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WELCOME

...to **EA**, the new magazine from the **Institute of Economic Affairs**.

The BBC's Andrew Marr has called us **"undoubtedly the most influential think tank in modern British history"** and we hope **EA** builds on our reputation for **innovative, influential** and **intellectually rigorous** economic thinking.

We'll be publishing three times a year, with a **focus on the fundamental importance of free markets** for vibrant economies and societies.

In this and forthcoming issues we'll bring you **the best writers** on economic freedom from **around the world**.

For example, this edition's cover story tackles the issue of the minimum wage and its damaging impact on employment in the **UK**.

Further afield, we look at ground-breaking educational initiatives in **India and Sweden**, examine the interface between the Islamic faith and free economies in the **Arab World**, and recoil at the red tape tangle in the **EU**.

We also ask if governments really can make us happy. And, specifically related to the UK, we question traditional thinking on child poverty, see how bad economic theory leads to bad taxes and assess why minimum alcohol pricing will hit the poor hardest.

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In the meantime, I sincerely hope you'll enjoy this – and future editions – of **EA**.

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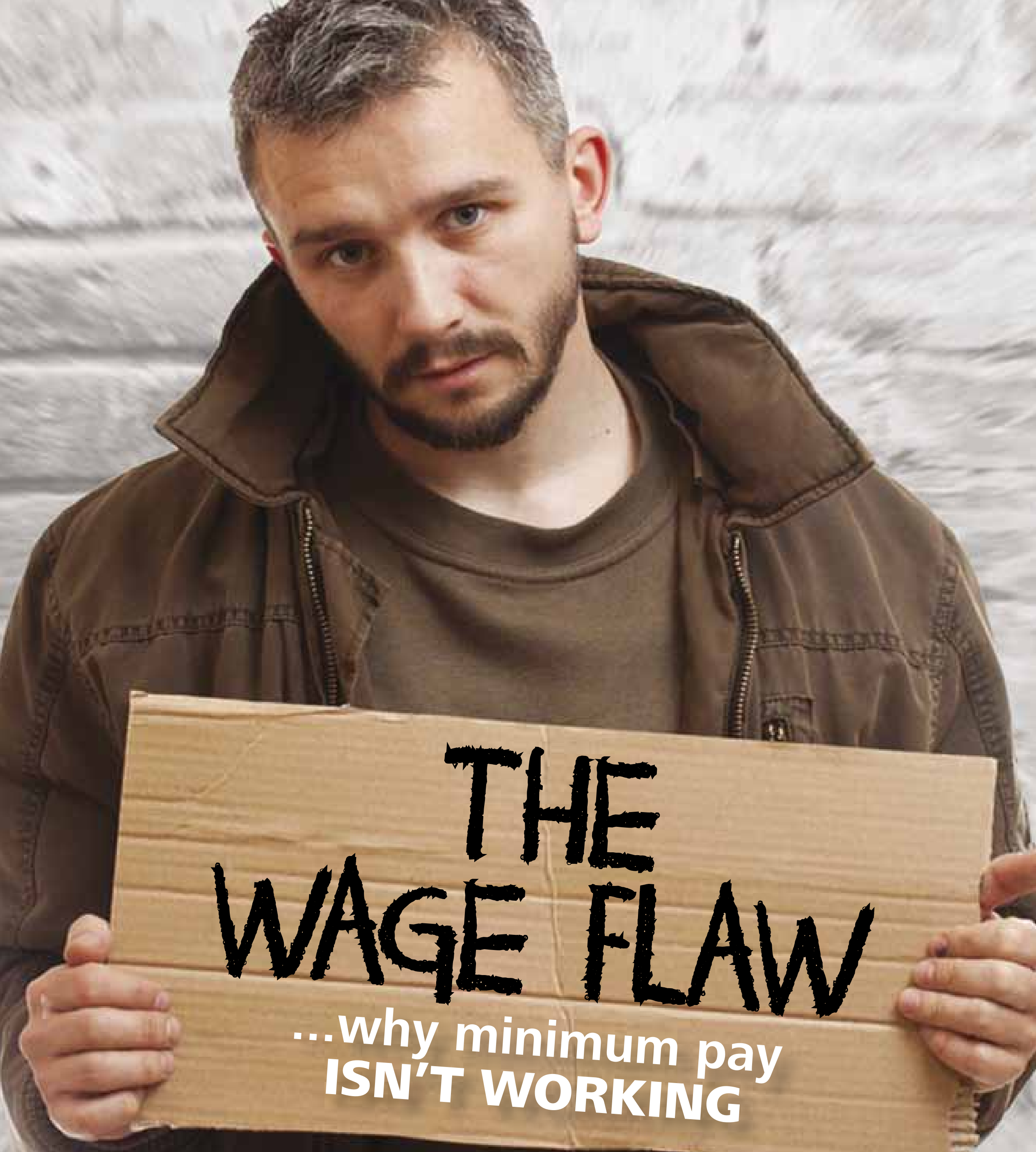

