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THE BIG CHILL

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WELCOME

… to the **Spring 2014 edition** of **EA**, featuring some of the **world's foremost economists** – and that's not a phrase I use lightly.

On page 32, **STEVE HANKE** – once described as **one of the 25 most influential people on the planet** – scrutinises the World Bank's Doing Business report – and shows how **market-led strategies** have created the **Singapore success story**.

On page 14, the **renowned JAGDISH BHAGWATI** is the subject of an **illuminating interview** on **growth in India** – and how trade can help the world's poorest people.

Nobel Prize winner, the late **RONALD COASE** – **perhaps one of the greatest economists in history** – is profiled in Foundations, a new series providing **insights for budding economists** (page 26).

And on page 25 we reveal details of this year's IEA Hayek Lecture by **PROFESSOR JOHN TAYLOR** – ranked by Bloomberg in 2012 as **one of the world's 10 most influential economists** – and a man whose work plays a **major part in A-level economics syllabuses**. Be sure to book your seats.

All this, plus a fascinating – and terrifying – look at the **true extent of government debt** in the **world's leading economies** in our cover story, **THE BIG CHILL**.

And, of course, much more.

I trust you'll find this latest spring edition of **EA informative**, **insightful** and **inspirational**.

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RUNNING on EMPTY

In recent months, there have been calls from many quarters to deal with the problems of stagnant standards of living by imposing price floors on wages and price ceilings on rents and energy.

But such policies have a long track record of creating shortages – in housing, power and fuel.

CHRISTOPHER J. COYNE and RACHEL L. COYNE say it's a fallacy to suggest that price controls improve living standards…

On September 25th, 2013, the *Financial Times* published an article entitled, "Labour leader Ed Miliband defends UK energy reform pledge". The article discusses Miliband's proposed reforms which include the introduction of energy price controls in the form of a 20-month freeze on gas and electricity prices. Miliband argues that his policy, if implemented, will address what he calls the "cost of living crisis" in the UK.

This ongoing debate provides an excellent opportunity to review whether price controls are an effective means to achieving the end of improving standards of living. To foreshadow our conclusion, they are not.

Price controls refer to government-imposed restrictions on how much can be charged for a good or service in the market. There are two types of price controls. A price ceiling restricts prices from exceeding a maximum price determined by government – for example, Miliband's proposed ceiling on energy prices. A price floor, in contrast, prohibits the charging of prices below a pre-determined minimum – for example, the minimum wage.

From an economic standpoint, price controls are problematic because they distort the price mechanism's ability to allocate resources to their highest valued uses. In unhampered markets, prices work to co-ordinate supply and demand and ration existing resources efficiently. By legally manipulating the market price, price controls distort this process. This distortion has both direct and indirect perverse consequences.

The direct effects of price controls

The direct effects refer to shortages created by price ceilings and surpluses created by price floors.

Consider an unhampered market in energy where supply and demand is balanced by the free-functioning price mechanism. If the government imposes a price ceiling below the market price, the quantity of energy supplied will fall, while the quantity of energy demanded will increase. The result will be a shortage of energy in that consumers who desire energy at the artificially lower price are unable to find an adequate supply.

The logic of price floors is the opposite. Suppose, for example, that the market for labour is coordinated through genuine market prices. In this case supply and demand will tend to be brought into balance. Now suppose the government imposes a minimum wage, above the equilibrium wage, with the goal of improving standards of living.

Under the artificially high price, the quantity of labour supplied will exceed the quantity of labour demanded resulting in a surplus of labour. In other words, workers who want to work at the artificially high price will be unable to find employment. There is a genuine welfare loss here. Workers who could be productive and receiving a wage will not be producing anything or receiving any wage if the minimum wage is above their level of productivity.

It is important to note that price controls do not make everyone worse off. Those who are able to secure goods at the artificially low price – in the case of a price ceiling – or those who are lucky enough to obtain a higher price for their services – in the case of a price floor – are made better off.

At the same time, those who are unable to secure the desired good, due to a shortage, or those who are unable to find a buyer for their goods, in the case of a surplus, are made worse off because of the price control.

The indirect effects of price controls

In addition to the direct effects of price controls, there are also a series of indirect negative effects emerging from government manipulation of prices.

While price controls do legally change the price, they cannot overcome the fundamental economic issue of deciding how to allocate scarce resources among an array of feasible alternatives. In the absence of the ability to use prices to ration scarce goods, alternative mechanisms emerge.

For example, shortages lead to long queues resulting from excess

"ECONOMISTS HAVE LONG BEEN SAYING THAT THERE IS NO FREE LUNCH BUT POLITICIANS GET ELECTED BY PROMISING FREE LUNCHES. CONTROLLING PRICES CREATES THE ILLUSION OF FREE LUNCHES"

– Thomas Sowell

demand for the good or service in question. This dynamic was evident in the centrally planned economies of Eastern Europe as well as in the US in the 1970s when the government imposed price controls on petrol.

Long queues tend to lead to subsequent government interventions with rationing schemes. For example, the US government reacted to long queues for petrol by limiting consumer purchases of petrol to every second day depending on the last number of their registration plate.

The emergence of crime and black markets are other indirect negative effects of price controls. Unable to adjust prices legally, producers and buyers may move into the extra-legal market to engage in exchange. Others, desperate to obtain goods for which there is a shortage, may engage in theft.

To provide one illustration of black market activities, consider the case of farmers in the UK during World War II. Facing wartime meat rationing, many farmers would under-report animal births to the Ministry of Food and then sell the additional meat in the black market.

Yet another indirect effect of price controls is avoidance which can take on a variety of forms.

For example, facing a price ceiling, sellers may charge additional fees or tie-ins to compensate for the fact that prices are required to be artificially low. Yet another manifestation of price control evasion is deterioration in the quality of the product itself. This may include the substitution of low-quality for high-quality ingredients in the production of the good itself, poor customer service, or lower investment in maintaining or improving the provision of services: supply can be made equal to demand by changing either the price or the quantity and, if the first is illegal, the second will be used more often.

In addition to affecting customers in the short term, quality deterioration will also affect consumers in the long run. In the face of price controls, suppliers will have a disincentive to invest in expanding production of the controlled good in future periods.

For example, price controls on energy will discourage investments in increased energy production in the future. This is problematic precisely because this increased supply of energy would lower the

price of energy in the future, the very end that proponents of price controls are seeking.

Controls of energy prices have been tried before – and failed.

Returning to the present situation in the UK, what can we say about Ed Miliband's claim that price controls on energy would lower costs and improve standards of living?

It is true that the price of energy itself would be lower due to the legal mandate. But we would expect this to be offset with energy producers compensating on other margins either through additional fees or deterioration in service.

In this regard it would be wise to look at California's experience with price controls on retail energy which led to shortages, manifested in rolling power cuts throughout the state.

Most importantly, price controls would discourage energy companies from making new, long-term investments, which is precisely what is needed to increase the supply of energy and improve standards of living.

What this means is that, at best, Miliband's strategy can provide benefits in the form of lower energy bills in the short term, but with the associated cost of some form of quality deterioration both in the immediate term and long term. This is precisely the opposite of what citizens of the UK need to improve their well being.

One issue remains. Given the problems inherent with price controls, why do they continue to remain popular among politicians and much of the public?

The answer to this question lies in the important difference between the seen and unseen. Price controls are readily observable – i.e., seen – in that the public can readily observe the lower price set by government. Given the difficulty of understanding and tracing the unseen - both the direct and indirect effects of price controls – it appears to many that these controls are pure benefit with little to no cost.

But the economic way of thinking indicates this is wrong-headed. If the goal is to improve standards of living, policy must focus on incentivising improved quality and availability. Price controls do exactly the opposite and, therefore, must be dismissed as a fallacy.

In reality, price controls lower the standards of living of many while providing political gains to few.

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The FRENCH CORRECTION

Showing why EUROPEAN GOVERNMENTS need a NEW APPROACH to AUSTERITY

For several years now, European governments have tried versions of austerity in an attempt to reduce the ratio of government debt to national income and in the hope of reviving the continent's failing economies.

But most of them, says VERONIQUE de RUGY, have failed. Indeed many believe these policies have actually made things far worse. Take France, for example…

F or months, the French economy has been stalled or shrinking.

Its debt to GDP ratio is growing and has now reached 90 per cent. The country's unemployment rate is well above 10 per cent, and a large number of rich and younger French people are leaving, seeking jobs or a more hospitable environment abroad.

More ominously, Reuters cited a recent OECD report which warned that France is "falling behind southern European countries that have cut labor costs and become leaner and meaner".

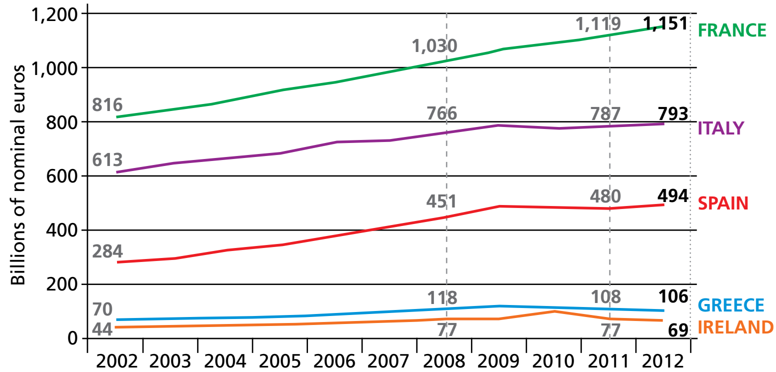
In fact, the whole mess led to Standard & Poor's decision to downgrade France to an AA+ bond rating, a move that outraged *New York Times* columnist Paul Krugman who seems to think that the downgrade has nothing to do with the country's economic health and is a plot against France for President Francois Hollande's refusal to pursue austerity measures and cut spending (a promise he made during his presidential campaign). Among other things, Krugman is well-known as an anti-austerity crusader who predicted a few years back that "Austrians" pushing for fiscal retrenchment would destroy Europe.

What type of austerity?

Unfortunately, the debate over the merits of austerity (the implementation of debt-reduction packages) has been a very frustrating one for two main reasons. Firstly, the word itself is confusing because it means different things to different people. That is because, in theory, a country can reduce its debt by increasing taxes, by cutting spending or by doing a mixture of both. What makes this more confusing is that not all policies meant to reduce the deficit and debt qualify as austerity measures. For example, policies that cut taxes can be growth inducing and lead to lower deficits because of their supply-side effects and therefore might have support from some supply-siders, as well as Keynesians.

The word austerity therefore causes a lot of misunderstanding on both sides of the political aisle. On the free-market side, people will say: "Where is the austerity in Europe?" when what they mean is "Spending wasn't cut very much in Europe, and often it wasn't cut at all". Their opponents will respond: "It is not true, austerity was implemented in Europe" while pointing to data about the size of fiscal-adjustment packages in Europe as a share of GDP.

Figure 1: Total government spending in selected euro zone countries



Source: Eurostat via European Commission. Accessed on May 1, 2013.
Note: Expenditure data accounts for all levels of government.

THE "BEST BUY" WHEN IT COMES TO DEBT REDUCTION IS STRUCTURAL REFORM COMBINED WITH SPENDING CUTS…INSTEAD IN EUROPE WE HAVE POLICIES THAT NEITHER SUPPLY SIDERS NOR KEYNESIANS WOULD RECOMMEND

In a sense, both sides are right, but are looking at the problem differently. Supply-siders want austerity in terms of government spending cuts and not tax increases (public-sector austerity rather than private-sector austerity) and Keynesians want neither.

Though austerity has taken place in Europe, with some rare exceptions the form of austerity has been to increase taxes and has not involved large spending cuts (*see figure1*).

In Greece, where there have been spending cuts and large tax increases, there was little chance that austerity, no matter what form it took, would work given that the country should have (or would have) defaulted if it were not for the numerous bailouts it has received over the last few years.

What does the research say?

This distinction between spending-cut austerity and tax-based austerity matters tremendously for the quality of this debate. That is because, as the large volume of work on fiscal adjustments by Harvard University economist Alberto Alesina suggests, when pursuing austerity, the important question has less to do with the size of the austerity package than the type of austerity measures implemented.

In fact, this is one of the rare areas of consensus in the academic literature: historically fiscal adjustments based more heavily on spending cuts are much more likely to achieve successful and lasting reductions in the debt-to-GDP ratio than tax rises. In their influential 2009 paper, Alesina and Silvia Ardagna looked at 107 examples in developed countries over 30 years and found that successful austerity packages – defined by a reduction in debt to GDP greater than 4.5 per cent after three years – resulted from making spending cuts without tax increases. This research is consistent with the work of economists at the IMF.

In 2010, Andrew Biggs, Kevin Hassett and Matthew Jensen of the American Enterprise Institute looked at how successful different kinds of spending cuts are at reducing the debt ratio. Consistent with other studies, they find that successful fiscal consolidations focus spending cuts in two areas: social transfers (which largely means entitlements in the American context), and the government wage bill (which means the size and pay of the public-sector workforce).

This should make intuitive sense to policy makers since austerity based on spending cuts signals that a country is serious about getting its fiscal house in order in a way that increasing taxes and continuing spending does not. Sadly, in a time of crisis (indeed especially in a time of crisis), lawmakers tend to adopt policies for the sake of politics rather than good policy. Countries in fiscal trouble generally got there through years of catering to interest groups and pro-spending constituencies (on both sides of the political divide) and their fiscal adjustments tend to make too many of these same mistakes. As a result, failed fiscal consolidations are more the rule than the exception.

The second source of frustration in this debate is that we tend to lump together the impact of fiscal adjustments on a country's debt and its impact on short-term growth. Yet these effects are very different and should be looked at separately.

Research shows that, while spending cuts will effectively reduce a country's debt, they can also lead to greater economic growth in the short term – though they do not necessarily do so. Alesina's work has shown that, in the past, austerity pursued through spending cuts accompanied by measures such as an appropriate monetary policy, liberalisation of goods and labour markets and other structural reforms is more likely to be associated with economic expansions rather than with recessions. Even Keynesian academics such as economist David Romer have admitted that possibility.

One leading paper in the austerity debate usually cited to show that spending cuts do not lead to economic growth is by IMF economists Jaime Guajardo, Daniel Leigh and Andrea Pescatori. But even this paper also shows that, whilst spending cuts can hurt the economy in the short run, they do not hurt the economy as much as tax increases.

These findings are consistent with the work that looks at the most recent attempts at austerity. The new work of Heritage Foundation economist Salim Furth looks at the data from the most recent episodes of fiscal adjustment, mostly in the USA and in Europe. He too finds very compelling evidence that raising taxes is not the way to go.

Supply-side only?

So, if the strongest research for the Keynesian case were accepted, it might lead to short-term concerns about growth if austerity were pursued through spending cuts. Does this mean a country should not try to reduce its debt by spending cuts and shouldn't engage in structural reforms designed to rein in its future debt by raising national income? I don't think so.

In fact, there is a strong case to be made that cutting spending and reforming a country's fundamental structural problems should be done independently of the impact on short-term growth, mostly because the alternative of doing nothing and letting long-term problems continue is not acceptable and will bring much more harm.

Indeed, if we look beyond the short term, spending cuts will tend to lead to more growth. In a recent paper co-authored with Harvard University's economist Robert Barro we look at the five-year impact of cuts to defence spending and we find that for each dollar cut the economy will grow by $1.30. Unfortunately, austerity critics refuse to acknowledge this point or even discuss it.

