks to securitise risky mortgages and invest in complex products; and deposit insurance and implicit bail-out guarantees reduced incentives to avoid excessive risk. In all these ways – and others – coercive government rules induced all manner of disastrous unintended consequences.

When it comes to complex financial products, market participants can adopt an easy 'rule of thumb' when faced with decision-making complexity – 'if you don't understand it, then don't buy it'. This is not an option they face when dealing with centrally imposed regulations and mandates.

Conclusion

If we are to understand free market economics, then it is best to read some of the original authors. Chang has done some respectable work in economics. However, his popular works, such as *23 Things*, would serve a better public educational function if they made a greater effort to present what 'free market economists' actually argue rather that resort to crude and simplistic caricatures•

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CAPITALISM WITHOUT THE CARICATURES:
USEFUL READING FOR STUDENTS OF ALL AGES

Douglas A. Irwin, *Free Trade Under Fire*, Princeton University Press:
http://press.princeton.edu/titles/9027.html

William Easterly, *The Tyranny of the Experts: economists, dictators, and the forgotten rights of the poor*, Basic Books:
http://williameasterly.org/books/

Alan H. Meltzer, *Why Capitalism?*, OUP, USA:
http://global.oup.com/academic/product/why-capitalism-9780199859573?cc=gb&lang=en&

Eamonn Butler, *Foundations of a Free Society*, Institute of Economic Affairs, available free online:
www.iea.org.uk/sites/default/files/publications/files/IEA%20Foundations%20of%20a%20Free%20Society%20web%2029.10.13_0.pdf

MATT RIDLEY is one of the country's leading authors in the fields of science and economics. His recent book, *The Rational Optimist*, has been widely admired and his Times columns are a weekly "must read". Matt won the 2014 IEA Free Enterprise Award. In this interview with IEA Editorial Director, **PHILIP BOOTH**, Ridley discusses why he believes the economic future is bright and how we could undermine economic progress

the RATIONAL OPTIMIST

You are the winner of the IEA'S 2014 National Free Enterprise Award and you are a champion of enterprise, though coming from a scientific rather than economic background. Can you give us some idea about the extent of human progress over the last 200 years? What key statistics sum up that progress?

I realised a few years ago that all the relentless pessimism I had been fed by so-called experts when I was student – about the inevitability of economic, ecological and humanitarian disaster before the century was out – had been wrong. In my lifetime, globally, per capita income had trebled, lifespan had increased by a third and child mortality had fallen by two-thirds. The world was becoming steadily and measurably healthier, happier, cleaner, kinder, safer, more peaceful and more equal. Yes, really: when I looked up the data, that's what I found. Forests were expanding, rare species were coming back, famines were getting less frequent, poverty was disappearing. And the time it took for a person on the average wage to earn the price of a pair of jeans had been cut by two thirds.

I became a bit evangelical on the topic, because I could see that young people were still being told that no matter how much better life had got, the future was still relentlessly bleak. There seemed to be almost a conspiracy to avoid talking about positive trends. "It is the long ascent of the past that gives the lie to our despair", said H G Wells. "On what principle is it that, when we see nothing but improvement behind us, we are to expect nothing but deterioration before us?" said Lord Macaulay. So I want young people to dare to be optimists.

I WANT YOUNG PEOPLE TO DARE TO BE OPTIMISTS

I call my optimism "rational" because it's evidence-based, not built on mere hope. And because behind it lies a persuasive rationale for *why* it happens – through the growth of exchange and specialization, driving innovation and encouraging collaboration between people as they work for each other.

Your most recent book was called The Rational Optimist. That presumably suggests you think progress will continue. What makes you so confident? What scientific and economic processes are the key to future progress?

Good as things are today compared with any time in the past, this world is still a vale of tears compared with what it could be, and probably will be in the future. That, by the way, is why my rational optimism is the very opposite of what Voltaire's Dr Pangloss believed. He went around saying all is for the best in the best of all possible worlds – that the world is perfect and cannot be improved. That's what the word "optimist" meant, when coined by Voltaire. He was mocking theodicy, which argued that since God made the world it must be "optimal", and even suffering must be a good thing, and improvement is impossible. That's what pessimists believe today, especially those in the green movement, who reject new technologies lest they make the world worse.

I see two chief reasons that improvements to living standards will continue. One is the inexorability, the inevitability of progress. There was only one year since 1945 when the world economy failed to grow – 2009 – and it shrank by just 0.9 per cent. It grew by 5 per cent the following year. People raise each other's living standards by profiting from delivering improvements for other people, and although chiefs, priests and thieves are quite good at stopping them, they just cannot keep up. It is getting harder and harder for them. They cannot turn the internet off; they cannot shut down world trade; they cannot stifle curiosity. A thousand years ago, in a simpler world, predators could kill commerce altogether, and often did. It's much harder now.

The second reason why I think we "ain't seen nothing yet" is because innovation comes from the recombination of ideas and there is no limit on the number of ideas. Therefore all the limits to growth that have been identified – running out of energy, or water, or minerals – make no sense, because we can, and do produce innovations that reduce the need for materials. We use less steel in buildings, we substitute glass fibre for copper, we cut the weight of cars. The energy consumed per unit of GDP growth is going down all the time. "Growth" often means doing more with less.

One interesting fact is the extent to which food prices have fallen as the population has risen in recent decades. Why did that happen?

In my lifetime the population of the world has doubled, which many predicted would lead to ever more famines, shortages and price rises. In fact the price of wheat has halved in that time, and the calories available per person have increased on every continent. The cause is yield improvements caused by synthetic fertiliser, tractors replacing oxen, better crop protection through chemical pesticides, better varieties through plant breeding and genetic modification – and more trade, meaning regions can specialise in crops they grow best.

It is astonishing to realise that we need 65 per cent less land to grow the same quantity of food as we did when I was born – that is a calculation done by Jesse Ausubel of Rockefeller University based on the yield improvements in each the world's main crops. He thinks we may now have reached "peak farmland", meaning we can actually reduce the acreage devoted to growing food while continuing to feed a growing and ever more affluent population. In some countries we are already releasing land from agriculture for nature reserves, forests and other "wilderness" uses on a large scale.

Could we have a new green revolution? What might stop it?

The green revolution of the 1960s turned India from a starving country dependent on aid and imports to a grain exporter despite a huge increase in population. It was achieved by the use of fertiliser on improved varieties of crops. Africa has yet to experience the same change, and its yields have hardly improved over the same period. So just getting fertiliser, tractors, pesticides and better seeds to that huge continent would be a huge green revolution.

But we could, and almost certainly will, experience another step change now we can use genetic modification to generate salt-tolerant, drought-resistant, pest-resistant, nitrogen-efficient crops. We can also improve the quality, rather than just the quantity, of food by fortifying crops with vitamins, minerals, micro-nutrients and omega-3 oils. It is a genuine crime that the environmental movement has prevented these improvements in Europe and elsewhere with devastating humanitarian and ecological consequences.

So, if you were an 18 year old reading this magazine, am I right in saying that you would expect to be better off than your parents?

I like to quote two statistics to illustrate how much better off a teenager is today compared with his parents or grandparents. The first, which I got from Don Boudreaux, is that on the average wage it takes 41 minutes to earn the price of a pair of jeans. In 1982 it took your parents 1 hour and 50 minutes to earn enough money on the average wage to buy an equivalent pair of jeans.

The second, which I calculated from a study by the economist William Nordhaus, is that it takes half a second to earn enough money to turn on a lamp with a compact fluorescent bulb for an hour. In 1950, it cost eight seconds' of work – 16 times as long – for your grandparents to earn the same amount of light from an incandescent bulb.

And then think of all the things that your parents and grandparents never had, from search engines to mobile phones, from budget airlines to carbon fibre, from genetic testing to Skype. It's an ever more wonderful world.

THERE WAS ONLY ONE YEAR SINCE 1945 WHEN THE WORLD ECONOMY FAILED TO GROW – 2009 – AND IT SHRANK BY JUST 0.9 PER CENT. IT GREW BY 5 PER CENT THE FOLLOWING YEAR

the **WORST** of **ALL WORLDS**

The new student loans system is hugely complex. It is likely that future taxpayers will face high costs as a result of large sums being written off. In addition, graduates will face high marginal tax rates. In many respects, the system combines the worst features of a graduate tax and a loans system, says NEIL RECORD

Students tend to dislike the idea of student loans, often believing that higher education should be "free" or paid for by the taxpayer. Whilst economic arguments can be made for certain forms of subsidy to higher education, for most students higher education has significant investment value in the form of higher lifetime average earnings.

This supports the argument that students should not receive government support, and should pay for tuition themselves, obtaining commercial loans from banks if necessary.

On the other hand, society (in the form of the state) may wish to provide subsidies to those prepared to delay starting to earn in return for the value to society of a highly-educated elite. It is argued that this elite will, on average, contribute disproportionately to national income and to the Treasury through tax revenue, and generally enrich the economy and society.

In these debates, economists tend to take a middle ground. Economists recognise the investment value of higher education. They also appreciate that the government might wish to subsidise, to some extent, some students because of the benefit of a highly educated society. However, there are two particular economic problems when it comes to students obtaining finance on commercial terms.

The first problem is that higher education augments a student's "human capital" – in other words the future earning-power of the student. However, unlike when borrowing money to buy a house, students cannot easily provide the bank with collateral for student loans. It is difficult, therefore, for banks to manage the risk of loans for higher education.

The second problem is that there is a significant element of chance in future graduate earnings. So banks face the same uncertainty as each individual does when he or she starts out on his or her career. This is compounded by the bank's lack of knowledge of each individual's willingness to repay – by definition, student loans are extended to a group with no credit record.

The first argument can be used to justify a government-guaranteed student loans system. The second argument can be used to justify some form of graduate tax. Neither argument addresses the decision as to how much (if any) the state should provide in higher education subsidy.

To some extent, the government's current student loan system in England tries to achieve the best of all worlds – a government guaranteed loan system with a graduate tax repayment schedule, and a 30-year write off which turns out to be a substantial subsidy.

But I argue here that in practice it combines the worst, not the best, features of a loan and grants system.

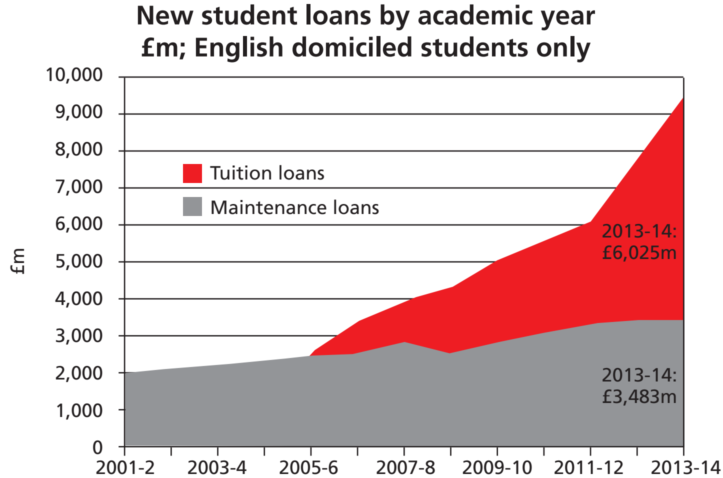

Figure 1: New student loans by academic year   Source: Student Loans Co.

volume of tuition student loans both granted and outstanding has expanded enormously (see Fig 1). The £9,000 cap came into force for all students beginning their courses from 1st September 2012. In practice, nearly all universities set their fees at exactly £9,000. Loans

THE INSTITUTE FOR FISCAL STUDIES REPORT ESTIMATES THAT AN AVERAGE OF £21,780 PER STUDENT IN 2014 PRICES WILL BE WRITTEN OFF BY THE GOVERNMENT

The English student loans system

Government-sponsored student loans have been available in one form or another in the UK since 1990. In the early years of the scheme, the loans were small and made available at low interest rates. The loans scheme was expanded in 1998 when a tuition fee cap of £3,000 per annum was introduced with loans to fund the tuition costs which were repaid gradually once earnings reached a pre-set level.

A further expansion took place in 2012 then the tuition fee cap was raised to £9,000 per annum. As a result of the 1998 and 2012 reforms, the

are also available to students to fund maintenance costs.

The tuition loan amounts granted each year will continue to grow strongly for another year (i.e. to 2014-15), and then flatten out as the third anniversary of the fee-rise runs off, and the whole student body is paying £9,000 per year fees. The situation for Scottish and Welsh students is rather different (and bizarrely complex) and not covered in this analysis.

Balancing the interests of students, universities and taxpayers

The politicians who proposed and negotiated the tuition fees were labouring under competing pressures. Universities were struggling to make ends meet with block grants from the government. These grants had not kept up with up student numbers: hence income and spending per student had fallen dramatically in real terms. At the same time, politicians wanted to ensure that the financial means of a family were not a barrier to university entry. This was against a backdrop of hugely increased higher education participation, up from 14 per cent of the cohort in the early 1970s to more than 40 per cent in the mid-2000s.

A solution was sought that was a compromise between asking the general taxpayer to subsidise the higher education of the privileged half of the population who attended university and charging individual students and their families the full cost of their higher education.

There were two feasible general approaches to this problem. One was a "graduate tax" whereby students paid a given proportion of their earnings to the government on graduation. This would ensure that the risk of attending university and not obtaining a well-paid job was spread across the student body. The second general approach was a loans system where students repaid loans to the government. The government guarantee deals with the problem of lending against investment in human capital identified above. The chosen solution was a loans system with graduate tax features.

Is today's solution fair or effective?

Students are given loans for their fees and also to cover part of their maintenance costs. That loan is forgiven after 30 years and interest is charged according to a complex formula. It is difficult to argue that the chosen solution is fair. Students face a maze of complexity. There is the inherent uncertainty that students do not know the likely return from the course they enter. However, the system is such that most have only a hazy idea of how student loans are repaid and no idea at all of the interest rates that will apply to their debt. The current system involves interest rates calculated as the sum of year-on-year RPI inflation plus a variable 'real' rate (between 0 per cent and 3 per cent per annum) that depends on earnings. This makes the actual future rate of interest unknowable. When they enter the labour force, subject to earning above a threshold, students, in effect, pay a 9 per cent additional marginal tax rate for around 30 years. However, whether they pay this depends on their earnings and, furthermore, the impact this has on reducing the capital of the loan depends on the interest rate they are charged which varies with earnings.

The terms of UK Government-sponsored student debt have changed regularly in the 20 plus years that they have been in existence, and the current system can hardly be regarded as a model of coherence and clarity that is likely to be stable. So there is a further risk that the whole system will change.

Most of today's students will face marginal tax rates of around 41 per cent (20 per cent income tax, 9 per cent loan repayment and 12 per cent employees' national insurance) when they start earning. When their earning rise above £42,000, they will have a marginal tax rate of 51 per cent. Those who have been out of the labour force for a while (say, looking after children) will have an even more complex situation and might wish to wait until their loan is forgiven after 30 years before returning to full-time work given the high marginal rates of tax they will face.

THE CURRENT STUDENT LOAN SYSTEM IS A BAD SYSTEM... IT IS BEING MIS-SOLD

Cost to the taxpayer

The Institute for Fiscal Studies (IFS) has recently published a report (Crawford and Wenchao, 2014) in which they looked in detail at the distribution of repayments across the income range, and consequently at the amount of debt likely to be written off under the 30-year forgiveness rule.

In summary, the report estimates that an average of £21,780 per student in 2014 prices will be written off by the government under this rule. Since the report assumes that the average debt starts at £44,035 in 2014 prices, this represents an average write-off of nearly 50 per cent of the real value of the debt. So, in summary, students are subjected to all the rigour of borrowing large amounts of money, and the subsequent rolling-up of interest, only to discover that, in fact, on average, half of the debt turns out to be a grant from the taxpayer.

In aggregate terms, this hits the taxpayer very hard indeed. Taxpayers are led to believe

that money lent to students, and repaid out of payroll to HMRC, will indeed be repaid. However, if the IFS is even close in its modelling, and the loan structure stays the same (which is unlikely), then the amount of today's loan book that the government will have to write off in 2014 money will probably be about £28 billion. This will rise rapidly as the average loan rises from around £13,000 to over £40,000 per student as the higher tuition fees from September 2012 affect the cumulative loans outstanding.