THE WAGE FLAW

…why minimum pay ISN'T WORKING

There has been a serious decline in labour market prospects for the most vulnerable groups since the minimum wage was introduced in the UK. There isn't sufficient UK evidence yet to pin the blame for this entirely on the minimum wage, but the international evidence points in that direction. Proposals for imposing a "living wage" by soft or hard coercion could be seriously damaging, says W.S.SIEBERT…

The UK's minimum wage began in April 1999, fulfilling a promise of Tony Blair's Labour government. Blair was responding to popular demand, since the Conservative government in 1993 had ended the old system of minimum wages. Michael Forsyth, the Employment Minister at the time said: "The biggest source of poverty is not low pay; it is having no job. Wages councils destroy employment". Most people, then and now, believe that there is a moral basis for a minimum wage. Certainly, the minimum wage is a popular policy, and the coalition government has not moved close to changing it.

The national minimum wage (NMW) system has some interesting features. Firstly, it is set in a technocratic way by experts who rely on research. Although the Low Pay Commission has both TUC and CBI members, it also has academic members, and an independent chair. Hence, a careful sifting of the evidence on how the NMW bears on business – including business in the regions – plays a large part in the debate. As such, changes in the NMW have responded closely to changes in the health of the economy. The biggest exception to this was in 2001 when the thrusting Stephen Byers saw electoral advantage in pushing the youth rate up considerably prior to the May 2001 election. The important point here is that the NMW is set explicitly to weigh as little on unemployment as possible.

Secondly, the minimum wage is "national", with no regional differentiation. The Low Pay Commission's terms of reference from the beginning excluded such differentiation. Hence, arguably, the level has always been too high for the north, and too low for the London area. The NMW does, however, have several age categories, with a youth sub-minimum, and an even lower apprentice sub-minimum. Thus, it has been sensibly conceded that young workers and apprentices are less productive. Again, we see an effort to mute the unemployment consequences of the minimum.

Despite this, the UK labour market is performing poorly for unskilled workers, as shown in *Table 1*, and the question must arise about the NMW's role in this. The table gives statistics for the 16-24 group, and we see that this group's unemployment rate has almost doubled to 24.7 per cent over the period since 1999. The working age population as a whole have not done nearly as badly as this. In addition, as the lower panel shows, unemployment duration for the young age group has worsened, to the point where 28.2 per cent of the youth unemployed have been unemployed for over one year. This figure compares with only 15.3 per cent in 1999. In fact, in many respects, the UK's youth labour market is now putting in a worse performance than that of France. This comparison is made in the last column.

Employment effects: UK evidence

The minimum wage has been raised considerably over the period since 1999. Hence, it makes a lot of difference to unskilled workers' earnings, and one would expect unemployment consequences unless counter-balanced by strong growth. The impact of the minimum wage can be seen in *Figure 1*, which compares the earnings distributions in both 1997 and 2010. The 2010 distribution has had its lower tail cut off compared with 1997, and there is also a concentration of workers at the minimum. The large increases in the NMW over time are shown in *Table 2*. It has increased by 72 per cent since 1999, considerably more than the average worker's wage, which has increased only by 50 per cent, which, in turn, just outpaced price increases of 45 per cent.

What effect has this had on job opportunities for the unskilled? There are inherent statistical difficulties of identifying the impacts of a policy that covers the whole of the UK. One way to judge this issue is to examine regional variation, since the NMW has more "bite" in poor than rich areas as shown in *Figure 2* which compares the hypothetical effect in a district such as Cambridge with one such as Liverpool. Assume that productivity and the demand for labour is lower in Liverpool. The NMW requirement would move unskilled employment from *point d* (dictated by the level of welfare benefits) to *point c* (the demand for labour at the minimum wage). Meanwhile, employment in Cambridge is barely affected. This result, of course, depends upon the demand (D) for labour curves not shifting over time.