Worst buy debt reduction policies

In light of these findings we should not be surprised about the sad state of the French economy.

In a recent paper for the Heritage Foundation, I looked at the policies implemented by the French government since the crisis started in 2007. The data show that under both Presidents Nicolas Sarkozy and Francois Hollande "austerity" mostly took the form of spending increases and severe tax hikes.

Specifically the tax increases detailed in the case study (*below left*) are notable, taking account also of plans up to the end of 2014.

The bottom line is that French austerity is a case study of how to increase a country's debt and trigger a recession. ising taxes, raising spending and not reducing regulation is the "worst buy" policy when it comes to dealing with high levels of government debt.

Best-buy debt reduction policies

Knowing what to do to get governments out of debt and economies towards higher growth does not mean that it will be easy. European countries have the added problem that they cannot set their own monetary policy to ease some of the pain of cutting spending (for better or worse). France and many other euro zone countries also have a serious banking system problem, which is made worse by the fear of contagion from country to country and this is quite paralysing.

Yet, doing nothing is not an option. As such, I would like to see a debate over austerity that unbundles the type of austerity that has taken place and that separates the impact of austerity on debt levels and its impact on growth. Hopefully that will encourage countries to implement austerity packages that actually help their economies rather than hurt them.

The "best buy" when it comes to debt reduction is structural reform combined with spending cuts and, if at all possible, tax cuts. Instead in Europe we have policies of tax increases and, often, government spending increases that neither supply siders nor Keynesians would recommend.

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FRENCH AUSTERITY: A case study

- **Between 2007 and the end of 2012, taxpayers were subjected to 205 separate increases in their tax burden.**
- **The marginal income tax rate rose from 40 to 41 per cent in 2010 and again to 45 per cent in 2012.**
- **Though Hollande's proposed 75 per cent tax rate on personal income above €1 million was struck down by the Constitutional Council, this will be revived in 2014.**
- **Value Added Tax (VAT), which has been stable at 19.6 per cent since 2007, is scheduled to increase in 2014.**


THE
BIG CHILL
The STAGGERING SCALE of the
GOVERNMENT DEBT ICEBERG
A new IEA study warns that many major governments
are on course for fiscal calamity.
JAGADEESH GOKHALE and PHILIP BOOTH

We are all aware of the level of government debt.

However, governments do not produce sufficiently forward-looking accounting measures – ones that transparently reveal the extent to which a government's future financial commitments cannot be met by future receipts.

We are therefore generally in the dark about the true extent of government indebtedness under current fiscal policies.

As populations age, the tax base is likely to grow more slowly. At the same time, in all developed countries, government social security and healthcare spending will rise more rapidly because of promises that have been made to today's older and middle-aged generations.

No funds have been set aside to meet these future commitments and, in any meaningful economic sense, they represent government liabilities and a form of indebtedness.

This article presents the main findings of the recent IEA Research Monograph – *The Government Debt Iceberg* by Dr. Jagadeesh Gokhale, senior fellow at the Cato Institute in Washington D.C.

Like an iceberg, that part of the government's indebtedness that is visible, the explicit debt, is only a small proportion of the total.

To extend the metaphor further, by failing to consider timely revisions to current fiscal policies, many governments are heading for the iceberg, seemingly unaware of the calamity they are facing.

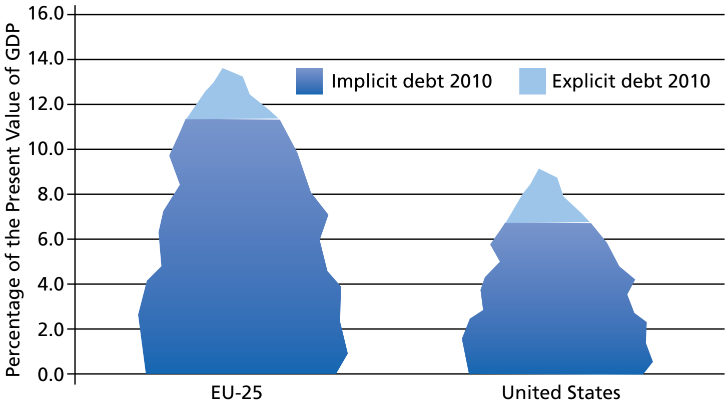
Short-term debt crises in the US and EU

The nominal value of outstanding explicit government debt is easily measured and reported. It is this debt that, for example, amounts to around 80 per cent of national income in the UK.

However, other government commitments – such as those to pay future pensions and provide healthcare – may be even more certain and predictable than the government's explicit debt.

Different forms of future spending commitments have different levels of certainty attached to them, but government promises to pay future pensions to public sector workers, for example, are probably even more difficult to renege on than commitments to repay explicit government debt. The unfunded portions of these commitments are not included in

Figure 1: Indebtedness icebergs in the European Union and the United States. Explicit and implicit debt as a percentage of the present value of GDP*



* Fiscal imbalance is represented by the peaks and not the areas of the icebergs

national debt measures.

The partial US government shut-down and the delay in congressional approval of a debt-limit increase until the very last minute has cast a bright spotlight

TOTAL US GOVERNMENT DEBT IS AROUND 100 PER CENT OF NATIONAL INCOME

on the processes and constraints lawmakers must navigate to achieve even temporarily acceptable outcomes in an era of rising debt.

The temporary resumption of US federal operations and small increase in the US federal debt limit provides a limited window for budget policy negotiations between lawmakers with starkly different policy preferences.

However, the focus has been very much on short-term crisis management and the level of debt that has accumulated as a result of past policy decisions. That debt is, itself, enormous: total US government debt is around 100 per cent of national income.

The short-term situation in Europe is not too different from that in the US, though the longer-term outlook is even more problematic, as we shall see.

In the euro zone, monetary union enabled governments to borrow at low interest rates – which less competitive nations did in excess.

In some euro zone countries, such as Spain and Ireland, governments bailed out banks, as happened also in the UK.

The recession that followed the financial crisis then led to revenue implosions and explicit debt levels increased rapidly. EU nations have witnessed sovereign debt levels surge from 60 per cent of national income during the mid-2000s to 85 per cent today.

The iceberg beneath the surface

Traditional national debt measures are backward looking. They show the extent to which governments have not been able to meet spending commitments from taxation historically. Additionally, traditional debt measures constitute only the tip of the debt iceberg.

Any proper approach to accounting also measures future commitments that would not be covered by future receipts: that is how insurance companies, for example, account.

A proper economic measure of government indebtedness measures the extent to which all future spending plans cannot be financed by current taxation plans – the sum of explicit debt (inherited from the past) and future excess spending commitments is known as the fiscal imbalance. It shows the effect of today's spending and tax policies that, if continued, will determine the evolution of explicit debt in the future.

The upward march of explicit debt will continue under today's policies as ageing baby-boomers in both the US and the EU are due to be paid retirement and health care benefits at a time when the growth of government receipts is likely to remain slow or plateau.

Policies may be changed in the future. However, policy changes should be judged according to their impact on the size of the fiscal imbalance and not simply according to their impact on the current government debt.

For example, in some EU countries, private pension funds have been nationalised to reduce the national debt, but the citizens who owned those funds have been given promises of future government pensions instead. The current national debt is reduced but the long-term future sustainability of government finances is not improved.

The fiscal imbalance shows by just how much policy has to change in order for the government to balance the books in the long term. Any policy changes to bring government finances back to a sustainable position are likely to affect younger and future generations negatively, because they will, in all likelihood, have to either pay more taxes or have their benefits curtailed below their expectations.

Changing policy course, dealing with long-term indebtedness and getting government finances on a sustainable long-term footing will not be easy.

Sustained and large prospective fiscal imbalances usually arise from rapid projected growth in social protection expenditures because of ongoing demographic shifts.

The beneficiaries of such programmes usually enjoy considerable security in their benefits. The benefits are usually strongly entrenched – either supported by difficult-to-reverse court judgments, constitutional guarantees or protected by large and influential political interest groups. Such benefit obligations are also frequently protected against erosion through inflation.

That may make prospective obligations on account of such programmes just as inviolable as payment obligations on government bonds.

Item	Included in explicit debt figures	Included in implicit government debt
Accumulated government debt	Yes	Yes
Future pensions promised to public sector workers	No	Yes
Future state pensions in social security schemes	No	Yes
Future healthcare costs for an ageing population	No	Yes
Future spending on defence, education etc. that cannot be financed at current tax rates	No	Yes

The complete indebtedness measure

The extent of public indebtedness and policy choices available to resolve it will largely determine the future economic environments in the EU and the United States.

Key questions concern whether those policies and resulting economic conditions will remain conducive to advancing living standards through sustained output growth, or whether the long-term austerity required to resolve fiscal imbalances will perpetuate economic stagnation.

THE US IS SAILING TOWARDS THE FISCAL ICEBERG WITHOUT CHANGING COURSE, ALONG WITH THE UK AND OTHER EU COUNTRIES

Moreover, decomposing such forward-looking fiscal imbalance metrics can help in assessing how future policy changes would affect different generations – young and middle-aged workers versus retired generations.

How large are the indebtedness icebergs for the EU and the United States? *Figure 1* shows the results for EU-25 nations (as a whole) and the United States.

For the EU as a whole, the total fiscal imbalance equals 13.5 per cent of the present value of future projected GDP. The explicit debt is 2.1 percentage points of future GDP (this is roughly 85 per cent of the current year's GDP mentioned above). The implicit debt relating to future spending commitments not financed by current tax plans is 11.4 per cent of the present value of GDP (over five times the explicit debt).

The United States' federal fiscal imbalance is 9.0 per cent, of which 2.2 per cent of the present value of GDP represents the explicit debt.

It is immediately noticeable that, although the EU and the US have similar ratios of explicit debt, the EU has a much larger ratio of implicit debt.

The higher EU implicit debt arises partly as a result of demography and partly as a result of policy decisions.

EU expenditures on social protection programmes are around 30 per cent of GDP compared with 15 per cent in the US. It is social protection spending which is especially prone to increasing as populations age.

This problem is then compounded by more rapid population ageing in the EU. EU countries will have smaller worker-to-retiree population ratios in the future.

That ratio is currently just above 5.0 in the US and about 3.5 in the EU. By 2040 the ratio is projected to be about 3.1 in the US and 1.8 in the EU.

A relatively lower and declining worker-to-population ratio also contributes towards higher implicit debt in the EU compared with the United States.

Policy options in the short and long terms

Recently, weaker EU nations have responded to rising explicit debt levels by imposing unpopular but unavoidable austerity policies while continuing to spend money on crucial government functions through bailouts from international agencies and stronger EU countries.

But the long-term fiscal picture examined in this monograph shows that even the economically stronger

EU nations such as Germany, Finland and the Netherlands, must deal with the long-term fiscal imbalance problems arising from pensions, healthcare and other social protection commitments.

The US fiscal imbalance mainly arises from its social security and Medicare programmes which support retiree consumption and health care expenditures.

Much of US policy reform will have to focus on bringing the finances of these programmes back into balance – something which will be a huge challenge given that most Americans have not saved to fund their own old age consumption and healthcare but, rather, rely on the taxes to be paid by future generations.

Closing the fiscal imbalance from the tax side would involve doubling federal taxes, from today into the indefinite future, or cutting all federal spending by over one third.

Resolving the fiscal imbalance in EU nations so that all spending could be financed by taxation would require, on average, an increase of 23.2 percentage points in the consumption tax rate – assuming that such a rise is feasible.

Alternatively, the fiscal imbalance could be closed by reducing health and social protection expenditure by about one half.

In the UK, total spending would have to be cut by more than one quarter or health and social protection expenditure by around one half compared with the level implied by current policy, to avoid tax increases if all spending is to be met from tax revenue in the long run.

Interestingly, the United States' spending sequestration adopted during early 2013 left major social safety net expenditures untouched. This is despite the fact that these areas have grown hugely in the last few years.

Similarly, the fiscal consolidation package in the UK has tended to spare pensions, health and other social protection programmes whilst cutting judicial, community and local government expenditures.

This policy is expected to improve private investment and economic growth prospects as market confidence in national budget sustainability improves. However, as far as the long-term budget position is concerned, both the US and UK are focusing on the wrong areas.

Unfortunately, we are unlikely to grow our way out of these problems. Many of the projected expenditures could increase if there is economic growth because the commitments are linked to wage growth, and most are protected against inflation during retirement.

Indeed, if countries do not address their fiscal imbalances now, the size of the necessary adjustment will increase over time, undermining investor confidence and reducing growth potential.

Instead, appropriate and timely structural changes to bring public finances into balance would be likely to spur economic growth.

EU NATIONS HAVE WITNESSED SOVEREIGN DEBT LEVELS SURGE FROM 60 PER CENT OF NATIONAL INCOME DURING THE MID-2000S TO 85 PER CENT TODAY

Conclusion

The long-term fiscal problems faced by most developed countries are much greater than is implied by government debt figures. It is possible that, in some countries, necessary reforms will be undertaken. However, things look grim in the US and most of the EU.

Given the differences in their preferences and the political and economic constraints they face in achieving fiscal policies that are acceptable to a bipartisan majority of lawmakers – even during the short-term – it remains quite unlikely that US national fiscal policies will soon be placed on a long-term sustainable course. The US is sailing towards the fiscal iceberg without changing course, along with the UK and other EU countries.

It is fair to say that, in some countries, measures have been planned which will ease the situation. The UK is raising the state pension age for example. However, it is being raised so slowly that life expectation at retirement will be longer at the end of that process than at the beginning.

These measures are inadequate, and little is being done to ensure that individuals save for and fund future pension and healthcare costs so that these growing costs are not borne by a shrinking tax base.

For current students, the long-term fiscal position of governments is one of the crucial issues for their generation. If today's fiscal course is continued for much longer, their expectations are likely to be disappointed – either in terms of higher future tax rates or in terms of reduced future benefits that will be provided by government.

Those larger fiscal burdens will be likely to increase tax-avoidance efforts on the part of mobile productive factors – capital and skilled workers. As the IEA Research Monograph by Dr. Gokhale clarifies, the quicker governments change policy, the more painlessly the situation will be resolved.

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INDIA: a recipe for GROWTH

JAGDISH BHAGWATI is one of the world's leading economists and an expert on trade, globalisation and the Indian economy.

He recently published *Why Growth Matters: How Economic Growth in India Reduced Poverty and the Lessons for Other Developing Countries*, co-authored with Arvind Panagariya, which was picked as a 'best book' of 2013 by the Financial Times.

Bhagwati was also the fictional winner of the Nobel Prize in an episode of the Simpsons!

In this interview with IEA Editorial Director PHILIP BOOTH, Professor Bhagwati discusses the relationship between trade, economic reform, growth and poverty in India, while also clarifying, at the editor's request, Amartya Sen's critiques and arguing why they are misplaced…

What does the empirical evidence suggest about the benefits of opening up trade for the world's poorest people?

The argument about trade helping alleviate poverty is analytically based on two propositions: firstly, trade leads to growth; and, secondly, growth reduces poverty. In turn, the latter proposition can be broken down into two component causations which I developed over a quarter century ago in a lecture on poverty and public policy: (1) that growth pulls up the poor above the poverty line (making it an activist "pull up" rather than a passive "trickle down" process); and (2) it generates revenue that will enable governments to spend on areas such as health and education for the poor. Every one of these propositions is empirically testable, of course.