Summary

The current student loan system is, in my opinion, a bad system. It is bad not because students are particularly hard done by, or, alternatively, that they are overly-subsidised. Its flaw instead lies in its design and its labelling. In summary, it is being mis-sold.

The government claims to the electorate that students are now paying their way by taking out loans for their education (with the implication that they will have to repay them). It simultaneously claims to students that higher education is affordable (and indeed possible) because the loans will not be a burden to them as they will only face repayment once they earn more than £21,000 per annum (i.e. to students what seems like a good salary). But neither of these claims are accurate reflections of reality.

University students will not pay their own way - on the basis of the IFS model and forecasts, taxpayers will find themselves paying for about half of student maintenance and tuition, but will only realise that this is so about 30 years later.

By contrast, graduates will find the student loan system turns out to be, in practice, a 9 per cent additional graduate tax with a partial exemption for the higher-paid. Lower and average earners will pay the tax until they reach about 50 years of age. By contrast, the highest fliers will pay the loan off fast, and, as a result, will pay substantially less. Graduates who choose to work abroad are likely to pay little or nothing.

LOWER AND AVERAGE EARNERS WILL PAY THE TAX UNTIL THEY REACH ABOUT 50 YEARS OF AGE

Sometimes it is possible to develop policies that combine the best features of two different systems. Sometimes, by contrast, similar compromises can lead to the worst of both worlds and this is what seems to have happened with the UK government's student loan system•

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The POLITICS of GREED

It's a fallacy to suggest that politics is free from competition, greed and self-interest, say CHRISTOPHER J. COYNE and RACHEL L. COYNE

It is often suggested that, because the pursuit of self-interest in markets can lead to undesired outcomes, we should give more power to politicians to regulate the economy. However, what happens when politicians are also partly motivated by self-interest and greed?

Many associate markets with self-interest and greed whilst associating politics with other-regarding, publicly-interested behaviour. Perhaps nowhere is this view more prevalent than in the speeches and writings of politicians who continually emphasise the importance of government for protecting citizens against the greed of markets. As Vince Cable, the UK Secretary of State for Business, Innovation and Skills said in a speech in 2010: "Markets are often irrational or rigged. Why should good companies be destroyed by short-term investors looking for a speculative killing, while their accomplices in the City make fat fees? Why do directors sometimes forget their wider duties when a cheque is waved before them? I want to protect consumers… and keep prices down and provide a level playing field for small business."

The implicit assumption in this and similar quotations is that people in politics are not subject to the motivations that characterise people operating in markets. If they were, giving power to politicians to interfere in markets would not be guaranteed to lead to an improvement. While markets are inherently self-serving and unfair, politics is presumed to be the opposite. Politics, it is assumed, is able to rise above the narrow short-sightedness of markets in support of the longer-term public interest. Nothing could be further from the truth and basic economics can explain why.

Economics is the study of purposive human action whenever there is choice. The need to engage in choice is the direct result of scarcity, which exists because there are more human wants than resources available to satisfy these desires. Given limited resources, decisions need to be made regarding how to best allocate them among an array of alternative uses. To illustrate this, think about your own life. There are 24 hours in a day. Each person, no matter their level of wealth or education, has to decide how to best allocate their scarce time each day. Should you spend your time with your family, working, or resting? This same logic applies to all other scarce resources.

The key implication of the prevalence of scarcity in our daily lives is that there is always competition. Most people associate competition with markets and profits, but this is far too narrow an understanding of the concept. Competition exists whenever, and wherever, there is scarcity and choices have to be made. The reality is that we can never avoid competition and the process of deciding how we would best like to allocate our scarce resources. This logic applies to entrepreneurs, humanitarians, and, even supposedly "publicly spirited" politicians and bureaucrats. The late James Buchanan won a Nobel Prize for his insights into the workings of competition in the political process.

Recognising that self-interest and competition is ubiquitous has important implications for the way we think about politics. While politicians are fond of saying that they are motivated by the desire to protect consumers from the self-interest and greed of markets, the reality is that their policies are the result of a competitive political process. It is true that this competitive process is different than that which occurs in markets. In markets, entrepreneurs must constantly compete for the scare income of consumers. They do this by attempting to offer a good or service that consumers value. In politics, in contrast, competition occurs for the control of policy and budgets. Politicians make an appeal for votes and campaign contributions by offering policies that will favour certain interests or groups of voters over other interests or groups of voters. In the UK, for example, Conservative politicians tend to offer land-use planning policies that favour current home owners over those who cannot yet afford to buy their own home. Labour politicians offer policies that tend to favour public sector trade union members over taxpayers. There are two undesirable outcomes.

Groups will invest significant resources to lobby politicians with the goal of influencing policy to achieve their own self-interested goals. This competitive, dog-eat-dog lobbying is zero-sum (or negative sum) in nature. When one group secures part of the budget for their pet project or policy, another group cannot secure that same part of the budget. Lobbying can be found in all political systems and is clear evidence of the competition and self-interest inherent in political systems. Consider the trends for lobbying in the US for the 1998-2008 period as illustrated by *Figures 1 and 2.*[1]

Figure 1 shows that lobbying expenditures more than doubled over the ten-year period from $1.45 billion in 1998 to $3.3 billion in 2008. *Figure 2* shows that the number of registered lobbyists increased from 10,406 in 1998 to 14,193 in 2008. A similar dynamic exists in the UK. According to a 2007 study, the UK government lobbying industry employs approximately 14,000 people and is valued at £1.9 billion.[2] These figures suggest not only that political competition exists, but that it is a thriving and profitable industry.

A second, and related, outcome of competition in politics is that citizens often end up being harmed. This is counter-intuitive to many people precisely because they are used to associating politics with the "public interest". To understand how average citizens can be harmed by political competition, consider a scenario in which government declares that it will pass new regulations to protect consumers. The industry subject to the regulation will incur the full cost of the new laws, while the benefits will be dispersed among many consumers. The result is that the affected businesses have an incentive to lobby the government to influence the specifics of the regulation. Economists call this "regulatory capture" which refers to situations where a regulatory agency is influenced and controlled by the parties they regulate. This can lead to the regulation not fulfilling its intended purpose and, also, the industry will often lobby for the regulation to raise costs to potential competitors to the benefit of incumbent firms.

The main point of this analysis is straightforward: competition is an unavoidable part of life. Politics does not, and cannot, transcend the realities of scarcity and competition. Since competition cannot be avoided, focus must be placed on the institutions and rules that channel competitive behaviour into positive-sum outcomes. The competitive market free from political manipulation and influence satisfies this criteria better than the alternatives. In markets, competition is driven by the incentive to satisfy consumer wants and demands. Whilst consumers can discipline businesses by going elsewhere, it is very difficult to discipline politicians. Elections are fought infrequently on a huge range of issues and individual voters have a tiny chance of influencing the outcome compared with the lobbyists. Not only does self-interested competition exist in politics, but it often makes consumers worse off and threatens the entrepreneurial dynamism of the market system by fostering cronyism: that is the uncomfortable lesson for Vince Cable.

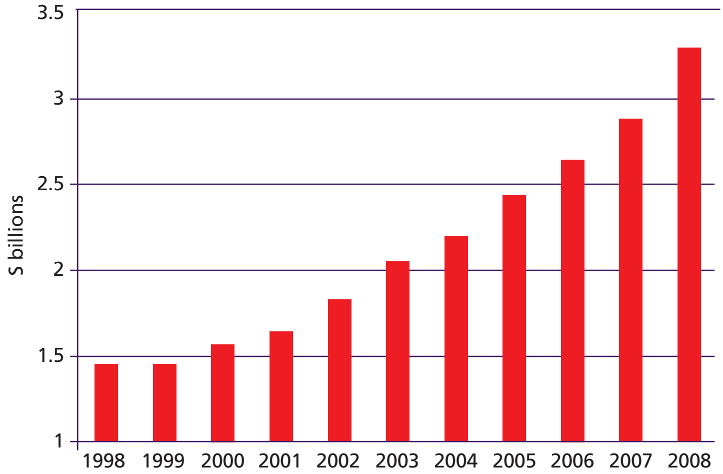
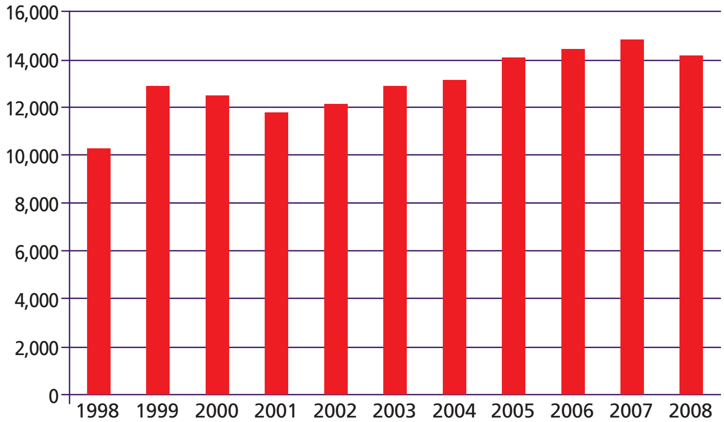


Figure 1: Total Lobbying Expenditures in the U.S. ($ billions), 1998-2008



2: Total Number of Unique, Registered Lobbyists in the U.S., 1998-2008

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[1] Source of data for both figures: https://www.opensecrets.org/lobby/index.php
[2] See Parvin (2007) page 10.

CHALKING UP SUCCESS

MARIAN L. TUPY and DALIBOR ROHAC on why the world is getting better…

There is a constant stream of doom and gloom about the world – especially since the financial crisis. In one of many statements by Pope Francis, for example, he said: "While the income of a minority is increasing exponentially, that of the majority is crumbling". Environmentalists and others echo this pessimism. However, the world is a much better place than it used to be. But although the state of humanity has greatly improved, progress cannot be taken for granted. Indeed, if we listened to the policies of the doomsayers, progress would be reversed. This article reviews some of the most important trends and argues that improvements in human well-being have been linked to the advancement of market-friendly institutions and economic globalisation.

The good news

Average life expectancy at birth hovered around 30 years from the Upper Palaeolithic Age to 1900.[1] Even in the richest countries, such as those of Western Europe, life expectancy at the beginning of the 20th century rarely exceeded 50 years.[2] Two-thousand years ago, annual incomes per person around the world ranged from $1,073 to $1,431 (see footnote[4]). As late as 1820, average global income was

$1,274 per person.

In the last 200 years, there has been a transformation. Average life expectancy in the world today is 71 years.[3] In 2010, global per capita income stood at $13,037 – over 10 times the level two centuries ago.[4]

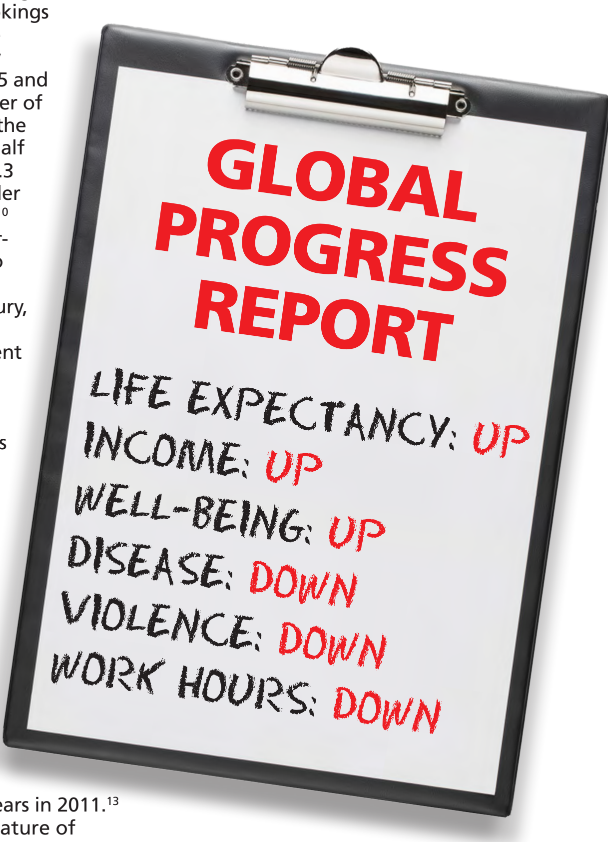
It is not only income and life expectancy that are improving. The world's daily calorific intake per person is increasing too – this is an important indirect measure of well-being. It has increased from an average of 2,600 in 1990 to 2,840 in 2012. In sub-Saharan Africa, the daily calorific intake increased from 2,180 to 2,380.[5] Furthermore, more children, including girls, attend schools (*see figure 2*), at all levels of education and, in wealthy countries, the wage gap between the sexes is declining.[6]

Our lives are also healthier. The prevalence rate of HIV/AIDS has been stable since 2001and deaths from the disease are now declining due to the increasing availability of anti-retroviral drugs. Some cancer rates are declining in industrialised countries despite the fact that cancer tends to be a rich country disease because its incidence increases with age.

Workers tend to work fewer hours[7] and suffer from fewer injuries.[8] We also enjoy more political freedom and are less likely to suffer from physical violence (*see figure 3*).[9]

In the recent decades, the rise of economies in Asia – most significantly of China and India – has contributed to a fall in global poverty which is without precedent in human history *(see figure 3)*. According to Brookings Institution's Laurence Chandy and Geoffrey Gertz, "between 2005 and 2010, the total number of poor people around the world fell by nearly half a billion, from over 1.3 billion in 2005 to under 900 million in 2010."[10]

While Africa under-performed relative to the rest of the world during the 20th century, African incomes increased by 41 percent between 1960 and 1999.[11] Moreover, between 1999 to 2010, African incomes rose by a further 36 percent.[12] Although the improvements in longevity were hampered by the spread of AIDS, countries that were less affected by the epidemic recorded significant improvements. Life expectancy in Ghana, for example, increased from 28 years in 1921 to 64 years in 2011.[13]



The hockey-stick nature of progress and the fact that many places around the planet are still desperately poor should remind us that there is nothing inevitable about progress. Even the modern

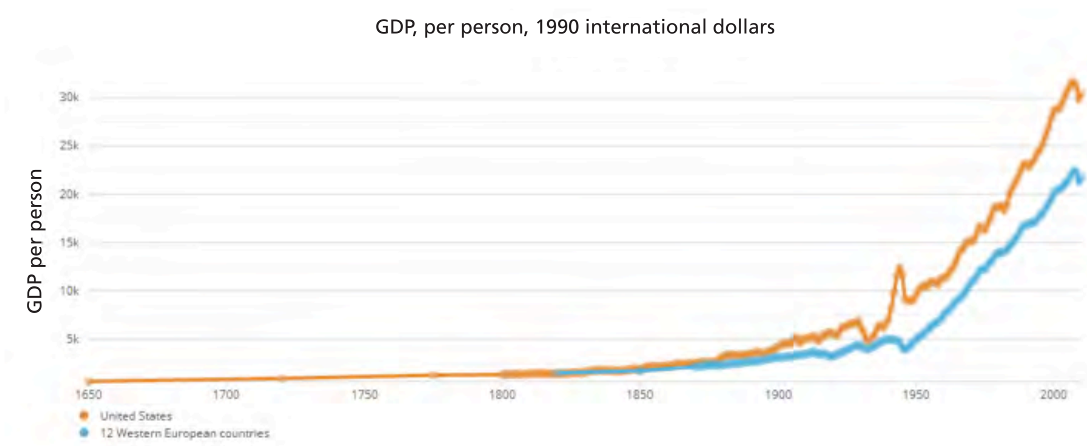


Figure 1: GDP per person (1990 international dollars): United States and average of 12 Western European countries
Source: www.humanprogress.org

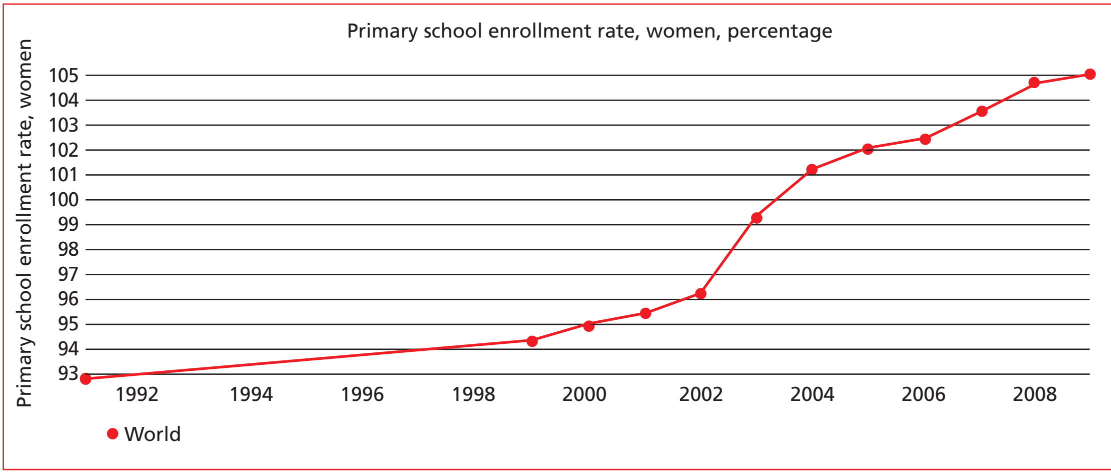


Figure 2: World female primary school enrolment
Source: www.humanprogress.org

history of the Western world is replete with examples of large setbacks – including two World Wars, the Great Depression of the 1930s, and the most recent economic calamity, triggered in 2008 by the collapse of Lehman Brothers. Furthermore, differences between the performance of different countries show how important good policy is for human progress.