The first person to conduct this type of study was Mark Stewart (2002), who used data for changes in wages and employment in about

		All working age	No qualifications	16-24	France 15-24
Unemployment rate (%)	1999	6.3	12.1	13.8	24.2
	2011	8.1	17.0	24.7	22.1
	Change 1999-2011 (percentage points)	1.8	7.9	10.9	-2.1
		All working age	**No qualifications**	**16-24**	**France total**
Unemployment duration (% of unemployed > 12 months)	1999	28.7	NA	15.3	40.3
	2011	33.3	NA	28.2	41.4
	Change 1999-2011 (percentage points)	4.6	NA	12.9	1.1

Table 1: Adverse Changes in Employment for Unskilled Workers
Sources: Low Pay Commission (2012, Table 2.10), ONS (2012) and OECD (2000, 2012)

Hourly earnings distribution for employees aged 22 and over, by 25 pence band, UK, 1997 and 2010

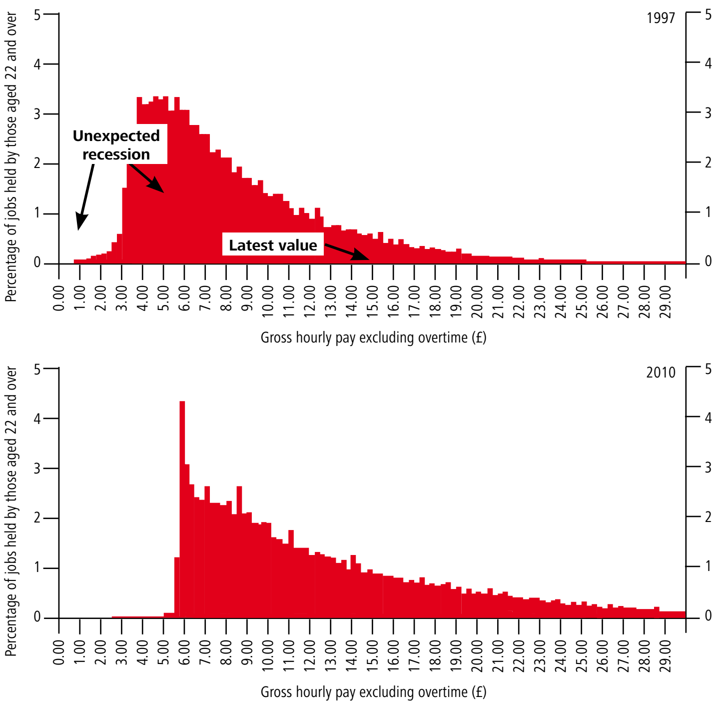

Figure 1: Changes in the Earnings Distribution due to the NMW
Source: Low Pay Commission (2011)

150 UK regions for the first year of the NMW. He found no adverse effect, but with only one data point per region he could not allow for region-specific trends or long-run effects. His work has recently been updated (Dolton et al 2008, 2010), this time experimenting with a lagged minimum wage variable so as to capture long-run effects. Again, while little effect on employment is found, there is a significant increase in claimant unemployment.

An alternative approach is to compare workers who have their wages raised by the NMW with workers paid just above that level (say, up to 10 per cent above the minimum). These workers should have similar skills, and welfare benefit options. This method was also pioneered for the UK by Stewart (2004). He again found no adverse NMW employment effects. However, in more recent work (Stewart and Swaffield 2008), he has found evidence that the NMW causes a cut in working hours of between 1 and 2 hours per week.

The latest work using this approach is by Dickens and Riley (2012), using data up to 2010 and encompassing recession years which hit unskilled workers harder. This research finds that the probability of remaining in a job (employment retention) is reduced by about three percentage points by the NMW for part-time women, the group who are most affected by the NMW. This result is important because a 3 point reduction is in fact quite large when measured against an average retention rate (i.e. probability of remaining in employment for one year) of around 70 per cent. About 10 per cent of female part-timers are paid the minimum compared with only 2-3 per cent for male and female full-timers.