DOES TRADE LEAD TO GROWTH? THAT IS CLEARLY OBSERVABLE

So, does trade lead to growth? That is clearly observable. But there are two obvious caveats. The trade opportunity has to be exploited or it does not lead to results. If you open the door but you have no traction in your legs, you will not go through the door. Also, we must ask whether such growth is sustainable. I once asked the trade-sceptic Dani Rodrik, who says that there are instances where autarky has also been associated with growth, whether growth associated with autarky was sustainable. My answer to this question is illustrated by the story of how Joan Robinson, my radical Cambridge tutor, and Gus Ranis of Yale University were once observed agreeing that Korean growth was a miracle, causing astonishment, until the audience realised that she was talking about North Korea and he was talking about South Korea! Now, of course, we know which Korean miracle was sustainable. Equally, in *The World Economy* Arvind Panagariya has analysed a lot of cross-country data and found strong correlations between high (low) economic growth and high (low) growth rates of exports. Of course, the causation can go from growth to exports; but is this really plausible except in special cases?

Next, as for growth affecting poverty favourably, there is much empirical evidence to support that element of the argument as well. As Panagariya and I explain in *Why Growth Matters*, detailed country studies, such as for India, show that poverty was hardly dented during periods of little growth resulting from bad economic policies and then was reduced dramatically once growth took off after the 1991 reforms.

What were the main reasons for India's poor growth performance and high levels of absolute poverty in the 45 years following independence?

The low growth rates – total national income grew at roughly 3.5 per cent a year but population was growing at 2 per cent - came after India adopted a series of bad economic policies that crippled the economy's efficiency. These bad policies were embraced with added vigour when Prime Minister Indira Gandhi came into power with the support of the left-wing Congressmen: a marriage of convenience turning into a bonding which turned into a kiss of death for the country.

How did the 1991 reforms contribute to increasing economic growth in India?

The pre-reforms policy framework consisted of the following key elements:

1. A senseless maze of controls: one thinks of course of Kafka but I once remarked more appropriately that India's problem was that Adam Smith's invisible hand was nowhere to be seen!

2. Massive proliferation of public enterprises which were grossly inefficient and loss-making. Once Amartya Sen defended them by arguing from familiar economic theory that the losses were compatible with social good, revealing that good policy sense means choosing an appropriate model to examine a problem. By contrast, John Kenneth Galbraith, who was US Ambassador in India at the time, showed acute

commonsense and policy grasp by describing the approach as "Post Office Socialism".

3. Autarky in trade: the Indian share of trade in GNP, and share in world trade, had both fallen thanks to tariffs, quotas, import licensing etc. Again, the left-wing economists were supportive of such autarky and there is no evidence otherwise apart from unprovable assertions. For example, Amartya Sen says he "told Manmohan", the prime minister now, that he supported liberalisation. But, why did he not write publicly and forcefully about it? After all, he is not shy otherwise.

4. A jaundiced view, and virtual rejection, of inward foreign direct investment (FDI); again there are quotable assertions by Amartya Sen and his colleague, the activist Jean Dreze, that Indians spend too much time considering whether Coca Cola should be allowed to invest and too little on discussing poverty, blissfully ignorant that FDI has often been a source of growth that led to poverty reduction. When the 1991 reforms started, the equity investment in India was as little as US$100 million!

These "anti-growth" policies began to be swept away in 1991. It was, however, like cleaning up after a tsunami. And the task is not yet complete, as Panagariya and I explain in depth in our book.

"ANTI-GROWTH" POLICIES BEGAN TO BE SWEPT AWAY IN 1991. IT WAS, HOWEVER, LIKE CLEANING UP AFTER A TSUNAMI

INDIA NEEDS LAND AND LABOUR-MARKET REFORM AND PRODUCT-MARKET DEREGULATION IN ORDER THAT MARKETS CAN DEVELOP THAT SERVE AND ENRICH THE POOR

Is it the case, as some people suggest, that increased growth has not translated into improved living standards for the majority of India's poor?
This is one of the many myths we destroy in Part I of our book. We cite empirical studies, some commissioned by us as part of a massive research project on such issues, that show that poverty has diminished since the reforms accelerated growth, and that the improvement in income extends to all marginalised groups such as women, scheduled tribes (ST), scheduled classes (SC) and Untouchables (Dalits). The studies by the noted political scientist Al Stepan also show that these groups are aware of their gains and also believe by a majority that their economic situation will continue to improve.

What more needs to be done to reduce poverty in India still further?
We have shown that growth in India has been "inclusive". But we also argue that we have had less impact on poverty with our growth than the Far Eastern economies have. Among the central differences has been that India has not used labour-intensive industrialisation (which increases demand for labour) and has relied more on skill-intensive and capital-intensive industrialisation (which tends to reduce the gains in wages). India needs land and labour-market reform and product-market deregulation in order that markets can develop that serve and enrich the poor. This might include, for example, allowing the entry of Wal-Mart and other big retailers which would enable small farmers to access foreign markets more effectively and bring wider benefits.

What are the obstacles to good policy in India and other poor and middle-income countries?
The obstacle to good policy in India is that any time the government tries to add to the reforms, the same set of left-leaning critics go into battle against them, all over again. This is why we have been brutally frank about their assertions in our book. As I sometimes say, their conclusions are more obvious than their arguments. It is noteworthy that Amartya Sen, who is certainly a fine economist when he sticks to theory, has appropriated the phrase that Indians are "argumentative" (which I used in a very different context some time ago to suggest that Indo-US relations were strained because Indians argued back with aid-dispensing Americans who were then offended) to suggest, astonishingly, that today's India is a Habermasian democracy. At the same time, he has refused to debate me on the economic arguments in the recent Bhagwati-Panagariya book: some argumentative Indian!

How would you characterise the differences between your own position and that of Amartya Sen, who has also participated in debates about economic reform in India?
Sen has made ex cathedra criticisms, but, as I stated above, he avoids a debate, telling journalists that "Jagdish wants to debate me but I do not want to debate him"! I have written an article that I have titled an epitaph for a debate that was not!

I have already indicated above that Sen was opposed, or failed to endorse wholeheartedly, nearly all the reforms that started dramatically in 1991 and which increased the growth rate and reduced poverty. Despite belated assertions to the contrary, he has produced no evidence whatsoever that he was in favour of the 1991 reforms. So I have argued bluntly that in this instance his sin with regard to reducing poverty was one of omission.

Now, he wants to make up for this by asking for more money to be spent on health and education and employment guarantee schemes. But where is the money to come from, if not from growth? As the present government plans to increase such spending while the revenue intake is slowing down with sluggish growth, Sen is in the position of supporting, wittingly or unwittingly, excess spending which will lead to more inflation, which will certainly harm, not help, the poor and the lower middle class. So, Sen is now guilty of a sin of commission as far as poverty reduction is concerned.

I might also add that one important difference between us is that I argue that, in countries such as India, Indonesia, Brazil and China, where there are many poor and few rich, social spending ("redistribution") is not a sensible programme for aiding the poor. Why? Because, as the famous Polish economist Kaleci told me in 1961/62 when I was working on poverty reduction in the Indian Planning Commission, "Bhagwati: India has too many exploited and too few exploiters". Even if you expropriated or taxed away the incomes at the top, and used the money to help the poor, you could give them maybe one more chapatti a day; and that too would not be sustainable if the population grew. So, my solution was that we should grow and that growth would generate the revenues which then could be spent on health, education etc. for the poor.

Sen has occasionally argued as if the added chapatti a day would produce growth and hence the revenues for further social spending. Yes, sometimes you can have your cake and eat it. But Sen has never produced any empirical argument to support this euphoric claim!

Instead he has also claimed that education would have a great payoff in terms of growth (for example, in his letter to The Economist where he attacks me angrily for misrepresenting him). He invokes Singapore. But the high level of literacy inherited from the Japanese would in itself have led to little in that country. It was the export-oriented growth that led to embodied technology being imported and the high literacy made it possible to gain more from the advanced machines. Without the growth strategy, based on outward orientation of the economy to the world, the high levels of literacy would have amounted to a hill of beans. In arguing otherwise, I am afraid that Sen reminds me of Kevin Costner in the film, *A Field of Dreams*.

I might also cite my co-author Panagariya, who has written about South Korea. He notes that there was a massive increase in literacy from very low rates to 84.5 per cent for males and more than 85 per cent for females by 1966. Yet during this expansion of literacy, growth was modest. For example, from 1954-62 it was just 4.2 per cent. Growth accelerated only from 1963 and this was due to other changes in policy, including those that led to a massive increase in labour-intensive exports.

Again, it is absurd to claim that India could have supported, despite the huge numbers of our poor, the level of expenditure on education in the early years that we could afford much later only after growth had occurred and revenues had been increased. Panagariya has produced the telling calculation that it would have taken a whopping 22 per cent of GDP in 1950-51 to reach the current, post-reforms, per capita expenditure on education!

THE CEASELESS DECLAMATIONS BY PRESIDENT OBAMA AGAINST OUTSOURCING AND AGAINST IMPORTS ARE DEPLORABLE

When it comes to trade, how can the West reform policy in a way that would benefit both Western consumers and the world's poorest people?

Developed countries should keep their markets open. This is where the ceaseless declamations by President Obama against outsourcing and against imports are deplorable: that is not leadership. In fact, he sounds exactly like Lou Dobbs, now not in his CNN job, who used to talk in much the same way: but what Lou Dobbs said mattered less because he was not the US President and he did not have the mellifluous voice of President Obama!

THE LIVING WAGE

…is a concept that's gaining traction and support in both the UK and US – and it seems here to stay. But PROFESSOR STAN SIEBERT argues that it doesn't help the really poor. Instead, it only succeeds in…

Giving to the haves

The living wage campaign is designed to relieve poverty, but it is misdirected because being jobless is the most important cause of poverty. Also, low pay is the result of low skills. We all wish to see a continuing reduction in poverty, but we need to address the underlying issues of poverty.

By tackling the structural issues, we can get to the root causes of poverty, such as poor education and family breakdown, rather than masking them through the living wage which benefits those working in prospering firms whilst doing nothing for the really poor.

The concept of the living wage is attractive, and it is receiving well-funded support both in the UK and the US. The Resolution Foundation's latest report (Lawton and Pennycook, 2013) shows this support. The paper is well written, and has good ideas on how to advance the living wage, including amending the corporate governance code to require listed companies to publish the proportion of their staff paid below the living wage.

There is now a "living wage accreditation process" to which several local authorities have signed up, as well as high profile private sector employers such as KPMG, Deloitte, Linklaters and Lloyd's of London.

The living wage is also receiving heavyweight academic support with Professor Alan Manning of the LSE (2012, p 23) envisaging the Low Pay Commission making "non-binding judgements" on affordable wages by sector. He sees such judgements as strengthening the arm of employees in securing better pay deals (and perhaps trade unionism would be strengthened thereby).

The living wage campaign seems here to stay, and we need informed discussion about this policy. Five arguments against the living wage are given below.

Jobs are vital to improving living standards

The best research here is by Steve Nickell who says simply (2004, p C2):"worklessness is a key factor" in determining whether people are poor.

Using a relative definition of poverty (see below for an examination of the concept of absolute poverty) based on receiving less than 60 per cent of median household income after housing costs, Nickell points out that about 20 per cent of people in the UK are poor, and this happens mostly when no-one in the household works. From his data, we can construct *Table 1* for individual poverty in 2000.

	% individuals	% of each type in poverty	% contribution to overall poverty
Workless	17	64	51
Part-time work	10	29	14
Single/couple one or both full-time working	73	8	35
Total	**100**	**21**	**100**

Table 1: Poverty and work status *Source: Nickell (2004) Table 2.*

	Lowest level literacy	Lowest level, quantitative literacy
UK	22 (17)	23 (25)
Germany	14 (19)	7 (21)
Netherlands	11 (12)	10 (14)
Sweden	8 (13)	7 (13)
US	21 (22)	21 (33)

Table 2: Adult illiteracy, mid-1990s

Source: Nickell 2004. Scores are from the International Adult Literacy Survey (IALS) in mid-1990s (bracketed scores OECD 2013 Adult Skills Survey – 16-65 ages). Note: Quantitative literacy measures knowledge of basic mathematics.

We see that 27 per cent of people are either workless, or only in part-time work. These groups are highly likely to be relatively poor. For example, 64 per cent of the workless are in poverty. Only 8 per cent of those in full-time work are in poverty.

Because the living wage cannot reach those without work, and many of those in work who would benefit from the living wage are from well-off families, it cannot help the really poor.

Lawton and Pennycook (2013, p36) even admit that only 10 per cent of low earners live in poor households, so that (p37) "the biggest beneficiaries from broader LW coverage would be middle income households". This is, indeed, a very interesting concession from the proponents of a living wage.

The UK's school and welfare systems fail the poor

Of course, getting people into work, and raising their skills so that they earn more in work are the problems that need to be solved.

The UK has a high percentage of adults who are poorly skilled. *Table 2* shows how the UK is as bad as the US, which is a much bigger and more heterogeneous country.

Countries such as the Netherlands and Sweden do much better than we do with those at the bottom end of the ability range in the education system.

We should try to address this problem through the education system. However, it is worth noting that family breakdown leads to poor schooling and poor employment prospects.

Iain Duncan Smith, Secretary of State for Work and Pensions (CSJ, 2007, p5) puts it well: "In the UK we now have one of the highest divorce rates, and the fabric of family life has been stripped away...with destructive effects upon millions of children...and links with addictions, educational failure and serious debt".

Table 3 shows the progressive breakdown of the family. This breakdown links to the way in which the welfare state penalises intact couples with children, the "partnership penalty".

For example, in a typical household where the man earns £15,000 and the woman (caring for children) £5000, living together brings £2,300 in benefits; but, by living apart, the female carer gains £7,800 (CSJ, 2007, p89), a partnership penalty of £5,500.

This penalty is felt only by low earners who become progressively more entrapped by the welfare system, a process well explained in Charles Murray's famous 1984 book "Losing Ground".

These problems need to be addressed via changing the welfare system, and improving the school system, including, for example, reducing local authority and union control. But the living wage has nothing to contribute to these important issues.

BECAUSE THE LIVING WAGE CANNOT REACH THOSE WITHOUT WORK... IT CANNOT HELP THE REALLY POOR

The market works

It is important to emphasise that the free market has delivered real improvements in living standards for unskilled workers. These improvements have come about without social engineering or union action – or indeed a minimum wage.

Table 4 shows this real-terms improvement for the bottom 10 per cent – increases in real wages represent a considerable reduction in absolute poverty.

Moreover, it is interesting to note that the improvement has come as much in the 1986-98 period, before the national minimum wage, as after.

This absolute reduction in poverty has come about at the same time as relative poverty (measured by the ratio of the top to the bottom 10 per cent) has worsened, which shows that relative poverty can be misleading when it comes to consideration of the living standards of the poor.

The living wage is not especially "moral"

The living wage comes from the same school of thought as the national minimum wage. However, the living wage is intended only to apply

Percentage of families with dependent children	1972	1992	2001	2011
Lone parent	6	16	20	24
Couple	94	84	80	76

Table 3: The rise in lone parenthood

Sources: CSJ (2007, p26) and Labour Force Survey (LFS), Office for National Statistics selectively, raising wages only where they are already relatively high (amongst employees of government and big firms and, as we have seen, predominantly amongst people who are not in the least-well-off households).

Donald Hirsch (2012), for the Rowntree Foundation, believes "the moral pressures are winning out over the economic pressures for a number of employers wanting to be seen to be doing the right thing".