Sources of progress

Explaining the forces behind progress is the single most important question of the social sciences. The large literature, extending from development economics, growth theory, economic history, analysis of institutions, to other fields, cannot possibly be reviewed here. However, the advances in the human condition cannot be dissociated from the Industrial Revolution of the 18th and 19th century, which spread from England and the Low Countries throughout the entire Western world. Neither can they be dissociated from the rise of the increasingly globalised markets in goods, services, capital and labour of recent years.

The Industrial Revolution involved a cluster of innovations relying on the use of raw materials, new energy sources, new machines and a new organisation of workplaces. These made possible the mass production of manufactured goods. Simultaneously, productivity growth in agriculture has been able to sustain larger non-agricultural populations.

These economic shifts were accompanied by sociological changes, including the growth of cities and of the working-class population, and – more importantly – by political shifts that

IN THE LAST 200 YEARS, THE WORLD HAS EXPERIENCED PREVIOUSLY UNIMAGINABLE IMPROVEMENTS IN STANDARDS OF LIVING

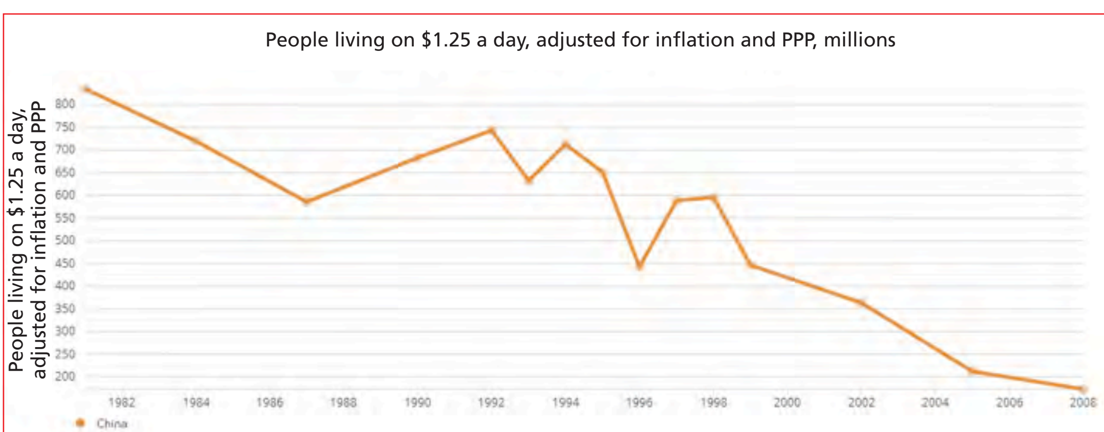


Figure 3: Number of people living on $1.25 or less a day in China
Source: www.humanprogress.org

led to the emergence of modern representative democracies. The transformation the Industrial Revolution represented could probably not have occurred without certain institutional and cultural prerequisites, including limited government, the protection of private property, and a climate that is supportive of entrepreneurship and innovation.

The improvements in human condition have been also linked to globalisation. Besides exploiting gains from trade, globalisation allows consumers to benefit from more efficient production methods and transfers of technology. Mass production, relying on the more efficient modes of production leads to cheaper goods and services, leaving households with more money to spend on non-essential items and raising global living standards.

This first era of globalisation ended with the outbreak of World War I and the concomitant disruption of world trade. By some estimates, globalisation did not reach its pre-World War I levels until the 1970s or even the 1980s. The 1980s marked the beginning of a new period of globalisation. Spurred by pro-market reforms both in the West and in the emerging economies, trade liberalisation, improvements in transport and information and communication, globalisation got a new lease on life and led to huge improvements in living standards amongst the world's poorest people, including those in China and India.

No Utopias

In the last 200 years, the world has experienced previously unimaginable improvements in standards of living, largely unreported and underappreciated by the general public. A large proportion of those improvements have taken place in the last 20 years. Attracting the attention of the public to these improvements through projects such as the Cato Institute's new website, www.humanprogress.org, does not imply painting a rosy picture of the state of humanity, but a realistic one.

We should compare the imperfect present with a much more imperfect past, rather than with an imagined utopia. More importantly, our efforts to address the world's imperfections should be informed by the fact of the huge progress that has been achieved through the combination of competitive markets, innovation, and trade.

THE WORLD IS A MUCH BETTER PLACE THAN IT USED TO BE

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Notes

1. See, e.g., Kaplan et al. (2000).
2. Prentice (2006).
3. United Nations (2012). United Nations World Population Prospects 2012 Revision.
4. See Bolt and Zanden (2013) who provide an update of Angus Maddison's dataset. Their data, originally in 1990 dollars, are adjusted for inflation.
5. See Food and Agriculture Organisation of the United Nations (2013).
6. Organisation for Economic Cooperation and Development (2013a).
7. Organisation for Economic Cooperation and Development (2013b).
8. Bureau of Labor Statistics (2013).
9. Pinker (2011).
10. Chandy and Getz (2011).
11. Kaplan et al. (2000).
12. Ibid.
13. Gapminder (2013).

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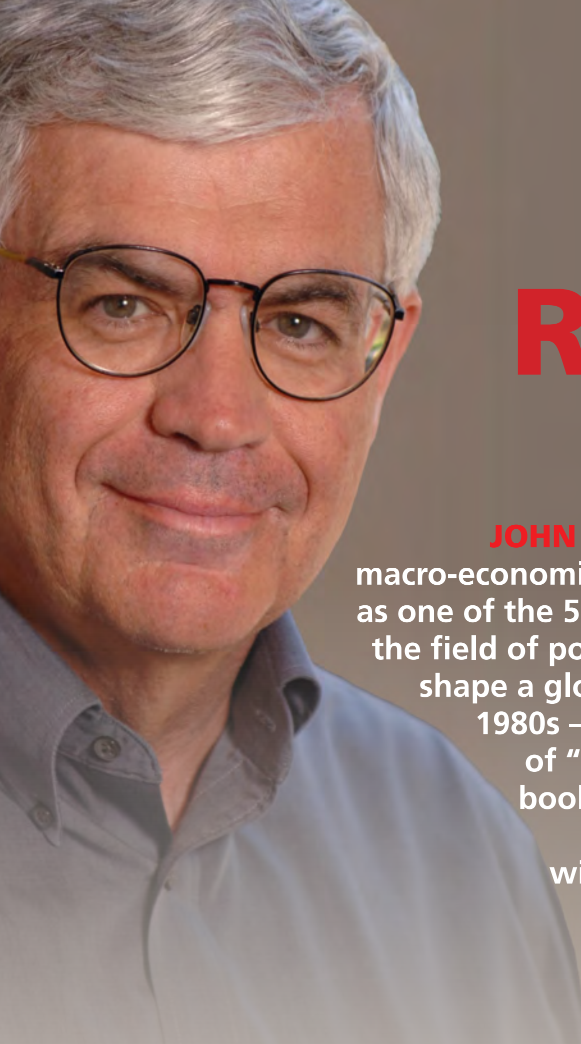

The GREAT RECESSION and beyond

JOHN B. TAYLOR is one of the world's leading macro-economists. In 2012, he was listed by Bloomberg as one of the 50 most influential people in the world in the field of policy, markets and ideas. His ideas helped shape a global revolution in monetary policy in the 1980s – specifically with regard to the adoption of "Taylor Rules" by central banks. His latest book is *First Principles: five keys to restoring America's prosperity*. In this interview with IEA Editorial Director, PHILIP BOOTH, Taylor discusses the changes in macro-economic policy in the 1980s, the Great Recession and its aftermath.

There are some who regard the years after the Second World War as a Keynesian golden age. However, things began to go wrong by the late 1970s and policy changed significantly during the 1980s. How did these changes affect economic performance?

The significant changes in economic policy in the 1980s and 1990s improved economic performance greatly. The inflation rate and the unemployment rate both came down, following large increases during the 1970s, and productivity growth eventually picked up. The shift in policy was largely away from the interventionist Keynesian monetary and fiscal actions which had become popular in the 1960s. In both the US and the UK monetary policy became more steadily focused on price stability. The Keynesian stimulus packages of the 1970s went out of style after many economists found them to be ineffective. There was also an important shift towards less economic regulation and intervention in specific markets, such as transportation and energy. Lower prices and more innovation were the result.

You are perhaps most famous for the development of the "Taylor Rule", a concept that is widely discussed within central banks when setting monetary policy. To what extent was stability in monetary policy responsible for the change in macro-economic performance?

I place a great deal of emphasis on the changes in monetary policy. In the United States, for example, monetary policy in the late 1960s and 1970s was characterised by an erratic series of go-stop shifts which eventually increased both inflation and unemployment. In the early 1980s—under Paul Volcker's leadership—policy became much more rule-like and predictable, and the economy improved. Many have shown that you can detect this shift by looking at how closely US Federal Reserve decisions can be described by the Taylor Rule. When policy was close to the rule, performance was good. When policy deviated from the rule, performance was bad. But you do not have to use a specific Taylor Rule to see this. As you suggest it is a shift from unstable discretionary policy to stable rule-like policy that is important.

Can you give an indication of how widespread this change in approach to monetary policy was around the world? Could we call it a "global revolution"?

The changes were quite widespread. In many countries—including the UK—the change took the form of a move towards inflation targeting of some kind. The idea was that, by focusing mainly on the goal of price stability, monetary policy would become steadier and less interventionist, and the stability of the general price level would in turn be good for economic growth. Economists have shown that this shift can also be described in terms of policy rules, such as greater adherence to the Taylor Rule. But I believe it was part of an improved understanding of monetary economics and the advantages of rules – following the ideas of Milton Friedman and Friedrich Hayek – that spread around the world. It was part of a broader move toward the principles of economic freedom that I wrote about in my book *First Principles*. Yes, it was a global revolution.

Of course, things seemed to go wrong in 2008 – or perhaps before. A period of great stability gave rise to a "Great Recession" which – in the UK at least – has been worse than the Great Depression in some respects. What in your view were the main causes of the financial crisis?

I believe that the main cause was that economic policy deviated from what was working well in most of the 1980s, 1990s and until recently. I will focus on the crisis and the Great Recession in the United States which I know best.

Firstly, it is clear that in the period from 2003 to 2005 monetary policy deviated from the earlier policy strategy by holding interest rates too low for too long. You can see this in the deviations from the Taylor Rule and also in other ways. For example when the inflation rate was near 2 per cent in 1997, the federal funds rate was 5.5 per cent. When the inflation rate was near 2 per cent in 2003, the federal funds rate was 1 per cent: a very different policy. These low rates caused a search for yield, excessive risk taking, and added to the boom in housing markets, which eventually led to the bust. While not every country had the same problem, you can see similar developments in other countries as well.

Secondly, there was a deviation from sound regulatory rules. This was quite evident in the risk taking allowed by government supervisors in the case of Fannie Mae and Freddie Mac in the United States, but it also occurred in the large money centre banks. One can argue that the regulations were not sufficient, but in my view the main problem was not enforcing the existing regulations. Effectively, as in the case of monetary policy, the rules were broken.

How poor has economic performance been since the financial crisis compared with previous similar events?

The recovery is much slower than one would expect from earlier events. Again, consider US history: there were eight recoveries in US recorded business cycle history that followed recessions associated with financial crises. These were recoveries from the recessions that started in 1882, 1893, 1907, 1913, 1929, 1973, 1981 and 1990. The average growth rate in the eight quarters starting with the trough of the previous recession averaged about 6 per cent per year in these recoveries. The growth rate over a comparable period in the current recovery is about 2 per cent per year. So the weak recovery from the deep recession of 2007-2009 is a clear exception.

What are the reasons for that poor performance?

In my view, the story is similar to the story of what got us into the crisis. Except for monetary actions taken during the heat of the panic in 2008, policy has continued to deviate from the basic principles of economic freedom. This is certainly true in the case of monetary policy which has continued with the unusual interest rate policies that began before the crisis, and added in other unconventional policies. But I think it is also evident in the outbreak of Keynesian stimulus packages, and the resulting increase in debt and concerns about policy uncertainty as they are unwound. In the United States we have also seen a large increase in regulatory and other interventions, especially in the health care and financial sectors.

THE MAIN CAUSE WAS THAT ECONOMIC POLICY DEVIATED FROM WHAT WAS WORKING WELL IN MOST OF THE 1980s, 1990s AND UNTIL RECENTLY

There is much concern about inequality in the Western world. Some even see it as one of the causes of the crisis. Back in nineteenth century England, the equality movement was a movement for free-market liberalism as the people tried to wrest control of economic life from vested interests. Today, the equality movement is largely dominated by people wishing to move to higher taxes and to increase discretionary regulation still further. Do you think this would bring about a cure that would be worse than the disease?

I see no evidence that an increase in income inequality caused the financial crisis. Indeed, the extraordinarily good performance in the 1980s and 1990s occurred during a time when many have documented an increase in inequality. Some argue that the recent slow recovery can be traced to income inequality because people with high incomes save more than people with low incomes, thereby raising the saving rate and lowering aggregate consumption. But the saving rate is lower than in the strong expansion in the 1980s in the United States.

And, how would you deal with poverty and inequality?

In my view the key here is improved access to good education and other opportunities which are not now available to all, in many cases because of the vested interests you mention. In the highly integrated world in which we now live, the basic economic freedoms are even more important than in the nineteenth century. And we know from the experience of the past thirty years, especially in the emerging markets, that more economic freedom works. It has brought hundreds of millions of people out of poverty. We need to match up the equality movement with the free-market movement: economic freedom for all●

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View John Taylor's IEA Hayek Lecture on ***Policy deviations and economic growth – lessons from the Great Recession for the US and the UK*** at: *www.iea.org.uk/multimedia/video/2014-hayek-memorial-lecture-prof-john-taylor*

the ODDFELLAS

Despite their differences, Marx, Mises and Minsky all believed that the problems caused by boom-bust periods were inevitable once the boom had been created. This is quite different from the modern Keynesian or neo-classical view, says IEA Education Drector, STEPHEN DAVIES.

Karl Marx, Ludwig von Mises and Hyman Minsky make an odd trio. Marx was the great critic of capitalism, Mises the staunch defender of that system and Minsky was a post-Keynesian who put forward proposals for radical change to aspects of capitalism.