So, the UK employment picture for the most vulnerable has deteriorated rapidly since the introduction of the minimum wage. However, there is not enough data to draw firm conclusions as to the cause as yet. What does the international evidence suggest?

International evidence

Studying a panel of countries or states (for example in the USA) offers a better way of analysing minimum wages since there is more variation in the minimum wage and more sophisticated statistical techniques can be used. An important study of long-run effects is that by Baker at al (1999) for nine Canadian provinces for 1975-93. He found that a 10 per cent increase in the minimum wage reduces teenage employment by 2.5 per cent and that it takes about six years for this result to be revealed.

There have been several further international panel studies, all finding serious adverse employment effects. Neumark and Wascher's (2004) analysis of 17 OECD countries for the period 1975-2000 finds that a 10 per cent increase in the minimum wage leads to a two per cent reduction in the employment rate for younger people (aged 15-24). More recent work by Dolton and Bondiabene (2012) confirms these estimates and also suggests that the much lower impact of minimum wages on adults tends to double during a recession.

Finally, the work by Addison and Ozturk (2012) on a similar sample concentrates on employment outcomes for adult women. They estimate that a 10 per cent increase in the minimum wage will reduce employment by 1.5 per cent.

In sum, while the UK evidence is thinner due to statistical problems, the research overall points to the minimum wage reducing employment as conventional economic theory predicts. In other words, the minimum wage undermines employment for the least productive whilst raising wages for others. The research also suggests that the workers who benefit are the better-off: where there is high

			Level, Oct 2012, £/hour	Increase since 1999 %
National Minimum Wage	Age categories:	22+ (21+ from 2010)	6.19	72
		18-21(20 from 2010)	4.98	66

Table 2: Minimum Wage Trends

unemployment there is heightened competition for jobs, with the better connected workers rather than the poor finding them. Thus, Ahn et al's (2011) research shows that, as the minimum wage increases, there is a shift in employment towards teenagers in families with highly educated heads and away from poorer groups.

Morality and new proposals for a "living wage"

Going beyond the NMW, the Joseph Rowntree Foundation and others are calling for a "living wage" of £7.45 an hour. This would be achieved by moral persuasion and possibly implicit and explicit government pressure. We are told that "the moral pressures are winning out over the economic pressures" (Hirsh 2012). Yet what moral virtue is there in a policy that causes the loss of jobs for low-wage, low-skill workers or which causes the lengthening of unemployment terms? Countries with high minimum wages and/or high social costs – such as France - have high long-term unemployment (nearly half the unemployed have been jobless for longer than a year in France). As unemployment terms lengthen, productivity declines and it becomes ever more difficult for people to find work once priced out by a high minimum wage.

The living wage would be tied only to living costs and median incomes and not to labour market conditions. As we have seen, the unemployment effect of the UK minimum wage has been reduced because of the pragmatism of those

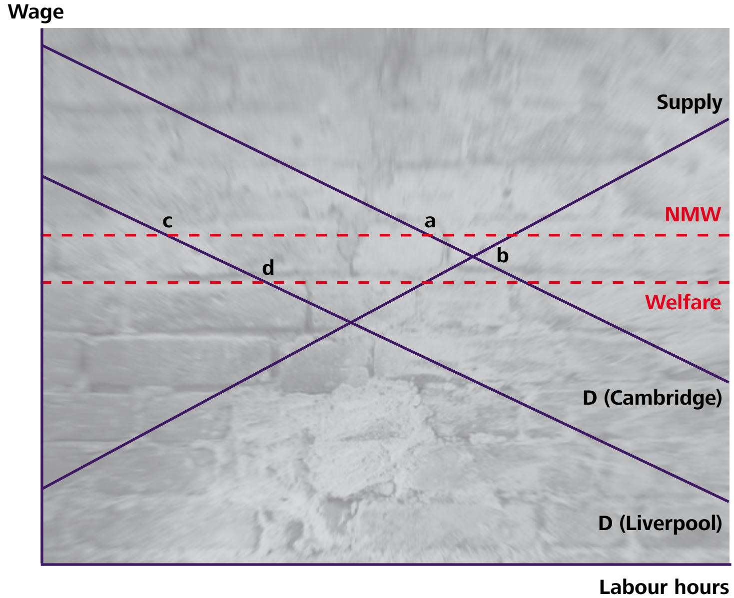

Figure 2: Assessment of NMW Effects

setting the rate. The imposition of the living wage – regardless of labour market conditions – would be a recipe for hugely increased long-term unemployment.