But the living wage would only help "the haves", which does not seem particularly praiseworthy or moral, especially if it came at the expense of high youth and long-term unemployment.

To give an idea of the groups that the living wage would pass over, *Table 5* shows long-term unemployment in terms of working-age incapacity benefit claimant rates.

We see, for example, that Cambridge has a rate of only 2.9 per cent, but Glasgow East has a rate of 16.8 per cent. In other words, people have given up looking for work and are seeking alternative pathways through the benefits system in places such as Glasgow and Liverpool because jobs are so scarce.

These are also areas of multiple deprivation, because nearly half of the families in Liverpool (CSJ 2007, p86) are also headed by a lone parent. Yet the living wage campaign would aim to raise wages in Wimbledon and Buckingham.

Real earnings, in 2011 prices	1986	1998	2011	Increase
Bottom 10% of earnings distribution £/hour	4.80	5.88	7.00	46%
Top 10%	14.78	22.13	26.75	81%
Ratio top/bottom	3.1	3.8	3.8	

Table 4: Increases in real earnings for the bottom 10 per cent *Source: ONS (2012)*

Parliamentary constituencies with highest incapacity benefit rates (population 16-64)		Parliamentary constituencies with lowest incapacity benefit rates	
Glasgow East	16.8	South Cambridgeshire	2.9
Glasgow North East	15.3	Maidenhead	2.7
Aberavon	15.0	Buckingham	2.4
Liverpool Walton	14.8	Wimbledon	2.3

Table 5: Incapacity benefit claimant rates, November 2011

Source: McInnes 2012 Table 3.

There are better policies than the living wage

A functioning market – which would require both lower benefits and lower wages in Liverpool than in Cambridge – would attract business, and relieve poor unemployed people.

Additionally, this would – if the planning system functioned properly – also attract people to move to seek higher-paid employment in more prosperous areas. To facilitate this, tax breaks for businesses in development areas could be considered.

John van Reenen from the LSE and Richard Lambert (formerly from the CBI) in an article in the FT on January 30th 2013 make three suggestions to improve productivity and wages based on people, infrastructure and innovation.

Under the people heading they call for better schooling and training, including more autonomy for schools to bring us to the levels of the Netherlands as mentioned above. They also call for more investment in transport, telecoms, energy and housing. Finally, they call for more competition in banking.

These ideas, if implemented properly, leave the living wage in the shade. They could be win-win policies rather than policies that lead some poor people to gain at the expense of others and people in relatively well-off households to gain at the expense of those who cannot get jobs•

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QE and the RICH

Poor old 'quantitative easing' (QE). Has there ever been an important economic policy that has been more thoroughly misunderstood and misjudged? TIM CONGDON

The rationale of QE is simple and can be explained in a few paragraphs. But much confused nonsense has been written about it, and that nonsense has led to foolish and unjustified criticism.

Did QE stop the Great Recession turning into the Great Depression?

Standard theory and a great deal of evidence argue that the demand to hold money balances is stable. This stability of the money demand function means that changes in the quantity of money and nominal national income are roughly equi-proportionate in the medium and long runs.

In other words, a change of a certain percentage in the quantity of money is accompanied by a change of more or less the same percentage in nominal national income.

Data from many countries over long periods of time show that this assumption is not silly, even if the short-run relationship between money and income is problematic.

Given these facts, most sensible people would accept that steady expansion of the quantity of money ought to be one aspect of macro-economic policy. They might have doubts and reservations about the emphasis to be placed on this principle, but almost everyone would surely endorse the view that stability in money growth is preferable to instability.

Unfortunately, in late 2008 and early 2009 many leading economies, including the UK, were close to a monetary disaster. If nothing had been done, the quantity of money was about to collapse by hundreds of billions of pounds.

Indeed, the prospective rate of decline, of about 1 per cent a month (or 10 per cent a year), was similar to that seen in the USA's Great Depression of 1929 to 1933, when the quantity of money went down by over a third in under four years.

The reasons for this parlous state of affairs are debated. Some 'experts' blame the banks for having too much risk in their balance sheets, and so being in danger of 'going bust' and failing to repay depositors in full.

Others say that banks were solvent throughout the crisis, and that they were obliged to shrink their loan portfolios and securities holdings only because of a sudden and misguided tightening of bank regulation which began in October 2008. But, whatever the precise cause of the trouble, a big fall in the quantity of money was imminent.

Fortunately, the creation of money by the state is easy. All that is required is for the government or the central bank to borrow from the commercial banks, and to use the proceeds of the loans to purchase anything (government securities, tanks and planes, old boots) from the non-bank private sector.

The effect of the purchases is to increase the bank deposits held by the private sector agents. People and companies can write cheques against the deposits, which are therefore

QE IS PART OF MONETARY POLICY AND MONETARY POLICY CANNOT IN THE LONG TERM CHANGE SO-CALLED "REAL VARIABLES" SUCH AS THE DISTRIBUTION OF INCOME BETWEEN LABOUR AND CAPITAL

money, and the new money balances can then circulate an indefinitely large number of times.

In essence, QE was and remains nothing more than the large-scale creation of money by the state. In the particular case of the UK, since early 2009 the amount involved has been about £400 billion.

Sure enough, in detail the mechanics of QE and the analysis of its effects can be hugely complicated. But the heart of it is that it caused the quantity of money to be about £400 billion – or roughly between 15 per cent and 20 per cent – higher in mid-2013 than it would otherwise have been.

Even allowing for some technical caveats, an unambitious conclusion is that nominal national income today is over 10 per cent above the level at which it would have been without QE.

Furthermore, QE did stop the Great Recession becoming the Great Depression that was threatening in early 2009.

QE and asset prices

It would be nice to think that QE would be given three cheers by the commentariat. However, that is not at all the case.

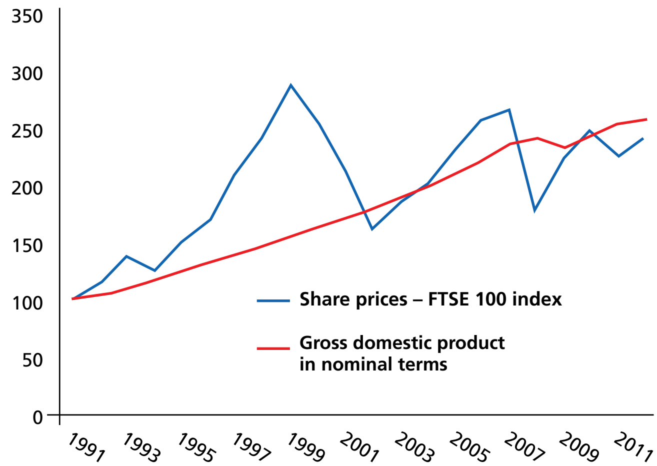
Many pundits give it one cheer for stopping a worse economic downturn, but say that it rescued the bankers, and bankers are wicked and undeserving by definition. Well-known columnists such as Liam Halligan in *The Sunday Telegraph* claim that QE is the last refuge of banana republics and bankrupt empires, and that it foreshadows hyperinflation. Another boo has come from critics who assert that QE gave an artificial boost to asset prices and was therefore biased in favour of the rich.

According to Merryn Somerset Webb in an article ("A policy that stigmatises the well-off") in the *Financial Times* on 12th October, in the aftermath of QE: "those with money have simply bid up prices of existing assets". The further consequences have been that QE "has pushed down the purchasing power of the general population and devastated their savings".

But QE is part of monetary policy and monetary policy cannot in the end change so-called "real variables" such as the distribution of income between labour and capital, or the valuation of some capital assets relative to others.

It must be admitted to Merryn Somerset Webb that asset price fluctuations are far more volatile than national income and that

Share prices and national income (1991=100)



short-run changes in asset prices are partly attributable to movements in the quantity of money.

But, in the long run, the real value of corporate and property assets depends on savers' preferences, not on monetary variables. Since the beginning of UK equity investment on modern professional lines in the early 20th century, the quantity of money and the level of national income have increased a very large number of times, but the valuation of equities has changed relatively little.

Because of the cyclical volatility of the stock market, share prices were depressed in early 2009, with the FTSE 100 index down at its worst point, in March, to a low of 3512. That was little better than half the all-time peak FTSE 100 figure of 6930 at the end of 1999. Since early 2009 the stock market has moved back towards the all-time peak, but never quite made it.

The figure shows that share prices and nominal national income have risen by more or less the same over the last 20 years taken as whole, but the year-by-year fluctuations have been much greater for share prices.

The recovery in the stock market between early 2009 and today was partly due to the increase in the quantity of money due to QE. This can be agreed.

Without QE the quantity of money and the UK equity market would have been much lower, and the recession would have been more intense than it was. This can also be agreed.

But QE cannot be blamed for the surge in share prices back towards the 1999 peak, since QE had not at that stage been invented.

Tim Congdon's
Money and Asset Prices in Boom and Bust
is available for free download at:
www.iea.org.uk/publications/research/money-and-asset-prices-in-boom-and-bust

Moreover, despite all this alleged favouritism of public policy towards the rich, the level of UK share prices today is lower than it was over a decade ago.

More generally, although asset prices are affected by monetary policy in the course of one business cycle, monetary policy cannot affect the real level of share prices, or income and wealth distribution, across a number of business cycles.

Further, it needs to be emphasised that QE has been good for demand, output and jobs, and the extra employment has been of greatest benefit to the poor.

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Ellie-lujah!

Congratulations to Ellie Heatherill, from Runshaw College in Leyland, Lancashire, who was chosen as winner of our Annual Essay Competition.

She won the **Dorian Fisher Memorial Prize** for her essay on "What do economists see as the sources of economic growth and which of these do you think is most important?"

Congratulations also to runners up Alexander Jackson, Daniel Dowe, and Tom Rutter.

An awards event took place at our Westminster headquarters for prize winners and those placed in the top 10.

Details of our 2014 competition will be published soon at ***www.iea.org.uk/essaycompetition***

Conference Call

Our programme of one-day conferences hosted at schools around the country continues to expand.

Recent events have taken place at Bromley Girls School; Bootham School, York; Nottingham High School; Loretto College, Middlesbrough; Royal Grammar School, Guildford; King Edward School, Stratford upon Avon and Radley College, Abingdon.

We're already planning our schedule for Autumn and Spring of the 2014-15 academic year.

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

The INTERN-ET!

Want to undertake supervised research and participate in a programme of educational events including lectures, debates, seminars, and discussions – as well as social events – for six weeks during the Summer?

Then you should apply to be part of our **Summer Intern Programme**, which runs from July to September.

This year we are inviting applications from people interested in taking part in specific research topics as part of a team, including Christian social teaching, and the private provision of 'public goods', as well as those from people who have a project of their own in mind•

Apply at ***www.iea.org.uk/ Students-and-teachers/internships***

ROADS to FREEDOM

The first regional event of the **UK Liberty League** took place in Manchester last October with over 60 attendees and speakers including the IEA's Dr Steve Davies.

This year's **Freedom Forum** – the largest youth political event in the UK – will be held in London on 11-13 April. Details can be found at the UK Liberty League website:
www.uklibertyleague.org

Applications are now open for this year's **Freedom Week**, to be held in Cambridge on 14-19 July. If you're interested in applying to attend and would like to learn more about liberty and free markets from top level academics, go to the Freedom Week website:
www.freedom-week.org

Taylor-made opportunity

PROFESSOR JOHN TAYLOR, of Stanford University and the Hoover Institution, will give our showpiece Hayek Memorial Lecture at Church House, Westminster, on June 25.

Bloomberg have listed Professor Taylor as **one of the world's 10 most influential economists** and his work plays **a major part in today's A-level economic syllabuses.**

His research made a **key contribution** to the changes in **monetary policy** that led to the long period of stability and growth from the early years until the financial crash.

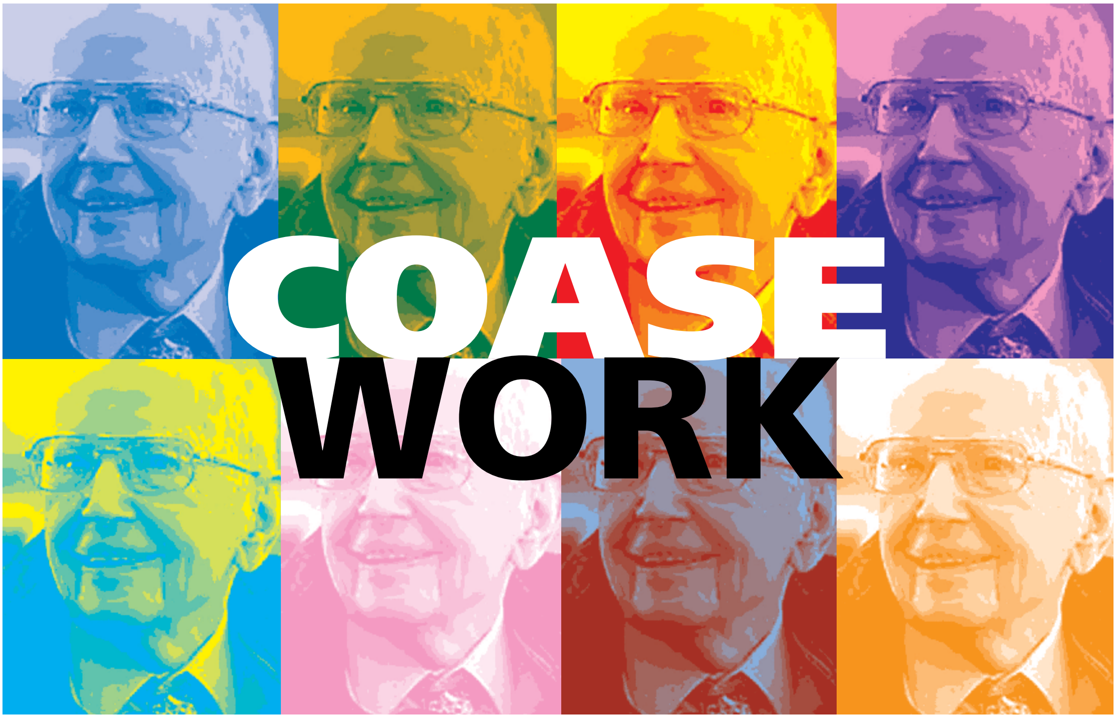
He's been an **incisive critic of economic policy** since 2008 and he will talk about the policies that have **inhibited economic recovery** since the financial crash and related economic concerns.

Attendance is free.

If you'd like sign up, e-mail: ***hayek@iea.org.uk***

TALKING the TALK

The IEA continues to give talks at schools, universities, and other venues around the country. Recent visits include Gumley House School, Dulwich College, Stretford Grammar, UCL Debating Society, Durham Economic Society, and Bristol and Exeter Universities. If you'd like an IEA speaker to talk at your institution or organisation then contact us at ***iea@iea.org.uk***



COASE WORK

In the first of a series of introductory articles, IEA Education Director STEPHEN DAVIES profiles a man who made a giant contribution to the world of economics

Ronald Coase died last year at the age of 102. Arguably he is one of the greatest economists in the history of the discipline.

He was only in his early twenties when he presented the lecture that ultimately led to him winning the Nobel Prize in economics.

Though Coase's most important ideas were developed decades ago and have influenced economic policy enormously, perhaps their most profound influence on policy will be in the 21st century. His work is highly relevant to the core topics on current A-level economics and undergraduate economic and social policy syllabi.