Despite this, their diagnoses of what happens in an economic crisis in a modern economy and of the content and immediate cause of booms and busts are remarkably similar - though their prescriptions are very different. Underlying this is a shared way of thinking about economics, despite their many and profound differences.

One of the big questions in economics is why we see episodes in which the level of economic activity departs sharply from the long-term average level and trend. Sometimes the departure is in the direction of more rapid growth (a boom) sometimes that of a significant decline in activity (a bust or slump). Depending on the answer to this question, and given any particular understanding of economics, the secondary question of what, if anything, can be done about the problem can be addressed.

Historically, major declines or upticks in economic activity usually had natural causes such as climactic fluctuations. Generally speaking episodes of unusually warm weather, such as the 12th century, produced an increase in economic activity while spells of colder weather, such as the 14th century or the first two thirds of the 17th century, led to a decline – often severe. In this case the cause of the economic fluctuations was exogenous, from outside the economic sphere.

The more interesting question arises in the case of modern economies in which there is a long run tendency for sustained growth and the climate is largely irrelevant. Here the issue is that of how far departures from that long-term trend are endogenous. They are driven by forces and processes that are internal to the economic life of society and therefore in some sense spontaneous or 'natural'.

Until the 1930s, the dominant view among economists was that business cycles (booms and busts) were an inevitable feature of a dynamic economy. In this view, there was a natural tendency for entrepreneurs and investors to become excessively optimistic when things were going well. This led them to make more high-risk investments and create more productive capacity than there was a need for (because they anticipated a future demand for products that then failed to materialise). This resulted in a misallocation of productive capital and labour towards the growth sectors. There was a problem, in other words, of over-investment. The correct response was to liquidate this investment and move the resources to other areas. This process of correction was painful but necessary. In this view booms and busts were simply a feature of the cyclical development of the economy and the main goal of policy was to manage the corrections so that they were as quick as possible.

This classical 'liquidationist' view could be combined with the neo-classical idea of a self-equilibrating economic system developed by economists at the end of the 19th century, above all by Walras. Schumpeter, for example, could accept that the cycle of boom and bust was endogenous (that is, internal to the economic system) and ultimately self-correcting. However, in later years, the increasingly dominant tendency, typified by Keynes, Hicks and Kaldor, was to see slumps and declines in economic activity as problematic. They still saw them as being produced by endogenous forces, particularly the investment cycle, but argued that the system was not self-correcting. Instead it was possible to have an equilibrium in which many productive resources were not reallocated or even used at all and consequently there would be high levels of unemployment. In other words, it was possible to have a decline produced by the natural economic process and then be stuck in that situation.

MARX, MISES AND MINSKY ALL THOUGHT THAT THE BOOM WAS WHERE THE REAL PROBLEM LAY AND THAT THIS WAS WHERE THE DAMAGE WAS DONE

There are two key features of this way of thinking, which remains enormously influential. The first is that, while slumps were seen as problematic, booms were not seen as problematic to the same degree. In some ways the goal became that of keeping boom conditions going or returning to them as swiftly as possible. Secondly, while the fluctuations were seen as endogenous, it was argued that there was a possible response on the part of government. This was to lift economic activity out of the depressed or stagnant level on which it had settled by boosting demand via a combination of cheap money and government spending.

The three Ms

By contrast with these dominant ideas, the 'three Ms all had a different take on the question of how to understand the business cycle and what to do about it. Despite their very different perspectives they agreed on the following:

- They all thought that the boom was where the real problem lay and that this was where the damage was done.
- All three thought that, while booms could have natural causes or be driven by factors internal to the economy, they were enormously exacerbated by factors that could be thought of as external, in particular government action.
- The principal aggravating factor was an enormous increase in credit, in the widest sense. For both Marx and Mises this was engineered primarily by the political apparatus, through central banks or other agencies of government policy, while for Minsky it was an inherent feature of the banking and credit system, which he saw as in some sense independent of the rest of the economy (and ever more so as the boom intensified).

They all thought that this increase in credit had damaging effects. The first of these, particularly for Mises, was that the price signals to investors (above all interest rates) were systematically distorted so that many business opportunities seemed much more profitable than they actually were. What Marx pointed out was that this effect was concentrated in particular sectors or geographical areas. The second harmful effect was the creation of a kind of speculative mania in which herd effects and a kind of manic over-optimism led many investors to abandon normal prudence.

There were three further points of agreement. As a consequence of the boom, there would be an enormous amount not just of over-investment (that is, too much of something that is inherently useful to some degree) but of "malinvestment" where productive resources are put into activities that will never make a return and are in some sense completely wasted. Furthermore – and this point of agreement is most closely associated with Minsky – eventually there will be a moment where the unjustified optimism suddenly vanishes and the result is a panic marked by a dramatic crash in the value of the assets that are the focus of the malinvestment (a "Minsky Moment").

Perhaps most importantly, the Three Ms all agreed that the crash and the subsequent liquidation of the malinvestment is both unavoidable and necessary. Trying to put it off will only make the eventual sorting out of the problems caused by the boom even more painful and drawn out.

Of course, they all disagreed about a great deal. For Mises the cause of the problem was government meddling while for Marx it was the logic of the class interest of capitalists. For Minsky the problem was the inherent logic of the money and banking system. Consequently their solutions in the longer term for avoiding the problem differed: for Marx it was socialism, for Mises principled *laissez-faire*, for Minsky strict regulation of the financial sector.

However, while all three disagreed about the longer-term remedy, they all thought that, in the short term, once the boom has ended there is no alternative to a painful but hopefully swift adjustment. This is quite different from both the neo-classicals and the Keynesians. The former believe that the bust can dissipate quickly and the latter that the problems of the boom can be avoided by an astute handling of the bust. In short, Keynesians believe that the hangover is the problem whereas the three Ms believed that the drinking binge is the problem and the hangover the inevitable result.

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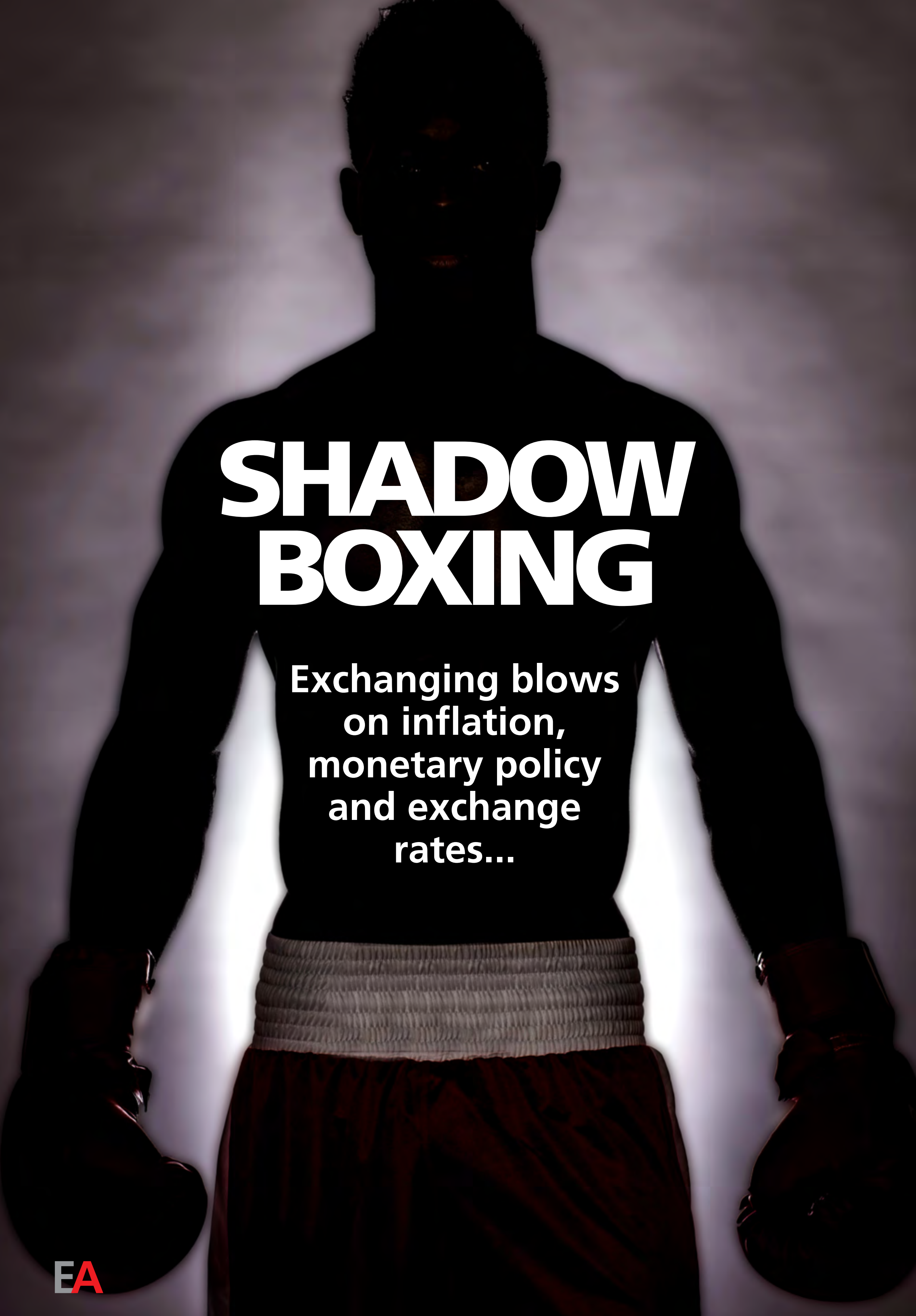


SHADOW BOXING

Exchanging blows on inflation, monetary policy and exchange rates...

Relentless intellectual embattlement was a hallmark of economic policy in the 1979–1990 Thatcher premiership as the consensus thinking of the preceding 30 years was rejected. Although the key events are now a generation ago, the battle of ideas continues – the events of that time have important lessons for today and are still debated. A case in point was a recent exchange in the letters pages of Standpoint magazine between Nigel Lawson, the former Conservative Chancellor of the Exchequer, and John O'Sullivan, one of Thatcher's speech-writers. It recalled bitter disagreements between Thatcher and Lawson about the role of the exchange rate in monetary policy.

Monetary control and the battle to reduce inflation

Famously, Thatcher believed in 1979 that inflation should be reduced by curbing the rate of monetary growth, and not by imposing interventionist controls on individual wages and prices. The Treasury was familiar with her doctrines, which were widely labelled "monetarism". In 1980 it gave evidence to a House of Commons committee mentioning "a clear relationship between the growth of the money stock and the rate of inflation in the medium term". Indeed, it warned that "the proposition that prices must ultimately respond to monetary control holds whatever the adjustment process in the shorter term may be".

Lawson, Financial Secretary to the Treasury in 1980, was certainly aware of these views. However, he was far from agreeing with them. In an earlier column in the Financial Weekly newspaper Lawson had advocated that Britain should reduce inflation by joining the European Monetary System (EMS). By fixing the exchange rate between the pound and the deutschemark (DM), German monetary discipline would be enforced on the UK and would break Britain's entrenched inflation habits. In June 1981 Lawson wrote a long note to the then Chancellor of the Exchequer, Geoffrey Howe, developing these arguments and proposing early accession to the EMS.

Howe did not take Lawson's advice and for some years the Thatcher government adhered to domestic monetary control. Inflation did come down. The annual increase in the retail price index fell from 21.9 per cent in May 1980 to under 5.5 per cent in every month in 1984. It stayed at about 5 per cent for the next three years. But Lawson, undoubtedly one of Thatcher's most able and articulate political associates, had succeeded Howe as Chancellor of the Exchequer in 1983. He was determined to combat inflation by a fixed exchange system under European auspices rather than by explicit money supply restraint.

Exchange rate targeting and the rise of inflation

Targets for control of the M3 money measure were dropped in 1985. In March 1987 Lawson started a policy of "shadowing the DM", which involved manipulating both interest rates and foreign exchange intervention to keep the pound-DM exchange rate in a narrow fixed band. The consequence was that interest rates had to be kept down to a level not too different from that in Germany. (If the exchange rate between two currencies is given, a speculator can make a profit effortlessly by borrowing in the low-interest-rate currency and re-depositing in the high-interest-rate currency.)

Unfortunately, the interest rate suitable for Germany, which had a somewhat larger economy than the UK, was too low and inappropriate for the UK. The British financial system had been liberalised in the early 1980s, and banks were keen to expand their balance sheets and profits. The practice of "shadowing the DM" lasted for a year, until, in March 1988, Thatcher prevailed over Lawson after a furious public row and instructed the Bank of England to let the exchange rate rise above the 3DM limit. In that year banks took advantage of the low interest rates and grew their stock of loans to the UK private sector by 21 per cent. The credit boom remained unchecked into the autumn of 1988, which saw a peak rate of increase in banks' loan books of almost 25 per cent, and persisted even into 1989.

The rapid growth of banks' loans (which are banks' assets) necessarily led to rapid growth of their deposit liabilities. Deposits are money, because people can write cheques against them and thereby make payments. In the year to March 1988 the growth rate of the M3 money measure was 20.9 per cent and in the year to March 1989 it was much the same at 21.1 per cent – *see chart overleaf*.

Let us remember the Treasury's words in 1980. Not only is "a clear relationship between the growth of the money stock and the rate of inflation" to be expected "in the medium term", but also "the proposition that prices must ultimately respond to monetary control holds whatever the adjustment process in the shorter term may be". How can two years of annual money growth of more than 20 per cent be reconciled over the medium term with 5 per cent inflation? The answer is that they cannot be.

THE THATCHER GOVERNMENT ADHERED TO DOMESTIC MONETARY CONTROL. INFLATION DID COME DOWN. THE ANNUAL INCREASE IN THE RETAIL PRICE INDEX FELL FROM 21.9 PER CENT IN MAY 1980 TO UNDER 5.5 PER CENT

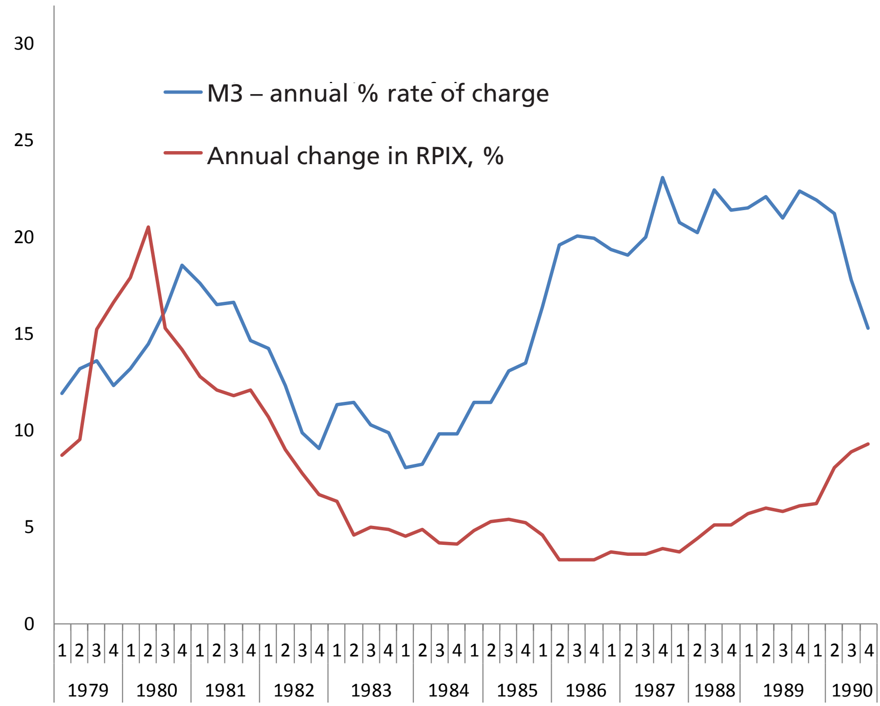
Once an economy suffers from a grossly excessive monetary stimulus of the 1987 and 1988 variety, two forecasts are easy to make. Firstly, the exchange rate will have sooner or later to weaken, whatever misleading short-term buoyancy it may have. Secondly, regardless of the foreign exchange markets, too rapid money growth invigorates such domestic inflationary forces as rising asset prices, notably rising prices of shares, houses and commercial property. In both 1987 and 1988 house prices and commercial property values were soaring, while in 1988 aggregate demand jumped more than in any other year in the late 20th century.