A functioning market would have lower wages in Liverpool than in Cambridge, which would attract business, and relieve poor unemployed people. If the market were allowed to work – which would require lower benefits as well as lower wages since benefits form a floor under wages – then businesses would move north. Of course, it is difficult to take on the benefit system, but even tax breaks for businesses in development areas would be better than a living wage. Such a policy would have its problems, but it would be better than living wages. The living wage is simply the worst solution to an admitedly serious problem – the high cost of living and high tax burden in the UK. In fact, as discussed elsehwere in this magazine, there are other policies, such as reduced regulation and taxes, that could reduce living costs and thus turn existing wage levels into "living wages".

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Welcome to Fads & Fallacies, the column that debunks dubious notions. Here, **CHRISTOPHER J. COYNE** and **RACHEL L. COYNE** explore Notion no 1:

GOVERNMENT can make us happy

In a 2006 speech, Prime Minister David Cameron argued: "It's time we admitted that there's more to life than money, and it's time we focused not just on GDP, but on GWB – general well-being."[1] Cameron's suggestion represents a broader trend not just in public policy, but also in the economics discipline, of focusing on the idea of happiness or subjective well-being.

The origins of the emphasis on well-being can be traced back to the research of economist Richard Easterlin in the 1970s. In what has become known as the "Easterlin Paradox", he found that, beyond some level of income, economic growth does not improve reported well-being. This had led to calls for a range of government policies such as progressive taxation, redistribution for egalitarian purposes, job programmes, etc, which are intended to increase society's well-being. Unfortunately, the research on well-being, and the subsequent policy implications, are plagued with significant problems that undermine the claim that government can maximise citizens' happiness through well-designed interventions.

THOSE LIVING IN THE FREEST COUNTRIES REPORT THE HIGHEST LEVELS OF LIFE SATISFACTION

Do we get happier when we get richer?

One problem with the research on subjective well-being is that it is unclear that the Easterlin Paradox actually exists. At the time Easterlin originally identified his paradox, he was working with a limited set of data. More recently, empirical research by Daniel Sacks, Betsey Stevenson and Justin Wolfers, who rely on a more expansive set of data, finds that happiness is in fact higher in countries with a higher average income. Moreover, they find that happiness is higher for people with higher incomes and that happiness within a country increases over time as income grows. These findings have serious implications for proposed government interventions grounded in the Easterlin Paradox. Whether one agrees with these recent findings or not, at a minimum they should give pause to those who conclude with certainty that government intervention is necessary to solve a problem that may not even exist.

Can government maximise happiness?

Another issue relates to the ability of government to effectively design and implement the necessary policies to maximise a society's happiness. Even if we (very charitably given the recent empirical findings) grant that the Easterlin Paradox holds, do we have reason to be confident that the government can resolve the problem? There is good reason to believe that the answer is no.

Those in government suffer from both a knowledge problem and an incentive problem when it comes to designing interventions. Even if the intentions behind general well-being policies are benevolent, how will the government know what aspects of well-being to maximise and by how much? Maximising well-being involves trade-offs and the trade-offs are different for different people. As F.A. Hayek famously pointed out, planners suffer from a knowledge problem whereby the relevant information necessary for successful co-ordination and production is context specific and cannot be aggregated in any meaningful way. This is not to say that government cannot provide certain goods and services that benefit narrow segments of society, but there is no way for those in government to maximise well-being across all citizens. This is important because policies that increase the well-being of one segment of society may decrease the well-being of other segments, making the net effect on well-being indeterminate at best and negative at worst.

In addition to knowledge problems, government officials face perverse incentives in both designing and implementing policies. Interventions are not formulated in a vacuum, but rather emerge through a political process characterised by a variety of competing pressures and interests. Those economists working in the public choice tradition have emphasised the central role of "log-rolling", or political vote trading, in the process of democratic decision making. In order to get desired policies

[1] Complete speech available at: www.guardian.co.uk/politics/2006/may/22/conservatives.davidcameron

[2] Source of graph: Fred McMahon. 2011. "Economic Freedom of the World: 2011 Annual Report, Part 1" Available at: www.freetheworld.com/2011/malaysia-conference-2011.ppt

passed, legislators must be willing to garner support by trading their future support for policies that other legislators find desirable. This has important implications for general well-being policies for two reasons.