The area where Coase first made an important contribution to economics was that of industrial organisation.

In his article, "The Nature of the Firm", he looked at a simple but profound question: why do firms exist? Classical economic theory would lead us to expect an economy made up of many self-employed people all contracting with each other. But this is not what we see.

Instead, much economic activity is organised through firms of various sizes with the majority of people as employees. What makes a company, for example, have an accounts department rather than contracting with self-employed accountants?

Coase's great insight was to realise that economic transactions such as trading or making contracts are not costless.

There are what we now call transactions costs, things such as the cost of making and agreeing the contract and of supervising their work, which might be more or less difficult if people are not employed by a firm. In a world without these costs we would not have firms.

However, because transactions costs do exist there is an incentive to reduce them by having a single transaction (the employment relationship) rather than a whole lot of separate costly ones.

Much standard economics and business studies teaching assumes the existence of firms but does not explore why they exist.

It is only when you realise that the critical explanation is the nature and level of transaction costs that you will understand better not only why firms exist but also why at any time there is a predominant form of industrial organisation, with variations between sectors.

It is transactions costs that will determine how much outsourcing – including to developing countries – takes place. If transactions costs decline then there will be a rise in outsourcing whereas a rise in transaction costs will lead to larger and more integrated firms. It is also the level of transaction costs that will determine how large firms become on average.

And crucial issues in the policy debates about the energy and railways industries can only be understood if we think about transactions costs.

Was railway privatisation a mistake, or was it just foolish for the government to split the train companies from the company that operates the track?

Should energy companies be vertically integrated or should they split up? One course of action might lead to more competition but it may also lead to much higher costs.

standard contemporary economic thought, externalities occur when economic activity leads to costs or benefits for third parties not involved in the original activity or transaction.

Because these costs and benefits are not internalised (i.e. borne by the party responsible for creating them) the price system does not do its work properly and resources are not allocated efficiently. Some goods will be over-produced and others under-produced. The solution in standard A-level thinking is government action, usually through

THOUGH HIS MOST IMPORTANT IDEAS WERE DEVELOPED DECADES AGO…PERHAPS THEIR MOST PROFOUND INFLUENCE ON POLICY WILL BE IN THE 21ST CENTURY

Coase made perhaps his greatest contribution in his 1960 paper, "The Problem of Social Cost". This dealt with one of the central ideas of modern economics, one that pervades the A-level syllabus: the problem of externalities. In

taxes, subsidies or regulation.

Coase showed that it is not clear where the blame for creating the externality lies and that in many cases the way to maximise efficiency is not through government action but through private bargaining.

Coase used a real life case of a dispute between a farmer and a rancher over the damage done by the rancher's cattle to the farmer's crops. Provided the property rights to land, crops and cattle are clear and the transactions costs of negotiation are low enough then the fence will be built, as long as the cost of building the fence is less than the value of the damaged crops. If the crop farmer has a property right not to have his crop trampled, the rancher will build the fence rather than pay compensation to the farmer. If the farmer has no such right, he will build the fence to keep the cattle out. Crucially, the initial allocation of the property rights does not matter for efficiency, though it may for fairness.

What this means is that when there are externalities there may not be a need for government regulation or taxes as the problem can be resolved through what has now come to be called Coasean bargaining.

However, if the transactions cost of bargaining are very high then a bargain may not be possible. For example, the transactions costs involved with compensating people living below sea level who may be affected by the externalities of

RONALD COASE: KEY INSIGHTS

- When transactions costs change – for example because of changes in communications technology – industrial structure could change radically
- If the wrong structure is imposed on an industry (for example, in railways in the UK) this can be very costly.
- Bargaining between affected parties can often overcome the problems caused by externalities. Governments should not get in the way of such bargaining.
- Public goods can often be provided privately by tying their use to private goods.

HIS GREAT INSIGHT WAS TO REALISE THAT ECONOMIC TRANSACTIONS SUCH AS TRADING OR MAKING CONTRACTS ARE NOT COSTLESS

carbon emissions or compensating those affected by green-field property development in the south-east of England might be too great to get an efficient outcome using markets alone.

In these cases we may have to resort to legal rules, but very much as a second best option. Crucially, the legal rule should aim not at achieving an outcome designed by planners but at achieving the outcome that people themselves would have wanted if they had been able to bargain efficiently.

In practice, we can try to solve these problems by making property rights more extensive or by trying to mimic market mechanisms (for example, by carbon trading or agreements between developers and parish councils that can help compensate people affected by housing development). Technological innovation may well play a large part in reducing transactions costs in these areas in the future.

Coase was very much a realist. He realised that in many cases government action may lead to higher levels of social cost (due to a misallocation of resources) than if the original externality had been left unaddressed. The burden of proof for the need for regulation has to be put on the government or agency making the regulation to show that their action will indeed increase welfare on balance.

The third example of Coase's originality was in the area of 'public goods'. These are another example of what is seen as a 'market failure' in economics courses.

The consumption of a public good is non-excludable so, once they are provided, they bring equal benefit to both those who pay for them and those who do not.

The result, in standard theory, is that there will be a strong incentive for people to not pay and to "free ride" on those who do. The good will then be supplied sub-optimally.

One classic example of a public good of this kind suggested in the literature is a lighthouse (others include national defence). In his 1974 article "The Lighthouse in Economics", Coase used empirical economic history to show that private action had successfully produced public goods including lighthouses. In this case privately owned ports paid for lighthouses in order to increase their own income.

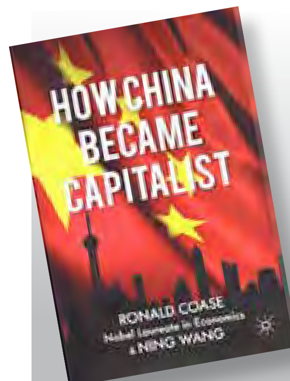
The crucial thing was the ability of people to find ways to co-operate for mutual benefit and find ways to connect non-excludable goods to excludable ones (in this case the use of the port). Subsequent work has shown that almost all the classic public goods can be and often are provided privately.

Coase's work had important practical applications in many areas of public policy. It led, for example, to a change in broadcasting policy with the creation of tradable property rights in the electronic spectrum rather than licences granted through a political process.

Later in his life he did important work on entrepreneurialism and the way industrial production was organised.

His last major book (with Ning Wang, and published by the IEA when Coase was 101) looked at how China had become a broadly capitalist economy and argued that this was due mainly to action by ordinary people in China, rather than by government policy.

Coase's work was creative, original and full of insights that should lead us to question many of the complacent assumptions of much contemporary economic and political thinking.



You can read more about ***HOW CHINA BECAME CAPITALIST*** *at:* ***www.iea.org.uk/publications/co-published-books/how-china-became-capitalist***

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DOING BUSINESS: Singapore style

In A-level and undergraduate economics courses, there's some discussion of the institutional conditions necessary for economic growth and development.

In this context, the World Bank's Doing Business report has provided useful information…but it's under attack from various campaign groups.

In this article, STEVE HANKE stresses the importance of good policy and institutions and the role of the World Bank's report in achieving these things…as well as examining Singapore's role as its star pupil.

Since 2004, the World Bank has produced the annual *Doing Business* report, which ranks countries on 10 factors reflecting the ease with which entrepreneurs and businesses may conduct economic activity in a given country.

At first glance, such a survey would hardly seem controversial. After all, with so much unreliable data coming out of official government statistics offices these days, one would think that an unbiased system for ranking the ease of doing business would be a useful tool – not only for businesses, but for governments as well.

Indeed, since 2005, a total of 1,940 reforms have been implemented by countries to improve their rankings. And, several prominent heads of state, such as Russia's Vladimir Putin, have made public pledges to improve their countries' *Doing Business* rankings.

As it turns out, however, a few countries (specifically those with low rankings) are none too happy about the *Doing Business* report. Most notably China (which ranks 91 out of 183) has been pressuring the World Bank to scrap the *Doing Business* rankings and weaken the report's analysis to the point of irrelevance. It hasn't helped that certain less-market-friendly NGOs, such as OXFAM, have also joined the Chinese government's crusade.

Indeed, under pressure from China, World Bank President Jim Yong Kim commissioned a panel to "study" the *Doing Business* rankings and present recommendations for "improvement." Not surprisingly, the commission recommended doing away with the actual ordinal rankings, and switching to a less embarrassing evaluation of each country.

Yes, the panel's recommendations are nothing more than a thinly-veiled attempt to gut the *Doing Business* report. Stripping the ordinal rankings and "reforming" the report's methodology would have the effect of completely destroying the report's credibility and usefulness as a policy tool.

Fortunately, the *Doing Business* report has one very important ally, Jim Yong Kim himself. A campaign to save the report has also been mounted by *Doing Business* report co-founder, former World Bank Group Vice President Michael Klein.

These World Bank insiders recognise a simple fact. The *Doing Business* report represents one of the few uniform, objective metrics available for measuring the ease of doing business across 183 countries. Indeed, in 2005, when asked what I thought then-newly-appointed World Bank President Paul Wolfowitz should do on his first day, I said his first stop should be at the office of the *Doing Business* report staff.

Good data, bad data

For an organisation whose stated goal is the alleviation of poverty, it is important to have objective metrics by which to measure economic prosperity over time (and thus the alleviation of poverty). One common metric for measuring economic prosperity is per capita income. The evidence is very clear that prosperity affects health – especially life expectancy – in a positive way.

Yes, economic growth is, quite literally, a matter of life and death. That said, relying solely on per capita income as a measure of economic progress can be problematic. For starters, this metric can be skewed for certain countries by "outside" factors such as famine, civil war, discovery of natural resource deposits, etc. There is also a more basic question of the quality of the data being used to produce these economic statistics.

As Morten Jerven illustrates in his recent book, *Poor Numbers*, economic statistics in Africa, for example, are often generated using incomplete data and faulty methodology – resulting in systematically flawed statistics in many countries.

Similarly, as Oskar Morgenstern documented (Morgenstern, 1950), the incompetence and wilful trickery of many governments often render data less than reliable. More recently, this "lying statistics" problem has been witnessed with official exchange-rate and inflation data in countries such as Iran, Venezuela, and Argentina.

ECONOMIC GROWTH IS, QUITE LITERALLY, A MATTER OF LIFE AND DEATH

Worse still, some governments will simply stop reporting official data when they don't like the results – see North Korea and Syria, as well as Zimbabwe circa 2008.

The solution to this problem is to develop unbiased statistics, using objective data. As Peter Blair Henry (Henry, 2013) shows, stock market data can provide a useful tool for measuring the effectiveness of economic reform efforts. Henry also highlights the importance of relying on objective data, rather than ideology, to develop tailored economic reform packages for different countries.

That said, objective data on macro-economic growth must also be complemented with micro-level data on specific reforms. This is where the *Doing Business* report comes into play. Rather than rely on often dubious official statistics, the *Doing Business* report uses data collected from over 9,000 accountants, lawyers, engineers and other business professionals around the world.

And, the *Doing Business* report provides vital data on the structural strengths and weakness of a given economy. By "structural" I simply mean the "rules of the game" for small and medium-sized businesses – in short, the government-imposed regulatory costs of starting, running, and closing a business in a given economy.

This also addresses the problem of data being skewed by outside factors such as famine and civil war, since the *Doing Business* report looks at factors over which governments have a greater degree of control: a few examples are in *Table 1*.

As it turns out, a country's *Doing Business* ranking can actually tell us a lot about a country's health as well. Countries with better *Doing Business* rankings also tend to have higher life expectancy rates.

A sceptic might claim that this simply results from richer countries being able to afford better healthcare.

But, the *Doing Business* report does not measure how rich a country is; it measures the costs imposed by government on businesses. So, what is going on here?

In short, when governments embrace market-augmenting, business-friendly policies, the cost of doing business goes down and economic prosperity tends to increase. Prosperity, in turn, leads to improvement in medical and public health factors that result in higher life expectancy rates.

For a real-life example of this transformation, simply take a look at the country that has held the number one spot in the *Doing Business* rankings for the past two years running: Singapore.

Lee Kuan Yew's "Singapore Strategy"

Singapore gained its independence in 1965, when it was, in effect, thrown out of Malaysia. At that time, Singapore was poor. Indeed, Singapore's real per-capita income in 1965 would be roughly equivalent to that of a country like Kosovo or Angola today.

However, Singapore's leader, Lee Kuan Yew, had clear ideas

THE DOING BUSINESS REPORT REPRESENTS ONE OF THE FEW UNIFORM, OBJECTIVE METRICS AVAILABLE FOR MEASURING THE EASE OF DOING BUSINESS ACROSS 183 COUNTRIES

about how to modernise the country – a strategy which I have dubbed the "*Singapore Strategy*." This strategy contained the following elements:

- *Stable money:* Singapore started with a currency board system – a simple, transparent, rule-driven monetary regime. Currency boards operate on autopilot, with automatic adjustments keeping the system in balance. Accordingly, currency boards deliver discipline to the spheres of money, banking and fiscal affairs. For Singapore, a currency board provided stable prices and free convertibility at a fixed exchange rate, which attracted foreign investment.

- *Singapore refused to accept foreign aid:* This is a far cry from many developing countries, where, when you pick up the paper, all you see are politicians and bureaucrats trying to secure foreign aid from someone, be it an NGO, a foreign government, or an international financial institution such as the World Bank. By contrast, "no foreign aid" signs hung, and still hang, figuratively, outside every government office in Singapore.

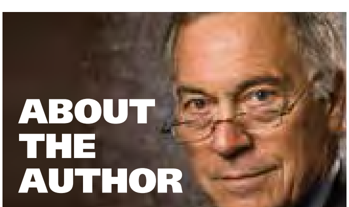
- *Singapore strived for competitive private enterprises:* This was accomplished via light taxation and light regulation, coupled with completely open and free trade – in short, policies that enabled Singapore's private businesses to become Asian tigers.

- *The rule of law:* The Singapore strategy emphasised personal security, public order and the protection of private property.

To accomplish these goals, the key was a "small", transparent government – a minimalist government that avoided complexity and "red tape" – hence its top ranking in the *Doing Business* report.

To implement this principle, Singapore appoints only first-class civil servants and pays them only first-class wages. In exchange for these high salaries, the Singapore Strategy demands that the government run a tight ship, with no waste or corruption.

By embracing Lee Kuan Yew's Singapore Strategy of stable money, no foreign aid, first-world competition, and law and order; and by demanding a government that is absolutely free of waste and corruption, Singapore has transformed itself from a poor, barren speck to a global financial centre. Indeed, a recent survey ranking the world's top five financial centres put Singapore as number one – ahead of Switzerland, Hong Kong, London and New York.



STEVE HANKE – seen here addressing the IEA's State of the Economy conference – served as a Senior Economist on President Reagan's Council of Economic Advisers and as a Senior Advisor to the Joint Economic Committee of the US.

In his long and distinguished career, he has advised governments around the world and was once named by *World Trade Magazine* as one of the 25 most influential people in the world.

In Singapore, the market is the guiding principle of the economy, just as Lee Kuan Yew's 1965 manifesto provides the guiding principles for Singapore's government. Indeed, the key to understanding the Singapore Strategy is to realise that it is a strategy in which the Singaporean government is mandated to produce market-augmenting policies that encourage economic growth.

It should thus come as no surprise that Singapore today is one of the freest, most flexible and prosperous economies in the world, as reflected by its number one *Doing Business* ranking. And, lo and behold, Singapore ranks in the top ten with regard to health outcomes.