The truth is that Lawson's policy of shadowing the DM had been responsible for a credit bonanza, highly inflationary rates of money growth and a more general boom[1]. By mid-1989 it was obvious that "the adjustment process in the shorter term" would be vicious. A drastic lurch to monetary restriction had

[1] As I forecast would happen before these events: see Congdon (1992).

Money growth and inflation in the Thatcher premiership, 1979-1990

Data are quarterly: RPIX is the retail prices index excluding mortgate interest costs



After initial difficulties, both money growth and inflation were reduced in the first half of the Thatcher premiership, in line with the monetarist principles to which the government had made commitments in the 1980 medium-term financial strategy. But money growth accelerated sharply in 1985 and 1986, and after a big boom in 1987 and 1988 inflation also started to increase. A large rise in inflation was avoided only by a doubling of interest rates in the 18 months to October 1989.

HERE WAS AN EXTREME BOOM-BUST UPHEAVAL THAT UPSET THE FINANCIAL PLANS OF MILLIONS OF PEOPLE

to be implemented to stop annual per cent inflation rate moving back towards the teens. Clearing bank base rate, 7.5 per cent in May 1988, doubled to 15 per cent in October 1989 and stayed at this crisis figure for a year. Lawson, well aware of the trouble ahead, resigned a few weeks after the announcement of the 15 per cent base rate.

Retail price inflation had already by then accelerated to over 7 per cent and in 1990 it was to exceed 10 per cent. Sure enough, inflation did not return to 20 per cent, but only because the British economy underwent a severe recession. Whereas domestic demand had climbed by 8.6 per cent in volume terms in 1988, it dropped by 2.4 per cent in 1991. Here was an extreme boom-bust upheaval that upset the financial plans of millions of people, and in its bust phase was accompanied by the trauma of lost jobs and the destruction of small businesses.

Conclusion

The dispute in Standpoint between Lawson and John O'Sullivan was about the extent to which the shadowing of the DM had been responsible for the disaster. No doubt the participants in this debate will defend their positions robustly. Much is at stake, since the setbacks of 1989 and 1990 ruined the Thatcher government's record for economic competence, and culminated in her own departure from office in November 1990. But one point surely is clear, that the Treasury of 1980 was correct to identify and emphasize a clear correlation between money growth and inflation over the medium term.

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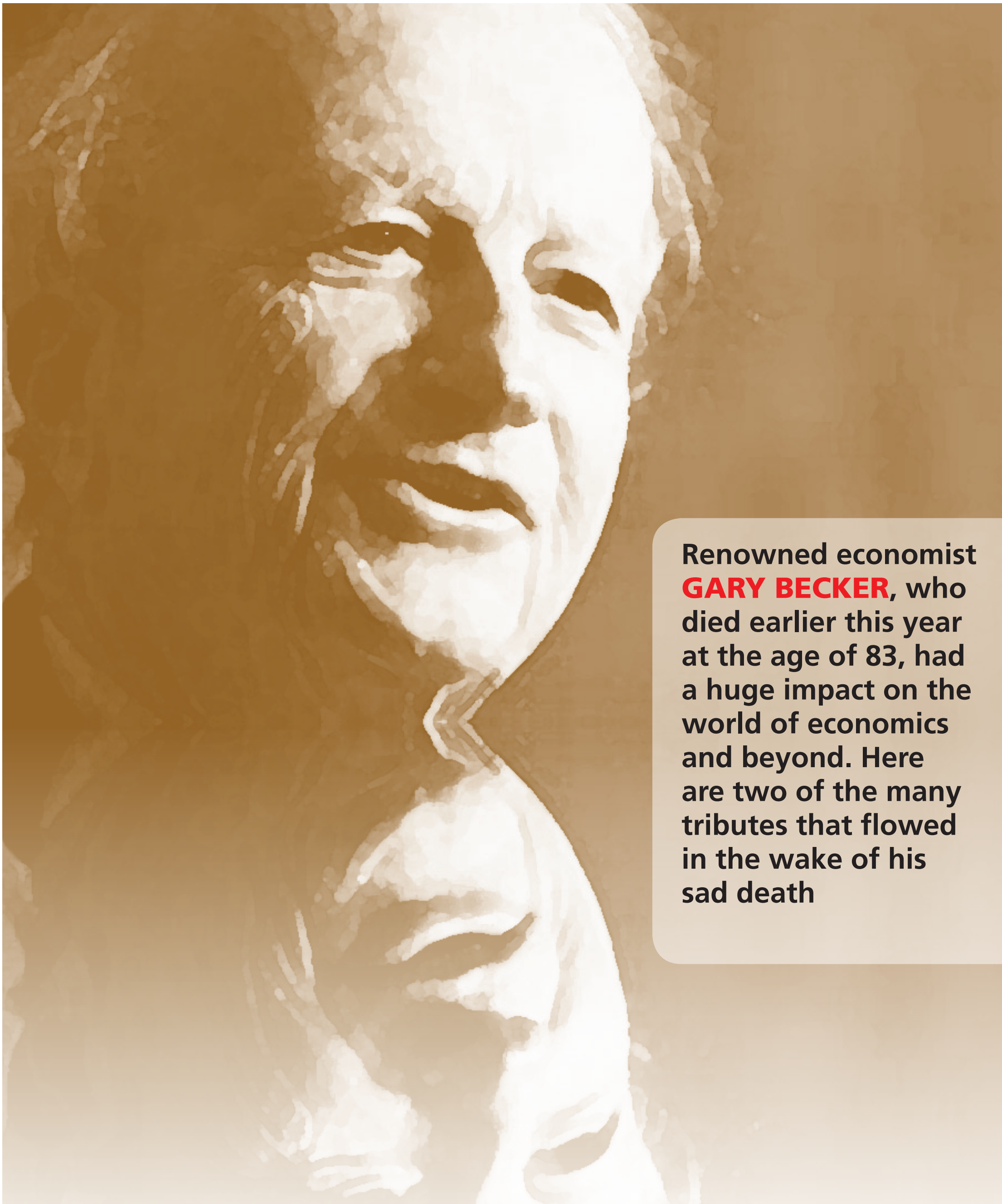

Renowned economist **GARY BECKER**, who died earlier this year at the age of 83, had a huge impact on the world of economics and beyond. Here are two of the many tributes that flowed in the wake of his sad death

TRIBUTES to a TRAILBLAZER

THE MAN WHO WON A NOBEL PRIZE FOR PARKING

From crime to tuition fees, countless aspects of our lives are influenced by the late economist Gary Becker

Why did Chris Huhne need to go to jail for dodging his penalty points for speeding? After all, as he constantly points out, hundreds of thousands of people have done this without giving it a second thought. Yet Mr Huhne would find his sentence less baffling if he reflected upon what happened the day that Gary Becker was late.

And in the days after the death of the great professor, I think that's worth doing.

A little more than 40 years ago, Becker was driving to the oral exam of a student when he realised that he wasn't going to get there in time. Not only that, but he would have to park the car and there were parking restrictions all around the building in which the exam was taking place. Finding a car park would take ages and then he would have to walk.

So here is what he did. He parked in a forbidden area, dashed to the meeting, made it on time and on his way won the Nobel Prize for Economics.

The decision about where to park had, in the end, been relatively simple. The fines for parking outside the building were modest and, more importantly, they were unreliable. In other words, he might park in the restricted area and not get a ticket. Against this was the certain cost of the car park and the professional cost of being late for an important engagement. It seemed to him that the benefit of the parking violation over legal parking was clear.

As he left the car behind, he began to reflect on what he had done. And to wonder whether others weren't doing it too. The standard theory of criminal behaviour at the time was that criminals were mentally ill or social victims. Becker, however, realised that the decision he had made to break the law had been entirely rational. Those who break the law balance the costs and the benefits of doing it.

From this insight came Becker's influential analysis of crime, one of the ways he transformed economics and one of the reasons he became a Nobel laureate. When his death was announced last week, Gary Becker was hailed as one of the most significant social scientists of his generation, at least the equal of giants such as Milton Friedman, with whom he worked at the University of Chicago. When awarding him the Presidential Medal of Freedom, George W. Bush described Becker as 'without question one of the most influential economists of the last hundred years'.

Becker's contribution was to use the traditional tools of economics - the analysis of supply and demand, the working of incentives, the weighing of costs and benefits - and, for the first time, apply it to social policy.

Take, for instance, Chris Huhne and his penalty points. The former cabinet minister thinks that he was sent to jail despite the fact that so many others commit the same crime and get away with it. In fact, a Becker-style analysis suggests that he was sent to jail precisely because so many others commit the same crime and get away with it.

THE WORLD HAS LOST ONE OF ITS GREAT THINKERS

If a crime is very hard to detect, the incentive to commit it is greater. The benefit of the crime outweighs the cost. As a result, you have to make the penalty greater so that, taken together, the punishment and the risk of punishment make transgression too costly to be worthwhile.

Becker's work was very influential on sentencing policy and prevention of crime. Yet more influential still was his impact on the field of economics. Instead of being a study merely of how money moves around, it became a study of how people behave.

One of his most famous pieces of work concerned racial discrimination in the American South. He showed that you could measure the preference for discrimination of employers by looking at how far they were willing to hire less productive workers merely because they were white.

He also developed and popularised the idea of human capital, now a common term but very controversial when Becker first used it. The professor argued that education could be seen as an economic decision in which the long-term benefit of a better job could offset the short-term cost.

It is impossible now to debate student tuition fees, for instance, without reference to Becker's ideas. Given that students increase their earning power as a result of a university education, but also that there is a social benefit, who should pay for it? And would tuition fees put off poorer students?

Becker would not have been surprised (as others have been) that the people most willing to pay tuition fees have proved to be the least well-off, and those least likely to pay have been the middle class. The cost is the same for both groups but the least well-off gain a greater benefit because they have less to fall back on without higher education.

During his life Becker was often accused of treating human beings as factors of production and purely self-interested. Yet this is a complete misunderstanding. The real significance of Becker's work is the opposite.

Becker won the Nobel Prize because he demonstrated the way in which economics was about more than money. Understanding people's incentives, and structuring social institutions in response to them, does not mean that people's incentives are purely selfish.

People might have a preference for altruism, for example, or for community living. A market-based system takes these preferences into account. It's quite wrong to equate markets with narrow economic selfishness.

This is relevant to the current debate on free schools or the NHS. Allowing competition and choice is not preferring self-interest over public spirit. It is simply structuring the system in line with people's preferences, and these preferences may be charitable.

Becker's work also shows why non-market systems struggle. People calculate the trade-off between costs and benefits. If the system gets in the way of their preferences, they work around it. That's why tourists used to swap their jeans for hard currency behind the Iron Curtain. Then the punishments get more severe to deter such defiance of the law.

The world has lost one of its great thinkers. Fortunately we still have the power of his thought.

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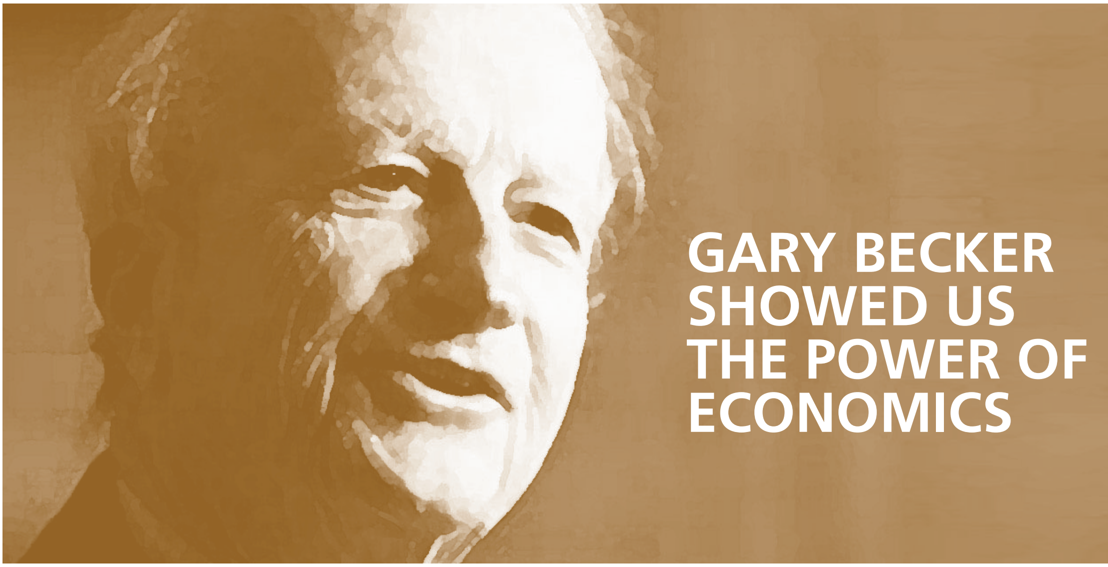

GARY BECKER SHOWED US THE POWER OF ECONOMICS

Gary Becker was one of the giants of economics. His work traversed at least a dozen separate areas of economics, including (but not limited to) the economics of the family and child-rearing; marriage; household production; the economics of crime and punishment; human capital; and discrimination.

The depth and breadth of Becker's work demonstrates his conviction that the basic principles of economics could and should be used to help us understand and predict almost any aspect of human behaviour and social interaction.

PERHAPS BECKER'S MAIN LEGACY RELATES TO THE METHODOLOGY OF SOCIAL SCIENCE

Let's take crime and punishment as an example. Becker's (1968) paper (cited when he was awarded the Nobel Prize) assumed - contrary to the usual approach of sociologists and criminologists that criminals were rational, purposive actors, and that they maximise expected utility subject to constraints. Becker assumed that criminals were just like the hypothetical consumer and producer we encounter in standard micro-economic theory. Thus was born the modern economic approach to analysing criminal behaviour.

One of the simplest but most profound insights of Becker's pioneering approach is that the 'price' that a criminal faces is determined by the penalty he expects to face: the probability of being punished, multiplied by the subjective disutility of the punishment. Measures which increase expected punishments such as higher monetary fines, longer imprisonment terms, or greater probability of detection – will increase this 'price'. Standard principles of economics then suggest that as this price rises, potential criminals will substitute out of crime and into other (legal) activities. This is the 'deterrence effect'.

There is a lot more to Becker's analysis than the simple deterrence effect, but the basic idea inspired a huge wave of theoretical and empirical research, which is still ongoing.

Economic theorists now routinely analyse criminal behaviour in a wide range of settings, and applied econometricians now routinely estimate the effect of changes in expected punishment on crime rates. The effect has been confirmed empirically in many studies across several countries.

The ideas can also be extended and applied to situations in which governments attempt to enforce regulation in labour markets, financial markets, and laws against cartel formation and price fixing in competition policy.

Overall, perhaps Becker's main legacy relates to the methodology of social science. These days you will never find economists shying away from applying their analytical tools to any aspect of human behaviour. If we could summarise Becker's main contribution in a single phrase, it would be that he showed us all the sheer power of economics.

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Read the full version of Alex Robson's tribute at: ***www.iea.org.uk/blog/gary-becker-showed-us-the-power-of-economics***

UNDER the MICROSCOPE: Mrs Thatcher's Industrial Legacy

Manufacturing's share of national income has fallen from a quarter when Mrs Thatcher entered Downing Street to just over a tenth today. ANNA VALERO asks how much this long-term "rebalancing" of the UK economy should be a cause for concern

The death of Mrs Thatcher in 2013 prompted a re-examination of her economic legacy. Economists legitimately dispute many aspects of her legacy - in particular, increases in inequality, high levels of unemployment in some areas of the country and easing regulation on the City of London. However, taking a dispassionate view of the data, one thing is clear: from the late 1970s, the UK began to reverse a century of relative economic decline. This was largely due to 'supply-side' reforms which increased competitiveness in labour and product markets, and were continued and reinforced under the Major and then subsequent Labour administrations.