It means that narrowly-focused special interests can successfully have their agendas passed as legislators garner support for these groups in exchange for supporting future votes benefiting other narrow interests. This is problematic since the stated goal of government policies related to well-being is to increase the happiness of society as a whole and not of specific segments of society who happen to be the most effective at turning their interests into policy. Secondly, through the process of special interests each pursuing their own agendas, overall government spending will tend to be higher than the level preferred by citizens. This excessive spending may have a negative effect on well-being since it means that more income is transferred from citizens to government.

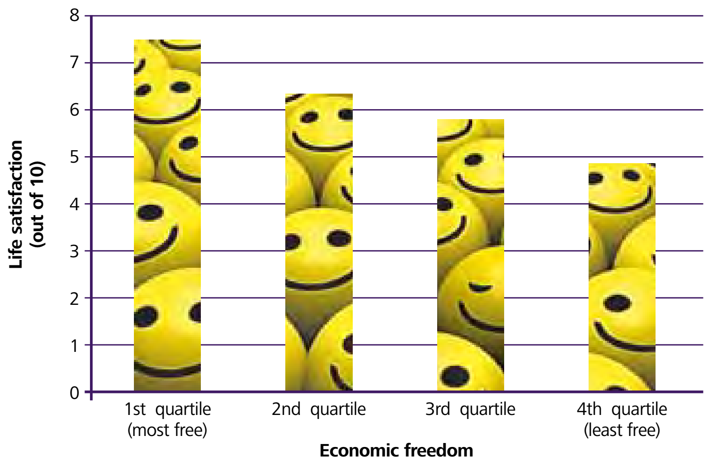
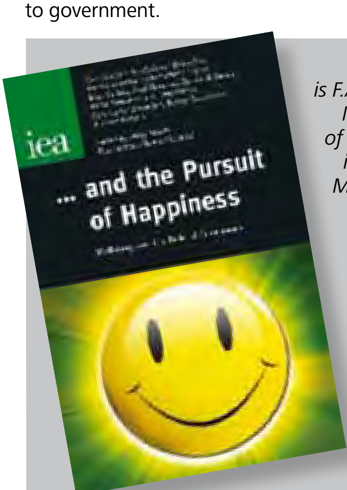


Figure 1: Economic Freedom and Life Satisfaction[2]



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If you'd like to learn more about these issues, there's a free download of our IEA monograph *...and the Pursuit of Happiness: Wellbeing and the role of Government*, edited by **Philip Booth**, at: www.iea.org.uk
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Well-being is subjective

Taken together, governments lack both the knowledge and incentive to maximise social well-being. But even if we were to put these issues aside, there is a more fundamental problem with the claim that government can maximise society's happiness. In order to measure happiness, one must assume that well-being is something that can be measured and aggregated across people and through time. This neglects the fact that well-being is not a predefined bundle, but rather something that is highly subjective and discovered through individual experience and experimentation. Given that well-being is a fluid concept both across people and across time, what does this imply for policy?

Ultimately, this implies that the central focus should not be on attempting to micro-manage well-being according to the dictates of politicians, but rather on creating an environment which allows people to engage in the process of discovery. Such an environment is provided by economic freedom which is grounded in individual property rights and freedom of choice. To see this connection, consider the relationship between economic freedom (as measured by the Fraser Institute's Economic Freedom of the World Index) and reported life satisfaction by citizens.

As *Figure 1* illustrates, there is a positive relationship between economic freedom and well-being, meaning those living in the freest countries report the highest levels of life satisfaction. There is good reason to believe that this is more than correlation. Freedom of choice and experimentation provides each individual the opportunity to determine what it is that they value. For some this may be a workaholic lifestyle while for others it might be spending significant time with family and friends. Economic freedom allows for a diversity of preferences regarding well-being instead of imposing a uniform notion of happiness on all citizens. Moreover, in allowing for experimentation, freedom of choice allows for mistakes and failure. While failure may increase unhappiness in the short-run, it is part of the human experience and also makes success that much more meaningful when it does happen. It should be added also that citizens may derive well-being simply from being in control of their destiny rather than having their lives controlled to a greater extent by government and its agencies.