As William A. Haseltine noted in his recent book (Haseltine, 2013), Singapore achieved dramatic, cost-effective healthcare results by embracing efficiency and fostering competition between private healthcare providers and the government.

Doing business topic	Methodology (summarised)
Starting a business	Procedures to start up and formally operate a business
Dealing with construction permits	Procedures required for a business in the construction industry to build a warehouse
Getting electricity	Procedures required for a business to obtain a permanent electricity connection
Registering property	Procedures necessary for a business to purchase a property and to transfer title
Getting credit	Legal rights of borrowers and lenders with respect to secured transactions and the sharing of credit information
Protecting investors	The strength of minority shareholder protections against directors' misuse of corporate assets for personal gain
Paying taxes	Taxes and mandatory contributions and the administrative burden of paying taxes and contributions
Trading across borders	The time and cost (excluding tariffs) associated with exporting and importing a standardised cargo of goods by sea transport
Enforcing contracts	The efficiency of the judicial system in resolving a commercial dispute
Resolving insolvency	The time, cost and outcome of insolvency proceedings

Table1: Doing Business report methodology

Source: World Bank (www.doingbusiness.org/methodology, accessed 12 August 2013)

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THE SINGAPORE STRATEGY DEMANDS THAT THE GOVERNMENT RUN A TIGHT SHIP, WITH NO WASTE OR CORRUPTION

Indeed, when it came to health care, Lee Kuan Yew once again ruled out passing the begging bowl and instead insisted on personal responsibility, via fee-based services and personal health savings accounts, among other innovative solutions.

While the Singaporean government does play a central role in the country's healthcare market, the key fact is that Singapore's health system is one characterised by simplicity and transparency – resembling neither the massive public monopolies of Europe, nor the complex regulatory nightmare of the US system.

If developing countries were to embrace the Singapore Strategy, they too would climb the *Doing Business* rankings very rapidly. Corruption and poverty would decrease, income and growth would increase, and, I suspect, health outcomes might just improve, as well.

At the end of the day, the key to implementing meaningful economic reform is objective data by which countries can measure their progress.

So long as Jim Yong Kim holds fast and preserves the *Doing Business* report, as is, countries will continue to be able to make strides and measure their progress.

The *Doing Business* report provides a framework for economic reform and serves as a challenge to implement it around the world. If countries such as China are embarrassed by a poor *Doing Business* ranking, they should leave Jim Yong Kim alone, and give Lee Kuan Yew a call•

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MISSING the POINT!

Labour's plans to deal with the UK's escalating cost of living recognise the symptoms – but not the cause. Using regulation, price caps and subsidies just won't work, says KRISTIAN NIEMIETZ…

The Labour Party's 2013 annual conference in Brighton was dominated by the issue of living costs. In principle this is good news. It shows that the Labour Party now recognises that the surge in living costs is a determinant of living standards in its own right, which is independent of the general state of the economy.

This recognition places the party miles ahead of economics commentators such as the Independent's John Rentoul, who still denies the existence of a cost of living crisis, and insists that the decline in living standards was simply another consequence of the general economic flatlining.

He is wrong. The Labour Party is absolutely right to address the issue of living costs separately, because on its own, an economic recovery will do nothing to solve this problem. The cost of living crisis is a matter of supply-side constraints.

Unfortunately, while the Labour Party conference speakers aptly describe the problem and its consequences, the solutions they propose are not solutions at all. The basic problem is that the party is trying to solve problems which have been caused by undue government interference with more government interference, inadvertently providing an illustration of what Ludwig von Mises called the interventionsspirale (spiral of intervention).

It should be noted that they are not the only party falling into this trap. Conservative politicians have proposed rent controls and higher minimum wages and the Liberal Democrats have proposed more childcare subsidies.

Housing, energy and childcare have been among the areas with the most rapid cost increases (see Figure 1). Senior speakers at the Labour Party conference have announced that they will cut housing costs by expropriating developers who are sitting on undeveloped land, cut (real-terms) energy costs through a price freeze and cut childcare costs by raising the entitlement to free childcare to 25 hours. Each of these proposals is a symptom treatment that ignores the causes of the prior cost increase in the respective sector, and each of these proposals would be counter-productive even when taken as a mere symptom treatment.

An energy market oligopoly?

Energy is probably the most obvious example. Labour leader Ed Miliband's argument is simple: energy corporations are ripping off consumers, which is why the state, the natural ally of the underprivileged, has to intervene.

The reality is a bit different, though. It is true that the energy market is fairly concentrated, and there is surely scope for greater competition. But the sector is more competitive than it is often assumed to be. Profit margins in the energy sector are only about 4-5 per cent (The Economist, 2013), so even if shareholders could be persuaded to supply capital for free, energy prices would not tumble.

A much larger share of energy retail prices – 16 per cent in the case of electricity, 10 per cent in the case of gas – is explained by legal obligations to buy energy from renewable sources (Niemietz, 2012, p124-132). If there were a special 'renewable energy tax' levied on each energy bill, with the revenue being handed over to renewable energy producers, public anger would be directed at the government responsible for this levy.

In effect, the current arrangement works precisely like that, except that renewable energy taxes are not officially called 'taxes', and renewable energy subsidies are not officially called 'subsidies'.

THE MOST STRAIGHT-FORWARD WAY TO REDUCE ENERGY BILLS IS TO ABOLISH RENEWABLE ENERGY OBLIGATIONS

The most straightforward way to reduce energy bills is to abolish renewable energy obligations. These obligations do not reduce carbon emissions, since the latter are already capped at the EU level through the Emissions Trading Scheme (the cost of which is not included in the above figures). All renewables obligations do is redistribute resources from energy consumers to a politically favoured industry. Imposing price controls while leaving these distortions untouched can only lead to a reduction in capital investment, which will make energy price rises in the future more likely.

The folly of reducing childcare costs through subsidies

Another key announcement was formulated by shadow chancellor Ed Balls, who plans to raise the number of free childcare hours for three- and four-year-olds from 15 to 25 per week. That, of course, would do nothing to change the fact that the UK has some of the highest childcare costs in the world. The policy would simply move the cost

At the Labour Party's annual conference in Brighton, party leaders announced several measures to deal with the UK's escalating cost of living. They plan to:

- address runaway housing costs by expropriating developers who are sitting on undeveloped land ('use it or lose it')
- address runaway energy costs initially through a price freeze and, later, through tougher regulation
- address runaway childcare costs by raising the entitlement to free childcare (for three- and four-year-olds) from the current 15 hours to 25 hours

All of these are misguided symptom treatments, which do not address the causes of the prior cost increases:

- The housing costs escalation has been a result of decades of under-building, caused by planning restrictions and 'nimbyism' – not land hoarding.
- The energy cost escalation is mainly caused by renewable energy subsidies, paid by consumers through their energy bills – not 'excessive' profits.
- The escalation in childcare costs has been caused by the exaggerated formalisation of the sector – not a lack of demand-side subsidies.

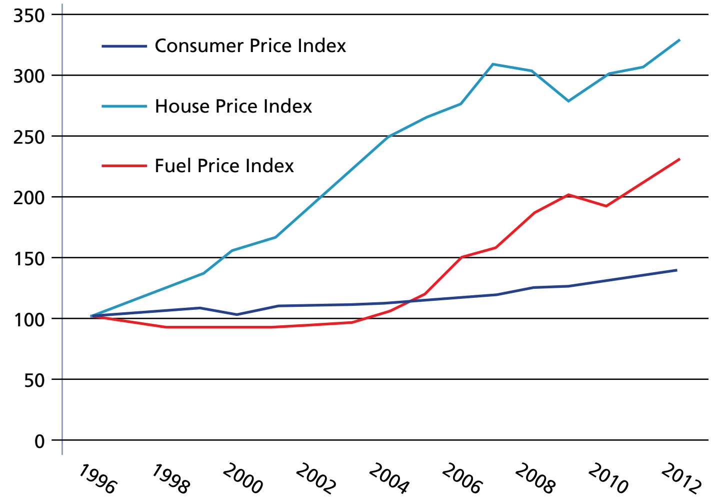
to the taxpayer so that the standard of living of taxpayers in general would be reduced.

Enthusiasts of state-funded childcare like to praise Sweden as a role model, but they overlook the fact that government childcare subsidies in the UK already match Swedish levels. Balls' proposal could well send them to the highest level in the world, especially when considering the dynamic implications.

An entitlement to free hours is one of the least efficient ways of subsidising childcare. It is a universal benefit, to which David Beckham's children are just as entitled as the poorest children in the country. Entitlement is irrespective of the parents' work status, so it does not specifically encourage parental employment. There is no co-payment for parents, who therefore have no incentive to choose a cost-effective provider.

It would be much more sensible to address the rules and regulations that push up childcare costs so much in the first place, such as minimum staff-to-children ratios, mandated curricula, Ofsted licensing and inspections etc. Childcare, after all, is not a high-tech sector. If a country pays out more than 1 per cent of GDP in public childcare subsidies, and parents still have to pay high user charges while huge gaps in coverage remain, something is wrong with the regulatory framework.

Figure 1: House price and fuel price indices in the UK, 1996-2012 based on data from ONS



THE MARKET FOR RESIDENTIAL LAND IS ANYTHING BUT COMPETITIVE, BECAUSE SUPPLY IS TIGHTLY CONSTRAINED BY THE PLANNING SYSTEM

Ending land hoarding is no solution to high house prices

Ed Miliband's proposal of bringing down housing costs through the threat of 'landgrabbing' is, at least, a supply-side measure, which contrasts positively with the Conservative Party's belief that a supply-side problem could be solved through a demand-side intervention (the infamous Help-to-Buy scheme).

The escalation in British house prices, however, is the result of at least three decades of a systematic shortfall in housing construction. 'Land hoarding' has nothing to do with this, because hoarding does not affect the total amount of residential development, it only affects its timing. Hoarders do not hoard land forever: they merely release it to the market a bit later than Ed Miliband thinks they should.

But it remains worth considering why hoarding occurs at all. Suppose you own an asset which you could sell for a price of 100 gold coins now. You believe that there is a 50 per cent chance that the price will rise to 120 gold coins next year, but an equal chance that it will fall to 90 gold coins. The expected value of the asset in a year's time is therefore 105 gold coins, which, if you discount it at a 5 per cent interest rate, amounts to a present value of 100 gold coins again. Thus, you might as well sell the asset now.

Hoarding is pointless unless both the magnitude of a potential future price increase, and the likelihood of that increase actually occurring, are very high. This is rarely the case in a competitive market, because you cannot control your competitors' behaviour. If you hoard your asset, somebody else with a similar asset might sell theirs, driving down prices and ruining your hoarding plan.

That is the situation in a competitive market. Yet the market for residential land is anything but competitive, because supply is tightly constrained by the planning system, which is why most of the time, prices move in one direction only: upwards. Hoarding would be pointless in a competitive land market, but it can be viable in the UK's artificially supply-constrained pseudo-market.

Miliband's proposal would do nothing to change this. It would leave the barriers which entrench market power untouched, so that the government can then act as the white knight who stands up for the little guy. It would be far more sensible to remove those barriers, so that nobody needs any white knights, but that is not the way politics works.

Taken together, it is commendable that the Labour Party at least recognises the existence of a living-cost crisis that will not be resolved by an economic recovery. But the party has not recognised that the problems it identifies have been caused by misguided government interventions. Their proposals will fail because they will continue that spiral•

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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.

The Economist (2013) 'Tilting at windmills. Ed Miliband's proposals to cut energy bills seem likely to do the opposite', print issue, 28 September 2013.

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

MARGINAL TAX RATES AND INCOME:

New time series evidence

The debate over top tax rates has been raging in political circles in the last three years. Until recently, there was a consensus in favour of a top rate of 40 per cent in the UK (relatively low by post-war standards). The rate was then increased to 50 per cent by the last government. Despite the fact that the now opposition Labour Party regarded that increase as temporary, they objected when the coalition government reduced the rate to 45 per cent. It is also worth noting that there is also little sign that the current government wishes to reduce the top tax rate back to 40 per cent. A further matter of contention is whether it was wise for George Osborne to begin his fiscal consolidation by increasing taxes.

This paper by Karel Mertens is important for these debates. Mertens' results show that reductions in tax rates for the top one per cent increase pre-tax incomes for that group; this is not simply caused by reduced avoidance. There is also an increase in national income following cuts in top marginal tax rates as well as an increase in incomes for the lower paid. This suggests that increasing taxes on those on higher incomes is likely to reduce national income and reduce the incomes of the less well off. Unsurprisingly, the author shows that increasing taxes on the top one per cent of income earners will reduce inequality. Regarding the fiscal consolidation issue, the author comments: "The results imply that raising marginal tax rates to resolve budget deficits comes at a high price and that a proportional across-the-board tax cut provides successful stimulus that does not necessarily lead to greater income concentration at the top".

KAREL MERTENS
Cornell University
NBER Working Paper 19171 (2013)
www.economics.cornell.edu/km426/papers/MTRI_article.pdf

CAPITAL MARKET INTEGRATION and WAGES

Though some economists like to cite the exceptions, most agree that free trade increases wealth. There is more controversy, however, about whether openness to capital flows always benefits a developing country. This paper, one of the authors of which is a former Obama advisor who has an impressive career trajectory as an economist, demonstrates the clear advantages of countries opening up capital markets. The authors point out that, due to the opening up of a number of countries in the 1980s and 1990s, we have an unprecedented body of data which can be used to examine whether capital market liberalisation leads to higher wages. In theory, it should. In developing countries labour is often plentiful and capital scarce (though China, of course, has a very high savings ratio). Capital market liberalisation should therefore raise wages and reduce the rents that can be received by owners of capital. In a sample of 25 emerging economies, which had significantly increased capital flows after liberalisation between 1986 and 1996, the authors' estimates show that the growth rate of real wages jumped from 1.8 per cent per year in the pre-liberalisation period to an average of 5.7 per cent in the year of liberalisation and the subsequent three years. Of course, there are a large number of potential data problems in this analysis. However, the authors find strong evidence for the argument that it is capital market liberalisation that causes increases in real wages. For example, labour productivity also increases along with the import of capital goods in those countries that liberalise. Capital market liberalisation also promotes the diffusion of technology into developing countries.

The authors conjecture – though do not investigate this further – that the increase in wage inequality in developing countries might be partly explained by the more complex technologies that are employed in production processes due to the import of capital goods.

ANUSHA CHARI, PETER BLAIR HENRY AND DIEGO SASSON
American Economic Journal: Macroeconomics 2012, 4(2): 102–132
http://archive.nyu.edu/bitstream/2451/31604/3/pbh%20%20capital%20market%20integration.pdf

JUVENILE INCARCERATION, HUMAN CAPITAL and FUTURE CRIME:

Evidence from randomly assigned judges

In the US in 2010, nearly 0.25 per cent of all 10-19 year olds were in prison. This is a rate out of all proportion to that experienced in any other country. A stay of 12 months in prison costs the taxpayer about £50,000 in the US. In this research, the authors examine the impact of the use of juvenile detention (imprisonment) on future outcomes. Using a database of 35,000 people over ten years, they find that, for those for whom the decision to detain is marginal, there is a decrease in high school completion and an increase in the likelihood of adult imprisonment if the individual is imprisoned. It therefore appears that, for the individual, juvenile imprisonment undermines human capital accumulation and increases the probability of a person pursuing crime as an adult. The authors point out that there are effective alternatives to juvenile detention. The most obvious are properly monitored and enforced curfews and electronic monitoring. It could be objected that, though these results suggest that imprisonment should be used less and would reduce future crime, it is possible that strict punishments might deter other juveniles and also that, whilst incarcerated, juveniles cannot commit crime and thus imprisonment may have a direct effect on crime. The authors argue that the first objection at least is likely to be of marginal significance.