In 1870, GDP per capita in Britain was a fifth higher than in the United States and over 40 per cent higher than in continental Europe. By the late 1970s, however, US GDP per capita was 40 per cent ahead of Britain; and France and Germany were 10-15 per cent ahead. This relative decline was not accompanied by absolute decline – all countries grew richer, but Britain simply became richer more slowly.

However, over the following three decades, Britain overtook France and Germany once more and significantly closed the gap with the United States (*see Figure1*).

Another way to see this is in *Figure 2*, which shows trends in UK per capita GDP since 1950, compared again with the US, France and now the entire Germany. Each series is based at 1980, so that the height at any date represents the difference between that date and 1980: hence a steeper line represents a faster growth rate. It is clear that, in the post-war years, the UK was falling behind (with the shallowest line of the four countries). However from the 1980s onwards we see that UK GDP per capita grew faster than the other countries for nearly all the period.

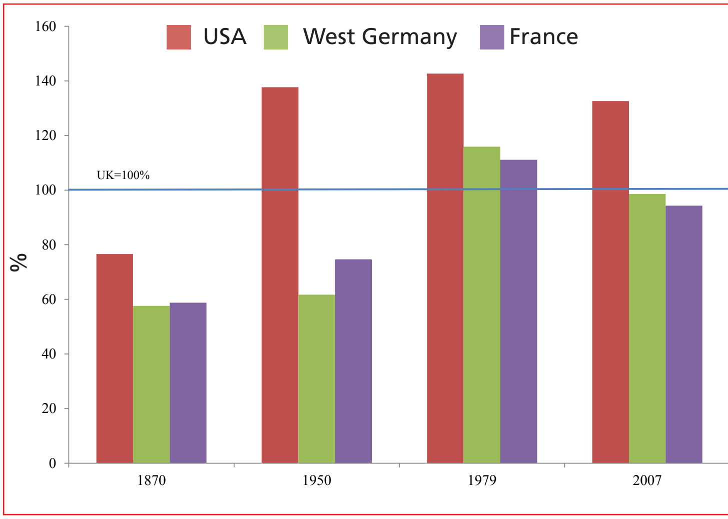

Figure 1: GDP per capita 1870-2007
Source: Crafts (2012). Note: In each year the base is UK=100 and each country's GDP per capita is relative to this. So a value of US=120, for example, implies the US has a GDP per capita 20 per cent higher than that of the UK. GDP per capita is expressed in 1990 International Geary-Khamis dollars.

The improvement in GDP per capita can be broken down into increases in the employment rate, and increases in labour productivity (GDP per worker or GDP per hour worked). The UK did well in both components: among the G6 countries, the growth of UK GDP per hour was second only to the US in the decade to 2007 (i.e. pre financial crisis in 2008), and the growth in the employment rate was better in the UK than in the US.

TAKING A DISPASSIONATE VIEW OF THE DATA, ONE THING IS CLEAR: FROM THE LATE 1970s, THE UK BEGAN TO REVERSE A CENTURY OF RELATIVE ECONOMIC DECLINE

Balanced growth?

Despite this success, it is claimed that the mix of industries underlying it became "unbalanced". It is argued that we became too reliant on the financial sector and that Britain's strong performance over the last 30 years was built on an unsustainable bubble. The prescription that often follows is that today's economy needs to be rebalanced towards manufacturing.

The global financial crisis of 2008-09 certainly revealed a huge failure of financial regulation that is only now being addressed. But it is wrong to believe that finance was mainly responsible for Britain's growth. If we focus on the market sector (removing health, education, public administration and real estate, sectors for which output is hard to measure), we see that productivity grew at around 2.7 per cent per annum during the Thatcher-Major era, and at over 3 per cent in the Blair-Brown years up until the eve of the global financial crisis. While the share of this growth attributed to Finance and Insurance services grew, and was certainly substantial at one sixth of the productivity growth from 1997 to 2007, other sectors grew too (*see Figure 3*). In particular, these were the knowledge intensive Professional Services and ICT (Information and Communication Technology) goods and services sectors. Professional services include law, accountancy, consultancy, architecture, scientific research and advertising, together with a number of administrative and support services (largely provided to other businesses, an issue returned to below). ICT goods and services includes manufacturing of computers and electronic equipment, publishing, broadcasting and IT services. The majority of these growth areas represent export sectors in which the UK has a comparative advantage. Productivity growth in traditional manufacturing (which consists of consumer and intermediate manufacturing and investment goods) stayed constant over the entire period at 0.5 percentage points. The contribution of "other production" fell substantially and is largely driven by reductions in mining productivity (in particular North Sea Oil).

So the data suggest that the economic gains since the late

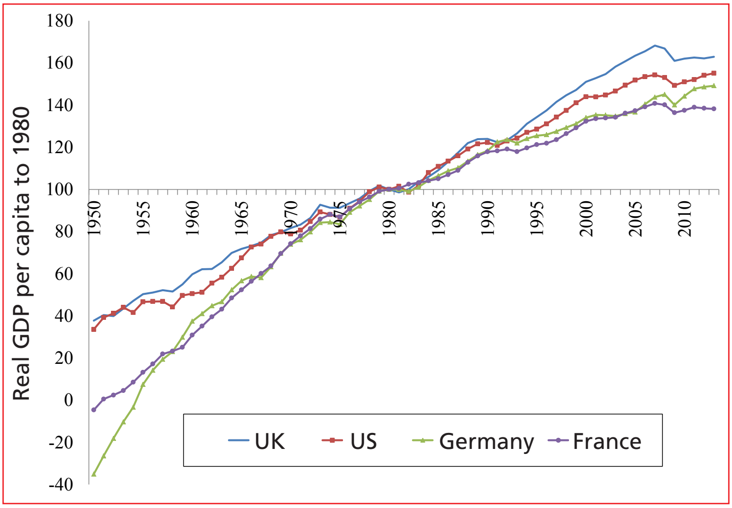

Figure 2: GDP per capita 1950-2013 (1980=100)
Source: Conference Board data, extracted 6 May 2014. GDP is measured in US dollars, at constant prices and constant purchasing power parity, with a base year of 2013. Note: log scale is used.

1970s were real and not driven only by finance. Furthermore, there is substantial evidence that policies (in both the Thatcher-Major and Blair-Brown eras) underpinned them. They included increases in product market competition through the withdrawal of industrial subsidies; a movement to effective competition in newly privatised sectors with independent regulators; increases in labour market flexibility through restrictions on union power and tougher conditions for receiving unemployment benefits; openness to foreign direct investment and global talent; and sustained expansion of the higher education system.

Accounting nuances

Nevertheless it is often argued that, given that manufacturing is export-intensive, it needs to grow as a share of the economy. Using the same data from 1980 to 2007, we see that manufacturing's share of market economy value added fell from 31 per cent to 15 per cent, which is certainly a substantial fall. As a percentage of the total economy (that is, if we add back the public sector and real estate), manufacturing went from a quarter in 1980 to just over a tenth today.

Interestingly, the trend towards outsourcing over time, and the accounting consequences of this trend, makes the share of manufacturing activity appear smaller than it actually is. Research by Guiseppe Berlingieri at the Centre for Economic Performance (*Discussion Paper No.1199*) shows that more and more businesses, including those in the manufacturing sector, outsource key functions to the professional services sector (for example, office maintenance, IT, tax or payroll services which historically were carried out in-house). The services constitute intermediate inputs for the firms buying them, but are accounted for as outputs for the professional services sector. This implies that manufacturing is still more important than the raw industry data suggest- but also that a productive service sector is a crucial input for a healthy manufacturing sector, in addition to being important in its own right.

THE DATA SUGGEST THAT THE ECONOMIC GAINS SINCE THE LATE 1970s WERE REAL AND NOT DRIVEN ONLY BY FINANCE

Manufacturing and economic policy

Even after adjusting for the outsourcing phenomenon, the share in manufacturing has declined substantially in Britain. However, this is a common trend across the rich world in countries that have pursued different types of policies over previous decades. This outcome is mainly a result of globalisation as the production of goods has moved to low wage locations (initially to the Asian Tigers, and now China and India). A fall in manufacturing would almost certainly have happened regardless of any change in policy direction in the UK after 1979. As shown in Figure 4, in France, where there was a much more activist industrial policy, the fall in manufacturing's share (28 per cent to 18 per cent of market economy value added) was also pretty large. And the fall in the more free-market US was the same as in France. So it appears that the impact of Thatcherite policies on the decline of manufacturing is much more modest than is usually thought.

But even if different policies could have increased the share of manufacturing, should they have been implemented? British manufacturing has grown more high-tech and knowledge-intensive, which plays to our strength. And we have a comparative advantage in many knowledge-intensive services which are also increasingly

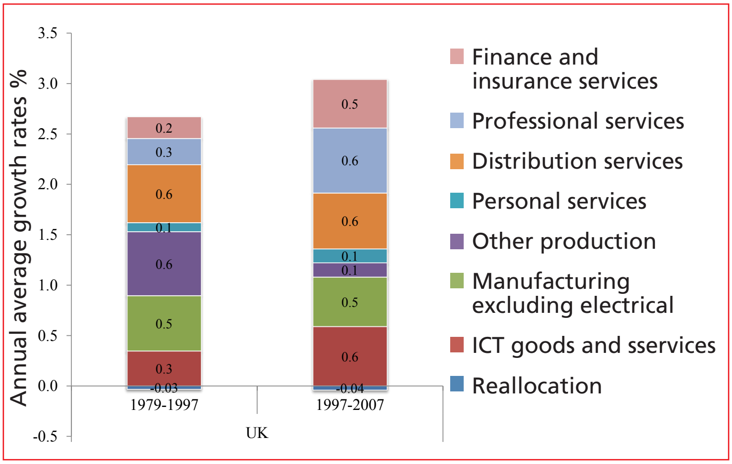

Figure 3: Sector Contributions to Market Economy Productivity Growth
Source: EU KLEMS data, extracted 6 May 2014. Notes: Average sectoral growth rates are weighted by each sector's average share in the market economy nominal gross value added over the relevant period. The reallocation effect refers to the labour productivity effects of reallocations of labour between sectors that have different productivity levels.

exported – not just finance but also many of the professional services which we saw above have contributed to our productivity gains, in particular: law, accounting, consultancy, design and marketing.

As China and India grow richer, their demand will switch from machine tools that power manufacturing (made in Germany and Japan) towards high-value services or other knowledge intensive goods. If Britain is open, confident and entrepreneurial, this is a major market opportunity.

A modern industrial policy does not fixate on manufacturing but looks to where potential lies and constantly searches for areas of future growth. Governments need to focus on removing barriers to the growth of these capabilities, regardless of whether they produce heavy goods or 'weightless' services like research and teaching.

Two examples of sectors where the UK has major current strength and future potential are higher education and pharmaceuticals. Our comparative advantage in the higher education sector is being harmed by government targets of reducing net immigration to fewer than 100,000 people a year and the cumbersome visa regime that accompanies it (policies driven by rising populism since the financial crisis). In the case of pharmaceuticals, the proposed takeover of Astra Zeneca by Pfizer deserves serious attention. Assurances that Pfizer would retain jobs and research activity in the UK in the short term are not enough for a company so material to the UK's economy (Astra Zeneca carries out nearly a tenth of the UK's research and development) and given Pfizer's previous track record of streamlining operations after a takeover. Retaining our comparative advantage in cutting edge research is essential for ensuring our economic prosperity into the future. All sorts of policy areas are relevant to this situation – intellectual property, the regulation of pharmaceuticals and the tax regime, as well as company takeover rules. The long-term impacts of policies in areas such as these, as well as in other areas such as education, infrastructure development, innovation and land-use planning must be addressed if the UK is to seize the growth opportunities of the next 30 years•

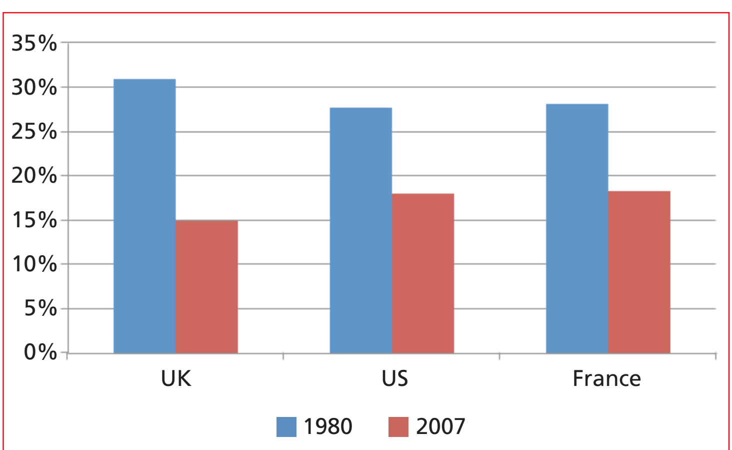

Figure 4: Manufacturing share of Market Economy Gross Value Added
Source: EU KLEMS data, extracted 6 May 2014.

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Footnote
This article draws on In Brief: Mrs Thatcher's Industrial Legacy, *by John Van Reenen in* CentrePiece, *Winter 2013/14, and the work of the LSE Growth Commission, in particular Chapters 1 and 2 of* Investing for Prosperity: A Manifesto for Growth. *The analysis has been updated where more recent data have become available since publication.*

THE IDEALIST: JEFFREY SACHS AND THE QUEST TO END POVERTY

Dreams, disappointment ...and defeat

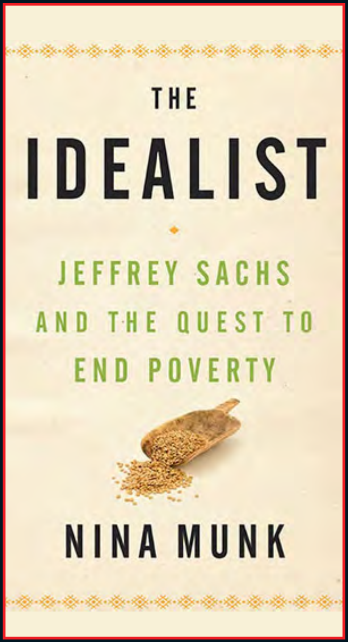
Nina Munk ***Doubleday, 2013***

The simplicity of Jeffrey Sachs' formula for ending poverty made it ideal for a successful advocacy campaign. All the problems of poverty had technological fixes, the Columbia University economist argued: bed nets to prevent malaria; wells to provide clean water; hospitals to treat curable diseases; fertiliser to raise yields of food crops. Ending poverty, therefore, was just a matter of raising enough money to pay for the technical solutions. Sachs would demonstrate his ideas by deploying these fixes in a dozen or so Millennium Villages in Africa. Success would build on success to scale Sachs' experiment up throughout the continent.

The Idealist, Nina Munk's brilliant book on Sachs, chronicles how this dream fell short of reality. Munk, a contributing editor at Vanity Fair, follows Sachs around as he tries to make all this happen. But she also goes out on her own to the Millennium Villages. She visits two villages repeatedly: Dertu, in the ethnic Somali region of Kenya, and the more centrally located settlement of Ruhiira, Uganda. Munk thus makes us see the villagers as real people, not stereotypes.

The technical fixes turn out to be anything but simple. The saga of Dertu's water wells is illustrative. Soon the local man put in charge of the wells had to order a crucial part lacking for the water wells' generator. It took four months to arrive, and then nobody knew how to instal it. Eventually a distant mechanic arrived at great expense. A couple of years later, Munk found the same problems.

A little over a year on, the Millennium Villages blog celebrated Dertu's wells as "the most reliable water supply within



the region." But then the wells ran dry altogether due to a drought.

Such examples multiply in Munk's book, showing that technological answers to poverty are not the silver bullet Sachs maintained. Technology requires implementation by real people subject to widely varying incentives and constraints in complex social and political systems.

Munk shows successes as well as failures. Sachs' project spent $1.2 million on health in the other village, Ruhiira, including hiring two doctors and 13 midwives. Many fewer mothers in Ruhiira are now left to their own resources to give birth, and the prevalence of malaria has fallen drastically. But the difficulty achieving the successes and the frequency of the failures contradicted Sachs' original promises.

Perhaps most revealing about the "big aid" debate is that this wave of criticism of Sachs arose from accusations that there were no proper evaluations. The critics pointed out that any positive trends in the Millennium Villages would have to be compared with the positive Africa-wide trends in health, access to clean water and overall development. Sachs had not set up the project so that this comparison could be done reliably.

Sachs' actual objective for the Millennium Villages – to show that aid could achieve the end of poverty – does not even merit a mention by Sachs' critics today. This idea is regarded as not worth refuting. The big aid debate is really over.

I should say a word about my own history with Sachs. In 2005, when I wrote a negative review of Sachs' book *The End of Poverty*, I became identified for years afterwards (with rising unwillingness) as the antithesis to Sachs' thesis, a never-ending debate – aid can end poverty! No it can't!

Eight and a half years later, I take no pleasure in the defeat of Sachs' big ideas, especially as this failure involves the sufferings of the people affected. And Sachs does deserve some recognition as a gifted and hard-working advocate for compassion for those still left out of the considerable progress that has happened in development. But the idea that aid could achieve rapid development and the end of poverty was wrong. It is time to debate what really does matter in development.

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A pioneer's prophetic words

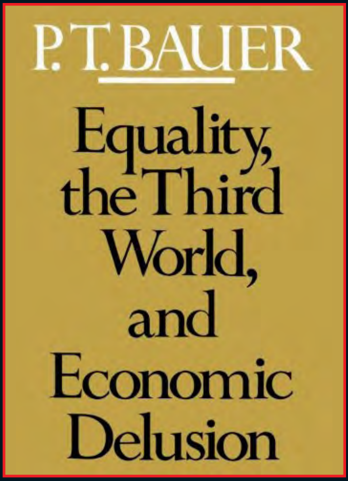
EQUALITY, THE THIRD WORLD, AND ECONOMIC DELUSION

PETER BAUER *HARVARD UNIVERSITY PRESS, 1981*

Peter Bauer was a modest, courageous man. For many years, this brilliant Jewish refugee from Budapest was seen as an eccentric maverick by fellow economists. Yet over time his criticisms of state directed aid to the Third World was accepted by a growing number of economists, both in Britain and overseas. Furthermore, his views eventually influenced the major multinational aid bodies including the World Bank whose Berg Report, published in 1981, clearly owed a major debt to Bauer in its criticism of the interventionist policies adopted by African governments.

This volume collects together a number of Lord Bauer's essays on economics and foreign aid. They are well worth reading. Bauer was an astute observer and undertook painstaking research into the operation of commodity markets. Indeed, he was a pioneer in collecting and analysing data, exemplified by his classic study on West African Trade published in 1954.

Bauer is scathing about the impact of ill-conceived government controls imposed on agricultural commodities in West Africa in the Second World War and the post-war period. In his essay reviewing 'British Colonial Africa', reproduced in this collection, Bauer points out that a cluster of state export monopolies known as marketing boards "became the most important single instrument of state economic control in British Africa". He highlights the fact that "from their inception the boards withheld large sums from the producer by paying them far less than market prices. They also exercised close control over processors and traders. Neither during nor after colonial rule did the policies of the marketing boards accord in any way with their ostensible objectives".



The people who suffered were small-scale farmers while, as Bauer points out, the huge sums that accrued to the government and its various tentacles of power "reinforced the effects of other state controls, especially of import licensing, in promoting large scale corruption". If the money was not pocketed by politicians, it tended to be channelled into prestige projects and, of course, official Mercedes limousines. Bauer laments, "a large proportion was spent on projects and activities that were uneconomic at best, or total failures, or instruments for personal enrichment and political patronage".

Bauer sided with the ordinary farmer and women selling their wares in street markets. His books demonstrate a profound respect for the citizens of the Third World and he clearly bristled at the patronising tone adopted by many mainstream development economists.

Bauer argues that, "In effect, state aid is a form of taxing the poor in the West to enrich the new elites in former colonies". This debate is just as topical today as when Bauer originally penned those words. Every week there appears to be a media story about politicians and commentators questioning the merits of maintaining Britain's substantial development aid programme.

Bauer argues that "foreign aid is perhaps the least questioned form of state spending in the West", even though "it is taxpayers' money which goes to foreign governments, and these are political matters". Since he first wrote those words his own writings have influenced an increased scepticism on the efficacy of bilateral and multilateral official aid. Increasingly, one hears trenchant voices arguing that it is more sensible to enable developing countries to export their goods and services to the protected markets of the EU and USA. One of the more notable champions of such a position is none other than Sir Bob Geldof, who now chairs 8 Miles LLP, a private equity firm investing substantial sums in businesses throughout Africa.

Bauer's long term influence is likely to be strongest on the growing number of successful entrepreneurs and political leaders emerging out of Africa. Dambisa Moyo, the Zambian international economist who sits on several corporate boards including Barclays plc, is a good example. Indeed, she dedicated her best seller *Dead Aid* to Lord Bauer. What finer compliment could one wish for? Bauer, who died aged 86 in 2002, was a charming man who would have appreciated her dedication•

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HEADING YOUR WAY: The ECONOMICS ROADSHOW

Following the huge success of our 20 one-day conferences in the last academic year, we are once again packing our bags and travelling to a school near you. Our Economics Roadshow includes topics such as market failure, the Eurozone crisis, the living wage, infrastructure projects, and much more.

We have a raft of top speakers lined up, including Professors Mike Wickens of the University of York, Jonathan Wadsworth of the London School of Economics, and Patrick Minford of Cardiff University.

If your school would like to attend a conference or if you're interested in hosting an event, then contact Grant Tucker: ***gtucker@iea.org.uk***

ITINERARY

2014

Monday 6th October: Southend High School for Boys, Southend
Wednesday 8th October: King Edward VI Grammar School, Louth
Thursday 9th October: Portsmouth Grammar School, Portsmouth
Friday 10th October: Headington School, Oxford
Monday 13th October: West Buckland School, Barnstable
Friday 7th November: Bromley High School, Bromley
Monday 17th November: Loretto School, Edinburgh
Tuesday 25th November: Whitgift School, Croydon
Tuesday 2nd December: Wellington College, Crowthorne, Berkshire

2015

Tuesday 20th January: Wallington County Grammar School, Wallington, Surrey
Friday 23rd January: New Hall School, Chelmsford
Thursday 29th January: Dulwich College, Dulwich
Tuesday 3rd February: Stephen Perse Foundation, Cambridge
Tuesday 3rd March: St Swithun's School, Winchester
Friday 6th March: Bishop Wordsworth's Grammar School, Salisbury
Thursday 12th March: Haileybury College, Hertford Heath, Hertfordshire

Each conference runs from 10am-4pm.

CHOOSING FREEDOM

Future Freedom is the name of our new series of monthly events exclusively aimed at under 30s – from sixth formers to young professionals. At our launch event in June, Hugh Pym, the BBC's Chief Economics Correspondent, talked to a packed room about his new book on the financial crisis.

At our next Future Freedom event on October 27th we will screen Ronald Reagan's ***Time For Choosing*** speech after an introduction by former US Deputy Assistant Secretary of State Colleen Graffy. If you are interested in attending Future Freedom events then visit ***www.iea.org.uk/events***

INTERN-ational Appeal

This summer the IEA brought together nearly 50 interns as part of our summer intern programme. For six weeks the interns from France, America, Germany, Mauritius and the UK, relocated to Westminster for a fun packed educational programme. It consisted of lectures, seminars, debates, discussions, and beer and pizza nights! During their time with us each intern produced a supervised research project mentored by one of the senior research staff at the IEA. Does that sound of interest to you? If so, we have internship opportunities all year round, from sixth form students to recent graduates. If you are interested in joining our intern programme or just want to find out more, contact Grant Tucker: *gtucker@iea.org.uk*

EXPECT FIREWORKS!

On Wednesday 5th November we will be holding another free Teacher's Seminar at the IEA (2 Lord North Street, Westminster, SW1P 3LB) on the topic of ***"China, Globalisation and the Future of World Trade"***. If you are an A level Economics teacher and are interested in attending, then please email *gtucker@iea.org.uk* to reserve your place. This follows our successful seminar in March on the topic of ***"Debt and Monetary Policy"***.

Speaking out

The IEA has an impressive roster of speakers who visit schools, universities, and other institutions around the world. In the last few months our speakers have addressed thousands of people at venues including Oxford University and Westminster Central Hall. **If you need a speaker for a talk or debate at your organisation** email ***gtucker@iea.org.uk***


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www.iea.org.uk
ARTHUR SELDON

BRIEFING: Summarising and signposting essential reading we've seen elsewhere...

GROWTH STILL GOOD FOR THE POOR

Is economic growth the key to helping the world's poorest people?

It is argued by some, for example, that higher economic growth in India has not generally benefited the poor. However, new evidence from economists from the Brookings Institution, Yale University and the World Bank suggests that general economic growth is overwhelmingly important for poverty elimination.

Using a rich dataset, the authors found a very strong relationship between overall economic growth and growth of incomes in the poorest quintile. They also found that, on average, income growth in the poorest quintile was very similar to overall growth. As such, ensuring the right conditions for growth would seem to be the best way to ensure poverty reduction. Interestingly, the authors also found that specific policies that might be thought to have distributional effects did not benefit the poor beyond their effect on general economic growth.

There might be some particular policies that could benefit one group rather than another in a particular country, but the authors conclude that these are difficult to identify in advance from looking at global data•

DAVID DOLLAR, TATJANA KLEINEBERG AND AART KRAAY
World Bank Development Research Group
Policy Research Working Paper 6568
www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2013/08/13/000158349_20130813100137/Rendered/PDF/WPS6568.pdf

GROWTH and POVERTY REDUCTION in AFRICA in the Last Two Decades

Whilst the raw statistics tell us that economic growth in the world's poorest continent has been healthy this is disputed.

Pope Francis, for example, weighs into this argument arguing that the rich are getting richer exponentially whilst the incomes of the majority do not improve.

As this paper by Andy McKay at the University of Sussex shows, such assertions are simply not true. McKay looks at a range of data and several indicators. Average African growth from 2005-2010 was 2.9 per cent per annum and in only two countries was growth negative. There have also been substantial reductions in poverty.

Furthermore, the growth is not simply driven by the commodities boom but is more broadly based. Interestingly, in the countries for which it can be measured reliably, inequality in Africa has tended to reduce too. Thus, though the pattern is not entirely uniform, growth, poverty reduction and reductions in inequality seem to be going hand-in-hand in Africa•

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Journal of African Economies, 2013, 22 (supp 1)
http://sro.sussex.ac.uk/42783/

MARRY YOUR LIKE: Assortative Mating and Income Inequality

There is much discussion about income inequality in developed countries.

However, an interesting phenomenon, rarely discussed by politicians who take an interest in this matter, is that of assortative mating.

As a result of a variety of social and economic trends, there has been an increased tendency for individuals to marry people who are more similar to them in terms of education and social class.

This paper examines the impact of assortative mating on household incomes. It confirms the hunch that people have been marrying spouses with a similar education to their own. However, there has also been an increased dependence of incomes on education that has combined with and exacerbated the effect of assortative mating.

In 1960, a married couple who both had post-college education would have earned 176 per cent of mean household income. By 2005, that figure was 219 per cent. At the same time, a household consisting of a couple who both had high school education fell from just above the average to 83 per cent of the average.

The trend in household income disparity is further reinforced by increased labour market participation by women. Overall, a clever man is more likely to marry a clever woman; individually their relative earnings have increased compared with the mean; and the woman is more likely to be earning. These are powerful forces increasing income inequality•

JEREMY GREENWOOD, NEZIH GUNER, GEORGI KOCHARKOV AND CEZAR SANTOS
NBER Paper 19829, January 2014
http://www.nber.org/papers/w19829?utm_campaign=dig&utm_medium=email&utm_source=dig

BALANCING the EQUATION

There is no shortage of concern about the UK's large balance of payments deficit and it is often suggested that Britain's high exchange rate is the key problem.

But would a depreciation of sterling make any difference? Whether a fall in the value of sterling would help reduce our trade deficit depends, among other things, on the cause of the high exchange rate.

It is possible that speculation is driving up the value of the pound. The Bank of England could try to reduce the value of sterling in these circumstances by loosening monetary policy. However, this is likely to give rise to an unsustainable boom in asset prices and/or inflation, and to nullify the benefits of any devaluation pretty quickly.

Alternatively, Bank governor Mark Carney could try to 'talk down' the value of sterling. But the effect of talking down the pound will probably be short term unless it is also backed by action on the monetary policy front – for example, some sort of target to lower sterling which is pursued by more QE. But this, as noted, would be a dangerous policy.

Perhaps we should look more carefully for the underlying causes. Consider Miss Profligate. Miss Profligate spends 105 per cent of her income on consumption, and borrows 5 per cent of her income from the bank. In effect, she has a trade deficit – she buys a greater value of goods than people buy from her (or more than they pay her to make). Now consider Miss Prudent. She has the same income, spends 95 per cent on consumption and saves 5 per cent. She has a trade surplus equal to Miss Profligate's deficit. She earns more than she spends, and people are willing to pay her, to make goods and services, an amount of money that is greater than the amount she spends on other people's goods.

OUR GOVERNMENT IS BORROWING ABOUT 6 PER CENT OF NATIONAL INCOME… GERMANY'S GOVERNMENT IS BORROWING NOTHING

In short, Britain is Miss Profligate and Germany is Miss Prudent. Our government is borrowing about 6 per cent of national income and Germany's government is borrowing nothing. The British private sector is saving about 4 per cent of national income and the Germans 10 per cent. These figures provide an (albeit simplified) explanation for our balance of payments position. We are spending more than we are earning and the Germans are earning more than they are spending.

How does this translate into a higher exchange rate? Borrowing by British consumers and by the government leads to an inflow of capital to finance that borrowing: 40 per cent of UK government bonds are owned by overseas investors. This pushes up the exchange rate. This creates the conditions that lead to the balance of payments deficit which is the counterpart to the UK being a net borrower.

Of course, there are other factors involved as well. But we cannot ignore the fact that, if our government is going to borrow on its current scale then, without huge levels of private saving, we will run a balance of payments deficit. The government is doing our exporters no favours by not getting its borrowing under control•

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Full version at www.iea.org.uk/blog/forget-fancy-schemes-government-borrowing-is-holding-back-uk-exporters

QUOTAS are BAD POLICY

Economists have long been critical of quotas which arise in many different contexts.

Import quotas are a non-tariff barrier to trade: countries, or customs unions such as the EU, may only allow in a certain number of foreign-produced cars or textiles or foodstuffs. Such quotas rarely do much good. They protect particular producers but penalise consumers. They discourage innovation and necessary change. Once instituted, they are very difficult to remove. In countries where the rule of law is weak, they are often the basis for corruption as well-placed government insiders get access to scarce imports and can exploit shortages.

Labour markets offer huge scope for quotas too, of course. Immigration is a case in point: governments claim to know that the labour market requires certain types of immigrant rather than other types of immigrant – a claim for which there is little objective basis.

We have also had religious quotas for membership of the Northern Ireland police force, and a similar policy has been advocated for ethnic minorities in the Metropolitan Police. The justification here is that community peace – another 'externality'

THEY DISCOURAGE INNOVATION AND NECESSARY CHANGE

– is best served by attempting to manipulate representation of different groups in policing communities. Yet experience in the USA and elsewhere suggests that cronyism and low performance can result. Moreover, the changing demographic composition of cities over time presents ongoing problems of representation.

A different justification is offered for quotas for women's representation on company boards: this is primarily on grounds of fairness or equity. To those who might query the prioritising of equality of outcome rather than equality of opportunity, a further justification is often offered. This is that 'diversity' improves organisational performance in various ways. The evidence for this is, however, rather weak. And it begs questions about what dimensions of diversity should be emphasised. Our company boards have few teenagers or religious leaders or comedians represented: should we be concerned?