ANNA AIZER AND JOSEPH DOYLE
NBER Working Paper No. 19102 (2013)
www.mit.edu/~jjdoyle/aizer_doyle_judges_06242013.pdf

STATISM ReBRANDed?

For as long as I can remember, the herbal schnapps Jägermeister has had a reputation for being an old man's drink.

So when I moved to the UK, I was amazed to discover that here, Jägermeister was considered trendy and 'cool' among teenagers. It would appear that, in the UK, the company was simply lucky to find trendy 'early adopters', who then became multipliers.

The realm of political ideas, too, follows fads and fashions, and the statism of the 1970s is currently experiencing a Jägermeister effect.

For a while, free marketeers were benefiting from the fact that crude statist ideas were simply considered old-fashioned. Price controls, wage controls, public ownership, bloating the public sector, deficit spending, idolising unions, punitive top tax rates, interventionist industrial policy – those terms used to sound so 1970s, even to people who, like me, have no personal memories of those years. They used to stand for the bad old days, for a past that few people wanted back.

But like Jägermeister, these ideas have become trendy again without any reworking or even a rebranding. The likes of Owen Jones or Russell Brand do nothing to update the rhetoric of Arthur Scargill, Michael Foot or Tony Benn. They just lend them an air of youthfulness.

THE STATISM OF THE 1970S IS CURRENTLY EXPERIENCING A *JÄGERMEISTER* EFFECT

There is a slight difference with Jägermeister, though: there is nothing inherent in herbal schnapps which makes it either old-fashioned or trendy. But the previous fall from grace of crude statism was more than a matter of changing fads. It had been the dominant ideology for a long time and failed. And bloating the powers of the state did nothing to 'empower' working people. Statism only empowered the state and its cronies.

It would be one thing if those of the Jones/Brand ilk acknowledged those past failures, and came up with a reason why things will turn out differently this time. But what they really do is simply to ignore all past experience with the kind of ideas they are advocating.

Free-market liberalism, in contrast, is quite able to absorb and learn from real-world experiences which are widely seen as failures of 'neoliberal' policies, justified or not. There are, for example, excellent 'neoliberal' contributions on the causes of the 2008 financial crash, on the problems with British railway privatisation in the 1990s, and so on.

It is rather fortunate that Jägermeister never changed in substance, because it has always been a fine liqueur, long before a travesty like mixing it with an energy drink would have occurred to anyone.

In contrast, no matter how 'cool' the command-and-control statism of the old left becomes, in substance it remains as wrong as ever•

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Full version at: www.iea.org.uk/blog/the-j%C3%A4germeister-effect-without-a-change-in-substance-1970s-style-statism-has-become-trendy-aga

Productivity Puzzle

There was a time when it was normal for the productivity of labour in the UK to be rising year by year, and for money wages increases to reflect this by forging ahead of price increases.

The last few years, however, seem to have turned these norms upside down. Has the economy hit an iceberg, or just an unusually strong headwind?

HAS THE ECONOMY HIT AN ICEBERG, OR JUST AN UNUSUALLY STRONG HEADWIND?

The case for believing the latter, and thus for hoping for better things in due course, takes off from the fact that businesses have lately been coming to rely more on the use of labour in their productive processes and rather less on capital equipment of various kinds.

This unusual shift in 'factor proportions' has occurred partly because, under the pressure of unemployment, money wages have risen less than prices, so that labour has become cheaper in real terms.

But at the same time, the upheavals in the banking system since 2008 have made it very hard for businesses to raise funds to invest in capital equipment. Under these two influences, the normal process of increasing capital per worker leading to increasing output per worker, and so to increasing real wages, has evidently ceased to operate.

Or has it just been suspended? It is reasonable to suppose that the effect of the upheavals in the banking system was essentially that of a shock whose impact, with the passage of time and the aid of reforms to the system, will sooner or later fade. As the blockage it applied to the flow of funds for investment turns out to be temporary and diminishing, the normal process of increasing capital per worker should be resumed, and with it the secular growth of labour productivity and real wages.

Nevertheless, the above could well fail to provide a complete explanation of recent developments, since increasing capital per worker is not the exclusive determinant of productivity growth. That also depends upon the flow of innovations of various kinds which enable more output to be produced from given quantities of capital and labour.

The American economist Robert J. Gordon has recently assembled evidence for the USA from about 1900 which appears to indicate what he calls "faltering innovation", and his paper poses the question "Is U.S. Economic Growth Over?"

Since the influence of the innovations he studies is much wider than the USA alone, his hypothesis implies what has recently been happening to productivity in the UK could be rather more than just an episode•

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Full version at: www.iea.org.uk/blog/the-uk-productivity-puzzle-%E2%80%93-or-is-it

ENERGY: Nationalisation or Liberalisation?

The British energy industry has gone from nationalisation to privatisation and back to government control in the space of 25 years.

In the 1970s and early 1980s, the consumer got a raw deal because long-term investment plans and contracts promoted by the government required electricity companies to use expensive indigenous coal. Government planning also dictated the development of a nuclear programme that is probably one of the most expensive government project disasters in history, losing £32bn.

The energy industry is, once again, controlled by the state. The same underlying drivers dictate policy in the new world of state control. It is not rational economic thinking and public-interested civil servants that determine policy, but interest groups.

Going back 30 years, it was the coal industry – both management and unions – and the nuclear industry that dictated policy. Today, it is green pressure groups, EU parliamentarians and commissioners and, often, the energy industry itself that are loading burdens on to consumers.

When the state controls the energy industry, whether through the back or the front door, it is vested interests that get their way and the consumer who pays.

In the late 1980s and early 1990s, the industry was entirely privatised. It was recognised that there were natural monopoly elements and so prices in these areas were regulated. At the same time, the regulator was given a duty to promote competition. From 1998, all domestic energy consumers could switch supplier for the first time and then wholesale markets were liberalised, allowing energy companies to source the cheapest forms of energy.

Privatisation was a great success. Instead of investment policy being dictated by the whims of government and interest groups, it became dictated by long-term commercial considerations. From 1986 to 1997, domestic gas bills fell by an average of 2.6% a year in real terms – a very large cumulative reduction. From 1990 to 1999, electricity charges for domestic consumers fell by 26%, with a larger fall for industrial users.

WHEN THE STATE CONTROLS THE ENERGY INDUSTRY…IT IS VESTED INTERESTS THAT GET THEIR WAY AND THE CONSUMER WHO PAYS

The trend towards liberalised markets, rising efficiency and lower bills then reversed. In the first place, there are carbon reduction targets. Even if carbon reduction is deemed desirable, it could have been achieved through the emissions trading scheme.

Alternatively, a simple carbon tax could be charged. A carbon tax would allow energy businesses and consumers to reduce carbon emissions in the most efficient way for them.

But the government has added to the emissions trading scheme a carbon price floor, a requirement to allow households to produce their own electricity and sell it back, and an obligation to produce energy using incredibly expensive renewables up to three-and-a-half times more expensive than the cheapest methods of generating electricity. As a result, we get carbon reduction but only at an unnecessarily huge cost.

As part of its environmental strategy, in a strange echo of the 1970s, the government has signed a long-term contract for nuclear power to be supplied at twice the current price of electricity.

The UK once had an inefficient and expensive energy industry. After privatisation, costs plummeted as the industry served the consumer rather than the mining unions and pro-nuclear interests.

Today, after a decade or more of increasing state control, we have an industry that serves vested interests rather than the consumer interest once again. Electricity prices before taxes are now 15% higher than the average of major developed nations. Electricity could be around 50% cheaper without government interventions.

We must liberalise again and not complete the circle by returning to nationalisation.

A longer version of this article appeared in the Observer newspaper

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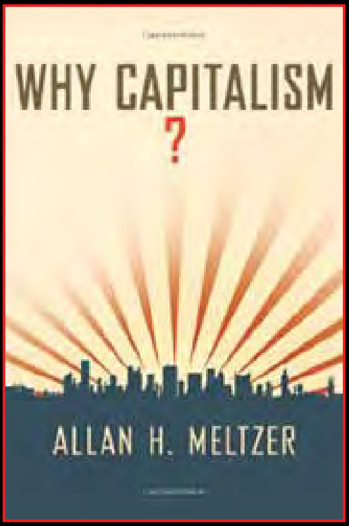
Full version at: www.iea.org.uk/blog/far-from-a-return-to-nationalisation-more-liberalisation-of-energy-markets-is-required

WHY CAPITALISM?

Allan H Meltzer

OUP USA 2012

A fascinating introduction to free-market thinking



Allan Meltzer is one of the greatest economists of his generation. I have admired Meltzer since I started studying economics in the early 1990s, and his work on monetary theory has had a very significant impact on the development of my own views.

His books on the history of the Federal Reserve and the reinterpretation of Keynes are among the most important books on monetary thinking written in the past 50 years. So it was with some excitement that I was looking forward to Meltzer's book *Why Capitalism?*, which was published in 2012.

Why Capitalism?, however, left me with mixed feelings. For free-market economists there is little to disagree with in the book – at least in the general sense. Meltzer argues strongly that the present crisis is not a result of the failures of capitalism and, instead, that the causes of the crisis are to be found in government failure. Whilst I do not disagree with Meltzer, a leftist or a centrist would not be convinced by his arguments. Furthermore, rather than explaining why a free-market system is so effective, in the way that Adam Smith, Hayek and Friedman did, Meltzer focuses on criticising government intervention. There is nothing wrong with his arguments, but the critics of the market will not be convinced.

However, whilst this might not be the book for the staunch critic of a market economy or for university students who have already read Hayek and Friedman, there is much in the book for the high-school student approaching the subject for the first time. Each chapter is well-written and easy to read. The areas chosen by Meltzer do not necessarily fit into a logical structure but each of them provides an overview of important areas studied in high-school economics courses.

The strongest chapter in the book is Meltzer's discussion of the welfare state and regulation, where I particularly found his discussion of moral hazard in the global financial system insightful and convincing. Meltzer provides an excellent summary of his own work on the Asian crisis and how this related to the 2008 global crisis. Indeed, this part of the book could usefully have been much further extended given Meltzer's experience.

The chapter on foreign aid is useful and is a policy topic still under discussion in many Western countries. The undergraduate student should probably go straight to William Easterly's *White Man's Burden*, rather than reading Meltzer's quasi-review of Easterly's work. But the sixth form student who is relatively new to economics can benefit greatly from reading Meltzer's summary.

The third chapter on public deficits and the fifth chapter on why Meltzer thinks we are going to have high inflation seem to fight yesterday's war. Even though countries are struggling with public deficits, it is much harder to find supporters for old-school fiscal stimulus today – other than Paul Krugman.

But, it has to be admitted that, in many high-school economics courses, Krugman is often treated as if he is a mainstream voice who has credibility in the field of monetary economics and public finance. Meltzer's summary of the alternative position will be a useful counterweight.

Meltzer's fear of inflation, however, does seem hard to justify. I would argue that the biggest risk to both the US and Europe is deflation. Indeed, Meltzer rightly warned against the risks of deflation in Japan in the 1990s and, in line with other monetarists such as Milton Friedman, he advocated large-scale quantitative easing. There is a striking contrast between that advice and warning about high inflation re-emerging as a result of the Federal Reserve's quantitative easing programme over the past five years.

My main criticism of *Why Capitalism?* is that it gives the impression that Allan Meltzer, like many other proponents of free-market capitalism, had grown overly confident after the fall of communism and the success of capitalism around the world. We felt that we had won the intellectual battle and, when the crisis hit in 2008, we were badly prepared to defend capitalism. *Why Capitalism?* is not that defence.

Nevertheless, for the student who is starting to study economics, it will provide a decent and highly readable introduction and a critique of some of the poorly formulated arguments of the left that so often pervade reading lists at this level.

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Spotlighting a seminal work on freedom

The CONSTITUTION of LIBERTY

Friedrich A Hayek

University of Chicago Press/Routledge & Kegan Paul, London,1960

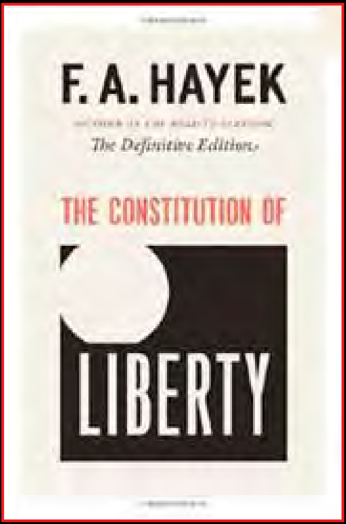
Does liberty need a constitution? Or, what might at first glance sound even more paradoxical, does it need a framework of rules for a free society to be established and to flourish?

F. A. Hayek's *Constitution of Liberty* addressed precisely this question, which has been fundamental for classical liberalism ever since its very inception.

The book was published a few months after Hayek's 60th birthday and is sometimes perceived as his most profound treatise on social philosophy. I am in agreement with this notion. Already in 1935 when debating collectivist economic planning, he distanced himself from "complete laissez faire in the old sense" and proposed instead to start a search for "the most appropriate permanent framework" for competition, which had been "sadly neglected by economists" over the preceding decades.

Very similar statements are contained in chapters 1 and 3 of *The Road to Serfdom*, as well as in Hayek's two presentations to the Mont Pèlerin Society in April 1947. In the mid-1940s he wrote to Henry Simons and Walter Eucken that he was intending to conceive a "positive complement" to his previously expressed critique of socialism and interventionism: whereas, until then, Hayek had expressed what he opposed, his positive programme would be about what he actively proposed. By 1953 such plans started to take shape.

What is the basic outline of the book? After an introduction in which Hayek explained that, although he still regarded himself "as mainly an economist", he had more and more realised that at that point in time the task of an economist should be "the recognition of principles that lie outside the scope of technical



economics or of any other single discipline" (p.3). And indeed, the treatise is not about "technical economics" and it has a truly interdisciplinary character.

Its 24 chapters are divided into three parts: "The Value of Freedom", "Freedom and the Law", and "Freedom in the Welfare State", the level of abstraction declining in the course of the book.

In Part I, Hayek established his conceptual basis, by defining meticulously not only his notion of liberty, but also of progress, reason, tradition, responsibility, equality, value and merit.

In Part II, both historically and theoretically, he argued for the absolute indispensability of the Rule of Law: rules being the only liberal way to circumscribe one individual's sphere of liberty vis-à-vis those of his fellow citizens.

In Part III, Hayek applied the principles of the first two parts to various fields of economic policy, ranging from trade unions, social security, taxation and redistribution, money, housing, natural resources to education and research.

Probably the most controversial sections have become the ones addressing social security, where he, after weighing different arguments, proposed a programme for "limited security", as opposed to the welfare state's "absolute security" utopia. His programme included "equal minimum income for all" (p. 259) as well as, intriguing for today's debates in the US, compulsory health insurance, within which the citizens can decide which of the competing agencies they would insure with (p. 286). This general idea is already contained in chapter 9, "Security and Freedom", of *The Road to Serfdom*.