Advocates of quotas believe that capitalism suffers from a wide range of market failures which can best be addressed through dictating arbitrary numerical targets. The job of the economist is to raise impertinent questions about the likely effects of such quotas and to point out the alternative means of achieving the relevant goals•

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Full version at: www.iea.org.uk/blog/quotas-are-bad-policy

Read more of the IEA blog at www.iea.org.uk/blog

WORKING HARDER… but not more productively

GDP growth of 0.7 per cent in the final quarter of 2013 confirmed that the recovery was taking hold. However, what was particularly disappointing about these figures was that employment had grown at about the same rate, which means that GDP per person employed hardly grew at all. In other words, in 2013, five years after the financial crash, we were still in the midst of a productivity crisis.

GDP per person employed in 2013 was only a fraction higher than in 2012 (0.4 per cent). GDP per hour worked tells the same story (there would appear to be a small fall in GDP per hour worked of 0.4 per cent). Output per worker to the third quarter of 2013 was only 0.3 per cent higher than in the first 9 months of 2012.

So from where is the growth coming? People are working more, producing more and spending more. However, unlike in recent decades, people are not increasing the amount they produce per hour worked. As such, even if living standards rise, given current trends, they will only be rising because we are working harder.

This shows the fragility of the recovery. There is a limit to the extent to which employment can rise. Until we see business investment picking up and the building of capacity, growth in the medium term will be anaemic.

This contrasts markedly with the record after the Great Depression or, indeed, after post-war recessions. Business investment in Q3 2013 (five years after its peak) is 24 per cent down from that in Q1 2008. In contrast investment in the Great Depression was 3.5 per cent up from its 1929 peak five years later.

What can boost growth? The answer lies in raising private investment to improve productivity.

This is a problem for the real economy which cannot be solved by monetary policy. Private investment is also affected adversely by political uncertainty. State spending is still at historically high levels and the budget deficit and government debt are not showing clear signs of being controlled.

As well as reducing the size of the state in terms of government spending, we also need to reduce its regulatory role. For example, there are clear signs of strong demand for housing in the UK, but planning controls prevent a substantial increase in supply (in contrast to the recovery in the 1930s). This not only prevents the productive activity of house construction; it also prevents labour and businesses from moving from low to high productivity areas. In the field of energy, regulation and subsidies are promoting power generation through very-low-productivity mechanisms. And in financial services government policy is strangling bank lending through capital regulation.

The good news is that there is plenty of unrealised potential for higher growth if policymakers decide to change course. The bad news is that there is little sign of a significant change in course.

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Full version at: www.iea.org.uk/blog/working-harder-not-more-productively


Soundbite

Hey, teachers: LEAVE THEM KIDS ALONE

Schools need to please parents. If they don't, parents won't send their children to school – at least where parents have an option. Schools need to please the government as the government pays for schools. The government wants people who are law abiding, upright citizens, who, when needed, will defend their country and be loyal and worthy citizens.

Schools do not try to please employers because employers don't fund schools. Most employers today need to train students when they leave school because schools do not educate them well enough. Schools also do not try to please the children – they do not matter in the system we have developed.

But schools as we know them now are the product of an age that has ended. They are out-dated and obsolete.

Until well past the middle of the twentieth century, the only communications technology available to manage the world was the telephone. Until the end of the 19th century even the telephone was not available. Data was written on paper and processed by clerks and managers. The system was perfected by the Victorians in the zenith of the British Empire. Like most things designed by the Victorians, it was a robust system. It worked. Networks of identical human computers, sitting in identical buildings across the continents created most of the world we live in today.

In order to keep this gigantic military-industrial machine working, the Victorians needed identical people who would fit into the right place in the machine, anywhere on the planet. Schools were designed to produce these people. Schools had similar curricula, pedagogy and assessment systems. They were efficient engines that would convert children into identical people in just ten years. The predominant skills would be reading, writing and arithmetic. Knowledge would be contained in books. Since books are not always accessible, their salient points would be stored in each human brain and used when needed. The government, major religions and the military decided on these salient points. Schools would ensure their storage and retrieval.

From the 1950s, computers were developed and the age of empires ended. The change was so rapid that there was no time to dismantle the old machinery. The schools continued to churn out their identical products – parts for a gigantic human computer that no longer existed, nor was needed.

Within a few decades, institutions began to dematerialise – banking, the stock exchange, entertainment, newspapers, books, money, were all strings of zeros and ones inside the evolving Internet that is now simply called 'The Cloud'. It is already omnipresent and indestructible. In a few more decades, it will probably be sentient, non-material and, therefore, eternal.

In 1999, I accidentally glimpsed 'The Cloud' though an experiment often called 'The Hole in the Wall'. I found that groups of children living in the streets of India would learn to use computers and the Internet by themselves. These were children who had very little or no knowledge of English and had never seen a computer before. In the next five years, through many experiments, I learned that groups of children can complete educational objectives by themselves, using the Internet, if you leave them alone. By 2009, it was possible to 'beam' teachers to places where they could not or did not want to go. I made a 'granny cloud' of retired school teachers who would encourage children to learn by themselves.

GROUPS OF CHILDREN LIVING IN THE STREETS OF INDIA WOULD LEARN TO USE COMPUTERS AND THE INTERNET BY THEMSELVES

By 2012, teachers around the world were using SOLEs, 'self-organised learning environments', where children would group around Internet connections to discuss "Big Questions". The teacher would merge into the background and watch as learning happened.

We need a curriculum of Big Questions; a pedagogy of self-organised learning; examinations where children can talk, share and use the Internet; and new, peer assessment systems. People don't need to be machines anymore.

Governments will find it hard to do this, but teachers can – if they stand back and let the Cloud in.

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To learn more about
Sugata Mitra's work visit
www.theschoolinthecloud.org

The GLOBAL City

In a previous EA column I argued that unprecedented urbanisation makes cities even more important in the global economy. One type of city is the "global city".

A global city is where truly global services cluster. Business – in finance, the professions, transport and communications -- is done in several languages and currencies, and across several time zones and jurisdictions. There are only five global cities today: London, New York, Hong Kong, Singapore and Dubai.

The global city has a relentless market logic. It has to be open to trade, foreign capital and migrant workers. It must have a very business-friendly regulatory environment. Its infrastructure -- physical infrastructure as well as "soft" infrastructure (such as education, skills and cultural activities) – must also be among the most advanced. Above all, it has to be a hive of individual freedom, where creative ideas and entrepreneurship can thrive.

But the logic of the global city runs counter to that of the "normal country". Normal countries are more ambivalent about the market and less open to the world. Their citizens want to lead settled, secure lives rather than constantly having to adapt to changing global market conditions. London and New York – global cities that are part of normal countries – face this contradiction all the time. The natives of Hong Kong and Singapore are no longer dirt-poor immigrants. Overwhelmingly, they are settled and middle-class, with increasing "normal-country" aspirations that sometimes jar with global-city imperatives.

How do global cities rate against each other? London and New York have historic "first-mover" advantages, especially in having the world's most advanced financial markets. Hong Kong is a *de facto* city-state, combining municipal and nation-state functions, though under Chinese sovereignty. Singapore is a *de jure* city-state, with its own military and independent trade and foreign policies. Both Hong Kong and Singapore outrank other cities, and indeed other countries, in having the best business climates, hard infrastructure and quality of governance. Their education systems are among the most advanced. They are the most open economies in the world to trade and foreign capital. Dubai is another *de facto* city-state, though part of the UAE's federal system. It is extreme in one respect: about ninety per cent of its population is foreign. Singapore comes next: about 40 per cent of its population is non-Singaporean. Dubai is also the most authoritarian global city: power is centralised in the ruler and his family.

IT HAS TO BE A HIVE OF INDIVIDUAL FREEDOM... WHERE CREATIVE IDEAS AND ENTREPRENEURS CAN THRIVE

Now take a look at a few key issues through the prism of the global city.

Firstly, global cities specialise in global services, which drive a cornucopia of ancillary local services. With the exception of Singapore, services account for ninety per cent or more of GDP in global cities.

Secondly, there is the importance of openness and governance. Here self-governing city-states have an advantage over London and New York. Not only can they excel at municipal policies, but they can also have free-trade policies and be exceptionally open to migrants. London and New York do not have that freedom.

Thirdly, there is the issue of geographic space. This is where city-states are at a disadvantage. Unlike London and New York, they do not have hinterlands within their territories where low-value economic activity can relocate and where people can move in search of a lower cost of living.

Finally, there is the question of how we handle inequality and related social issues. Globalisation has delivered unprecedented growth and prosperity. But it has probably played a part in increasing in-country inequality, giving higher returns to capital and to educated, skilled workers than to the unskilled and semi-skilled. This is most visible in the global city.

Take Hong Kong and Singapore. Now their settled populations are more sensitive to rising income inequality. There is more pressure for government to provide more affordable housing, and more generous coverage for health care, pensions and social security. And there is more resistance to large-scale immigration. How should governments respond to these "normal-country" concerns without undermining the essential logic of the global city?

Such are the challenges of the global city. But it remains a hallmark of early twenty-first century globalisation. It combines freedom and prosperity better than any other political-economic unit. In that sense we all have a stake in the global city.

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HARD to SWALLOW

In most product lines everyone is used to the idea that the more we pay the better the product. A £40,000 Mercedes is probably better than a £10,000 Honda for example.

What about medicines? Some patients may well suspect that the brand name original will be better made and maybe work better than a generic medicine, but I suspect that most people never think about it. When people get a doctor's prescription, they don't ask which generic medicine they have or for the evidence that the generic medicine works as well as the branded original. People may well compare car performance figures, but I doubt that many patients do so when it comes to drugs.

Perhaps people trust, directly or tacitly, the regulator (and their doctor) to ensure that all products work properly. But why should a regulator of medicines be better than any other bureaucrat in any other field? Maybe we trust the companies making the products – assuming that both their desire to please customers, and the fear of the loss of business, or threat of prosecution, means that their products work.

Part of my latest research shows that chain pharmacies in emerging markets have higher quality medicines than stand-alone pharmacies. The assumption is that they take greater care over the sourcing of their products, and discover problems more easily than their independent counterparts. Perhaps one would find the same effect in the UK or US. But since the vast majority of medicines are assumed to work, undertaking such an exercise would be a waste of money – it could cost hundreds of thousands of pounds to find any samples that don't work.

SHOULD WE BE ABLE TO PAY FOR DIFFERENT LEVELS OF QUALITY IN OUR MEDICINES?

But maybe that assumption is no longer correct. Most of the western medical agencies, like MHRA in the UK and FDA in the US, spend the vast majority of their time overseeing new products. Monitoring clinical trial data and approvals of exciting new products is where the attention is focused. They conduct site inspections on plants selling "old" products and occasionally find problems, issue warnings, levy fines, sometimes recall products and occasionally prosecute producers. This is assumed to ensure safety.

The focus of their efforts towards new products was based on production systems of the 1980s and 1990s, when the vast majority of final medicines, and intermediate chemical products, came from the US and Europe. But today well over half the ingredients for medicines, and maybe a third of the medicines themselves, come from India and China where production costs are much cheaper.

Regulators in these countries are often corrupt, understaffed, underfunded and not particularly competent; businesses may not have decades of experience of legal fights that sharpen incentives for quality control. The result is that the quality of drug exports is not uniformly good. Most of the worst products find their way into Africa and other emerging markets. However, if evidence from US scientists and doctors such as Harvard's Preston Mason, and Harry Lever of the Cleveland Clinic is correct, some may be finding their way into richer markets too.

I chaired a Congressional briefing in February on this topic, and the FDA reacted very aggressively towards both Mason and Lever. It seems that the FDA does not want the US public to be made aware that the quality of imported medicines is not always good.

In any other market, it would be simple to deal with this issue. Generics from India would not be expected to perform as well as products made in, say, Italy or Switzerland and would be priced at a discount. Consumers, patients and doctors would be able to specify what generic they wanted based on their tolerance for risk. But with the fiction that all products are equal, and little choice in what generics one can take, there is no viable market response.

This status quo will probably continue until some tragedy occurs, when heavy-handed legislation will demand changes in labelling and drug sourcing. Till then *caveat emptor*•

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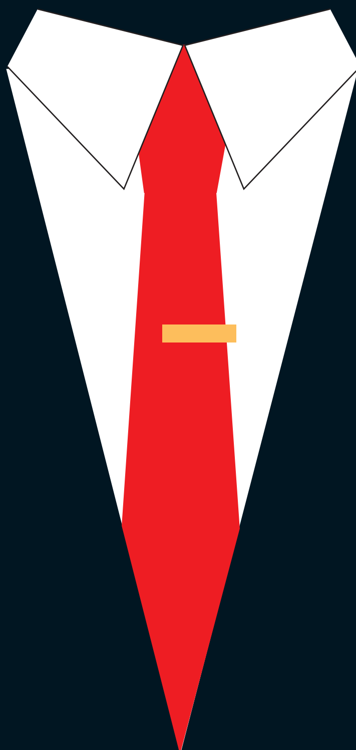
Roger Bate runs the website ***www.searchingforsafety.com*** which houses many of the sources of information discussed in this article

NOT SO... MADMEN

Advertising is one of the many issues where economic evidence clashes with received wisdom. The economist Julian Simon once wrote that 'the economic study of advertising is not deserving of great attention', ruefully adding that 'this is not a congenial point at which to arrive after spending several years working on the subject'.



Very few economists have dedicated as much time to the topic as Simon and most ignore it entirely because its impact on a nation's economy, though broadly beneficial, is not thought to be terribly important. By contrast, critics of advertising – of whom there are many – see it as a powerful and malign force that allows businesses to exert control over the public. The most common complaint is that clever marketing manipulates people into buying products they do not really want while encouraging a culture of rampant consumerism. Some want advertising heavily restricted or even banned.

The empirical evidence simply does not support the critics' view. Advertising can help develop brand loyalty in existing customers and it might – at best – entice us into trying

THE WEIGHT OF ECONOMIC EVIDENCE SHOWS THAT ADVERTISING FOLLOWS SOCIAL TRENDS, IT DOES NOT INITIATE THEM

a particular brand, but it cannot make us regular customers and it cannot coerce us into fundamentally changing our behaviour. The weight of economic evidence shows that advertising follows social trends, it does not initiate them, and companies only start spending the big marketing bucks when they are confident that demand already exists. Advertising is overwhelmingly aimed at getting existing users of a product to either switch brands or stay loyal to their current brand. Advertising campaigns are often described as 'aggressive', but the business of advertising is largely defensive. As much as companies want to attract new customers, their priority is to stop existing customers drifting off to the competition. The ubiquity of expensive marketing campaigns in developed countries is not an expression of corporate power, as critics claim, but of corporate vulnerability. From their perspective, we consumers are treacherously fickle and disloyal.

It is not that businesses would not like to manipulate us into buying products we do not want, only that the lever of manipulation has never been invented. As governments soon discover when they use advertising to encourage us to get out to vote or to eat 'five a day', it is very difficult to make people do things that they are not already minded to do.

Much of the empirical evidence about advertising's effect on business is mixed. It tends to be associated with profitability, but there are plenty of exceptions. It tends to promote competition, but not always. Some advertising works, some does not – and it is difficult for companies to predict in advance which will work and which will not.

But, say the critics, if advertising is not very important, why do businesses spend so much money on it? One answer is that they actually don't spend a great deal of money on it. Advertising typically makes up two per cent of a business's expenditure, often much less. The other answer is that, for all its faults, advertising remains a better way of communicating with the buying public than any of the alternatives. Travelling salesmen and discount vouchers might work for some companies, but to reach a mass audience and develop economies of scale, the mass media is required.

It is because advertising shifts demand from one company to another that it is of more interest to businessmen than economists. The only people who really take advertising seriously are the academics who hate it and the advertising executives who love it. The rest of us learn to treat advertising messages with scepticism from a very young age. But, although marketing is a fringe issue in economics, its benefits to the consumer should not be overlooked. It provides information, albeit from a biased source, it saves us time by reducing search costs, and it is generally associated with lower prices and higher quality. Advertising is an imperfect means to achieve the goals of both the buyer and the seller, but we would all be worse off without it.

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