Even though not a bestseller due to its academic character and style, *The Constitution of Liberty* received some prominent reviews by close acquaintances of Hayek such as Henry Hazlitt, Jacob Viner, Lionel Robbins and Ludwig von Mises. Although they were generally positive, they did criticise some important issues, with Mises being rather harsh precisely on Part III.

Hayek's impressive treatise shows to me that, even if liberals often agree on fundamental principles, there are different possible ways of applying these principles to the policy issues of the real world.

One debate within the liberal community was directly invoked by the famous postscript "Why I Am Not a Conservative". This has ignited debates, for example, about the political tradition of Margaret Thatcher. Was she to be seen as a Tory or rather, in Hayek's opinion, as a Whig? A debate which, to my knowledge, was unfortunately never resolved in a definitive manner•

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Soundbite

Cities Slicker

It is commonplace to think, as Adam Smith did, of the wealth of nations. Now we should also focus on "cities and the wealth of nations". More than ever, cities are the lifeblood of the global economy. The competitiveness of cities – what makes them more productive and successful – increasingly determines the wealth of nations, regions and the whole world.

The map of the global economy most of us have in mind is one of nation-states connected to each other via flows of trade, capital, people and technology. That is still highly relevant. But throughout history the most intensive cross-border economic transactions have been between cities – mostly cities located on coastlines.

So think of a different map of the global economy: one of cities connected across land borders, seas and oceans through the exchange of goods and services, foreign investment, migrants and short-term workers, and border-hopping technology.

Unprecedented levels of urbanisation make this city-based map especially relevant. Three years ago, for the first time in history, over half the world's population lived in cities; they account for over 80 per cent of global GDP.

According to McKinsey Global Institute, as of 2007, 1.5 billion people (22 per cent of the world's population) lived in the world's 600 most populous cities and accounted for a GDP of $30 trillion – well over half of global GDP.

The top 100 cities, with a GDP of $21 trillion, accounted for 38 per cent of global GDP. In 2025, McKinsey reckons that the top 600 cities will have 25 per cent of the world's population and nearly 60 per cent of global GDP.

Most productive policy innovation is happening in cities and sub-national regions, not at the level of national governments, let alone in international forums such as the UN, EU and G20.

Policy-making is more flexible and practical the closer it is to the citizen. And this is more conducive to all-round learning and adaptation: cities emulate each other and adopt best international practice often better than nations do.

HONG KONG AND SINGAPORE ARE THE ROLE MODELS... THE BENCHMARKS FOR OTHERS TO EMULATE

This is true of cities and state governments in the USA while Washington DC remains gridlocked. In the EU, national governments and the EU institutions are stuck in sclerotic political cartels with failed policies. Can Europe's cities break out of this straightjacket and unleash long-delayed reforms?

However, this century's story of cities and the wealth of nations will be scripted mainly in the emerging world – outside the West.

Over the next two decades, about 170 million people will move to cities in developed countries – but 2.6 billion people will do so in developing countries.

Asian cities, stretching from India to China and north-east Asia via south-east Asia, will be the main players. McKinsey Global Institute's list of the top 600 cities contains 220 from developing countries. But it estimates that, by 2025, 136 new cities will join this list – all from developing countries. Of the new entrants, 100 will come from China alone.

What are the ingredients that make cities more productive? Some vital municipal policies are parochial: urban planning and zoning, housing, water, sanitation, policing and so on.

But the most successful cities, like the most successful nations, also have the following: stable and solid public finances; low, simple and competitive taxation; simple and transparent business regulation; strong and impartial rule of law; openness to international trade and foreign investment; a welcoming environment for "foreign talent"; good "hard connectivity" – roads, transit systems, ports, airports; and good "soft connectivity" – education, skills and technology diffusion.

Like nations, cities with limited – but effective – government and competitive markets do better than cities with big, inefficient government and distorted markets. The city-states of Hong Kong and Singapore are the role models. They are the benchmarks for others to emulate.

Cities were at the heart of the medieval and early modern European Miracle. *Stadtluft macht frei* – city air makes you free – was the refrain of the day.

Cities are now at the heart of the Asian Miracle. Richard Cobden and Jane Jacobs had a vision of cities as the best available political-economic units to promote prosperity, freedom and peace. Will this vision come closer to realisation in the twenty-first century?

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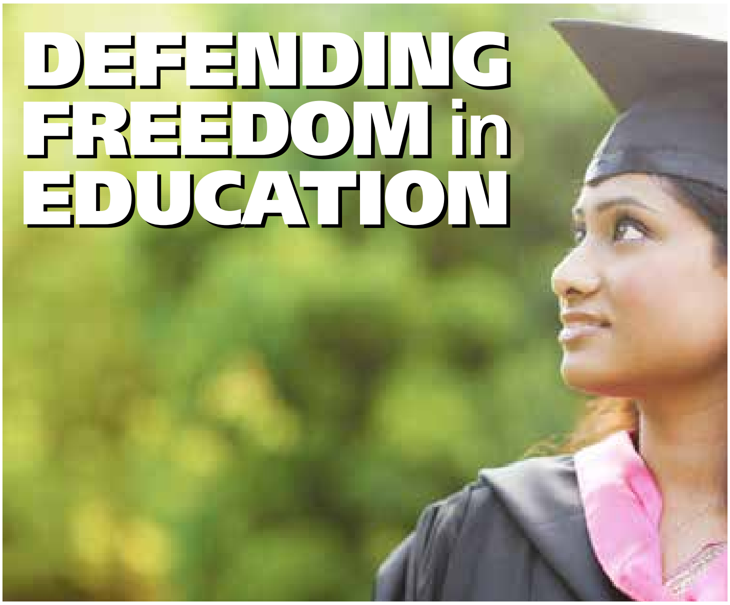

DEFENDING FREEDOM in EDUCATION

In October 2013, Sir Michael Wilshaw, the Head of OFSTED, accused some of our leading independent schools of living in "isolation" and preferring to educate "those whose parents have deep pockets" rather than local disadvantaged pupils.

As many independent schools were established with the express purpose of providing an education for the poor, Sir Michael demanded that these schools should now renew and deepen that commitment.

The head of OFSTED has lost his way on this issue and needs to be reminded of some home truths.

The government initially intervened in education in the late 19th century to help support disadvantaged pupils living in deprived areas. The sole purpose of this intervention was to focus on helping those most in need and not to disrupt or interfere with the already flourishing private, voluntary and religious sectors which were already educating the vast majority of children.

What followed was a comedy of errors and broken promises. Local officials directed all local taxes to their new government schools despite the fact that this was challenged in Parliament as it was seen as penalising the poor by restricting their choice of school. When these schools failed to attract children, more taxes were handed out to enable them to reduce fees until they became free of charge.

This subsequently forced the closure of thousands of fee paying private and voluntary schools across the country, leaving only a small number of established private schools, many of which were founded long before the introduction of parliamentary democracy and the civil service. As previously noted by Frédéric Bastiat, the shoe industry would fail very quickly if the government decided to give everyone shoes free of charge.

The government and its army of school inspectors became the new self-declared champions of the poor. As a result, the surviving private schools were left with no choice but to change and adapt their schools to cater for the minority of parents who could now afford to pay for their children's education twice – once through taxation and again through school fees.

Because of the way in which successive governments have funded education, they have created a system that penalises disadvantaged children – the very same disadvantaged children that the government initially intervened to help.

Any system of education that restricts the freedom of parents to choose will hit those on low incomes the hardest. While better off families can either move house in search of a better school or purchase private tuition, those on low incomes who live in poor areas are forced to accept their local government school, irrespective of how it performs.

Government intervention has therefore had the opposite effect from the one that was originally intended. In fact if I had to design a system of education which cost over £50 billion a year, but which still managed to penalise and restrict the poor, then our system is exactly the system that I would choose.

It is a sorry sight to see a Chief Inspector of Schools attempting to shift the blame from his own organisation's failure onto a handful of private and independent schools who have simply been minding their own business.

However, let's be clear – social divisions and barriers in education are primarily a result of the way in which all previous governments have subsidised the sector, which has denied parents their fundamental right to choose, crowded out the vast majority of private alternatives and penalised those families living in poor areas. This is government failure on a massive scale and it has nothing to do with any private or independent institutions.

BECAUSE OF THE WAY IN WHICH SUCCESSIVE GOVERNMENTS HAVE FUNDED EDUCATION, THEY HAVE CREATED A SYSTEM THAT PENALISES DISADVANTAGED CHILDREN

Politicians and civil servants should remember that their primary purpose is to serve the public and to protect their fundamental freedoms.

They should also take note of the well-known dictum 'an Englishman's home is his castle', which refers to an English legal tradition dating back to the seventeenth century that recognises a person's home as their own private domain where they are free from external interference. This applies to all private institutions and not just the home.

There is not much freedom left in our education sector. We must defend what remains.

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STEALTH BOMBER

Declaring war ON SIN TAXES

Imagine a tax that took 30 per cent of the income of the poor but took only 15 per cent from the rich. Imagine further that this tax was popular with anti-poverty campaigners and that many of those who oppose the market economy wanted it to be levied at an even more punitive rate.

There is no such single tax, but the figures above represent the combined impact of 'sin taxes' and VAT on the top and bottom fifth of households as measured by disposable income. Over many decades, the burden of indirect taxation has crept steadily upwards. Tax now makes up 79 per cent of the price of an average bottle of whisky, more than 80 per cent of a budget brand pack of cigarettes, half the price of a bottle of wine and around 60 per cent of a litre of petrol. VAT, which was originally set at 8 per cent, has climbed to 15 per cent, then 17.5 per cent, and now stands at 20 per cent.

As the state has grown fatter, politicians have increasingly relied on stealth taxes to fund their spending. These taxes fall disproportionately on the poor. If someone in the bottom income quintile drinks moderately, smokes and drives a car, they will spend a staggering 37 per cent of their disposable household income on VAT, motor fuel duty, tobacco duty and alcohol duty. Forget the cost of the products themselves: that is just the tax.

If we really wish to lift people out of poverty, we should not be taking so much of their money. If we halved taxes on fuel, alcohol and tobacco, scrapped green energy subsidies financed through higher bills and reduced VAT back to 15 per cent, it would represent a major step forward in reducing the cost of living and would put money back in the pockets of those who are in greatest need. With the economy recovering, David Cameron has said that he wants to see "taxes cut for all". This is the place to start.

Some argue that the negative externalities of 'sinful' products necessitate Pigouvian taxation (taxes which represent the "external" or "non-private" costs of consuming such products and/or which raise money to pay for the external social costs incurred by a product's use).

But a close inspection of the figures reveals that sin taxes in Britain far exceed any burden that consumption of the relevant products place on the state.

Taxes on motoring not only exceed the costs of maintaining the road network by £30 billion, but also exceed the environmental costs associated with driving. The £2.7 billion a year that smoking is said to cost the NHS is paid for four times over by tobacco taxes and

> **SIN TAXES IN BRITAIN FAR EXCEED ANY BURDEN THAT CONSUMPTION OF THE RELEVANT PRODUCTS PLACE ON THE STATE**

the £12 billion paid in alcohol duty comfortably exceeds the £6 billion spent on healthcare and policing that is attributed to alcohol.

Cutting these taxes would bring many benefits. High motor fuel prices hamper the economy in numerous ways, raising barriers to work and increasing the price of everything that is transported by road. Halving taxes on alcohol and tobacco would kill their respective black markets and would bring an end to cross-channel 'booze cruises'.

Cutting VAT to 15 per cent would put more than £20 billion back into the pockets of the British people and improve work incentives considerably. Of course, this is another way of saying that the state would have £20 billion less to spend. But, with the government spending close to 50p in every pound, the state should cut spending and consider carefully which taxes to cut at the same time.

Of course, a large proportion of state spending involves the provision of welfare payments to the very people paying disproportionately high sin taxes. Cutting both spending and cutting the taxes identified above would be complementary measures.

Those who support paternalistic sin taxes argue that people on low incomes can avoid the taxes by avoiding the products. Whilst this is trivially true, large numbers of people on low incomes exercise a preference to buy 'sinful' products and will continue to do so for the foreseeable future, despite some of the most punitive taxes in the world. There is a welfare cost when people change their consumption habits simply to avoid taxes.

The hard reality is that these taxes are discriminatory and highly regressive. Those who support them whilst claiming to be fighting a war on poverty are fooling themselves•

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Are LIFESAVING DRUGS all they seem?

Far more patients are likely to be eligible for cholesterol-lowering drugs called statins, if doctors follow new heart guidelines issued by the American College of Cardiology and the American Heart Association (AHA).

Statins are widely prescribed to reduce the risk of heart attacks but the new guidelines recommend that they also be considered for people at high risk of stroke.

But whether they follow these recommendations there is a deeper and more pervasive controversy that no one is discussing: the quality of the statins we are already ingesting.

It is far from common knowledge, but many cardiologists will tell you in confidence that they routinely switch patients from a generic statin back to the brand original or to another generic because of clinical problems.

As one cardiologist put it to me in view of the new guidelines "the new heart recommendation may put tens of millions of more US patients on statins, and this may be the correct advice, but only if the statins work properly". But doctors are skittish about saying these things on the record for at least three reasons.

First, they don't want to appear to be in the pocket of the brand-name drug companies. Second, they are confused – after all, generics prescribed in rich nations all have regulatory approval. Third, it can be difficult to spot when many medicines fail, since clinical symptoms may not be noticed for weeks or months.

Dr. Preston Mason of Brigham and Women's Hospital, Harvard Medical School, is bucking the trend. He recently presented a paper on 36 different generic versions of the most widely prescribed statin, atorvastatin.

The generics were procured from pharmacies in North America, Europe and Asia to "evaluate the chemical purity of generic atorvastatin". These generics were compared with the original atorvastatin (patented by Pfizer as Lipitor) – and the findings were alarming. The "widely-available" generics were found to contain an impurity that could prevent them from working properly.

THERE IS GROWING CAUSE FOR ALARM AS EVIDENCE OF CORNER-CUTTING MOUNTS

A lot of these generics are made in India, where quality is an ongoing concern. In May 2013, one of India's largest companies, Ranbaxy – the manufacturer of generic atorvastatin – pleaded guilty to seven felony counts related to lies about drug quality data and was fined $500 million by the US government. Yet India's drug regulator, the CDSCO, still has not sanctioned Ranbaxy.

My research team has sampled thousands of medicines from India and other emerging markets and found major errors in formulations in at least ten per cent of the samples. Gross failings of drug quality are manifest in most emerging markets. But because of western oversight and the threat of litigation against corporate mistakes, most medicines prescribed in the US and Europe do not have obvious errors.

The discerning eye will note, however, that the scientific literature is being populated with examples of oncology, transplant and other critical medicines with impurity problems like those found by Dr. Mason – some of which make their way to European patients. Yet, impurity profiles of medicines on the market are not routinely assessed by western regulators.

If regulators are doing their job properly, they should conduct random sampling of statins (and probably all medicines) sold on the market, and submit these products to myriad tests to find problems with impurities.

Currently, products that receive approval may work fine at the time of assessment, including having low impurity levels. But there is growing cause for alarm as evidence of corner-cutting mounts – particularly among Indian generics manufacturers, with the products sold after approval not matching up to those that achieved approval. Only time will tell how lethal the consequences of this corner cutting will be.

This is an interesting and problematic issue. The existence of regulation can crowd out methods of quality control that can arise within the market itself. However, in many areas of economic life we expect regulators to rectify problems that economists describe as "market failure". Unfortunately, rather like in the financial markets in 2008, we can see that regulators can fail too.

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