If the ultimate goal is a free society where private citizens can engage in the ongoing discovery of what makes them happy, then the fad of government-planned well-being must be rejected and replaced with the freedom of individuals to discover and pursue that which they determine to be the good life•

Hung up on RED TAPE

Calls for harmonising regulation in the EU are distinctly off key, says the Institute of Directors' GRAEME LEACH

A key part of EU policy over the last 20 years or so has been the completion of what is described as an "internal market". This involves not just the removal of explicit trade barriers between EU countries but also, in many cases, the harmonisation of regulation. I strongly support – as does the Institute of Directors – the essential elements of a genuine internal market: the free movement of capital and labour. I also support trade liberalisation, open markets and the creation of a comprehensive internal market, but the current reality falls well short of a genuine single market, and it is certainly not a free market.

It is obviously true that harmonisation of regulation reduces transaction costs because businesses do not have to adapt to different regulatory regimes. From a static perspective, the removal of these transaction costs through harmonisation of regulation represents an efficiency gain. However, harmonisation also prevents regulatory competition. From a dynamic perspective, the loss of regulatory competition will almost certainly entail large additional costs and inefficiencies. Regulatory competition can both restrain regulatory over-reach and also allow different approaches to regulation to be tried in different countries.

However, at the same time, we should not assume that, without the harmonisation of EU regulation, we would have the perfect regulatory environment here in Britain. In the absence of rules and regulations from Brussels, we would still have rules and regulations imposed from London and many of those rules would be harmful.

- **Social, employment and environmental regulation should not be determined at EU level**
- **The fundamental freedoms of the EU should be fully supported but we do not need to unify regulation to have free trade**
- **Regulation is used to raise rivals' costs and is becoming ever-more centralised**
- **Unfortunately, Britain not only "gold plates" EU regulation, it also encourages the growth of regulation both domestically and in Europe.**
- **The UK government should criticise Brussels, but it also needs to get its own house in order**

Social, employment and environmental regulation

Perhaps the most contentious forms of regulation are those covering social, employment and environmental issues. With few exceptions, regulation at the EU level is simply not necessary to liberalise trade within the EU. The notion that an internal market requires harmonisation of employment and social legislation is based on the fallacious 'race to the bottom' theory: the idea that countries with lower employment and social standards will gain an 'unfair' competitive advantage over the more stringently regulated ones. This runs contrary to most of what is known about the functioning of labour markets.

Wage rates are set by market forces and levels of productivity. Legislation affects the composition of the pay package, but not the pay level. If legislators in one country insist on extensive fringe benefits and regulation that, for example, improves safety standards, these will come at the expense of lower cash salaries. The total compensation level has not increased; it has merely been shifted from payment in cash to payment in kind. But what affects employers' business calculations is the total cost of employing people, not the precise method of dividing non-pecuniary and pecuniary benefits between regulated and unregulated aspects of the total pay package. This reasoning applies both to employment regulation and also to health and safety standards for employees.

Even in the case of environmental standards, in most cases a similar logic applies. Environmental standards are about a trade-off between (perceived) environmental quality and material prosperity. Local electorates in different places will make different trade-offs in this respect and, as long as there are no major inter-country spill-over effects, it is reasonable for legislation at country level to reflect this plurality.

In fact, the way in which the EU deals with these matters should be turned entirely on its head. The EU should be asking whether domestic legislation is designed to be trade inhibiting or is significantly trade inhibiting in practice. If it is, the EU Commission should be trying to over-turn such regulation through the European Court of Justice rather than centralising regulation.

Harmonisation which is justified by the alleged need to create a "level-playing field" can be abused to pursue a strategy of "raising rivals' costs". An example of this would be the Working Time Directive, which was classified as a health and safety measure rather than a social policy measure, in order to avoid the requirement for unanimity. A specific example of attempts to raise rivals' costs has been seen recently with the attempts to impose a financial transactions tax which would yield much of its revenue from one country – the UK.

A common market does not require a centralisation of economic or social policy competencies at the EU level. The desire to centralise competencies has to be seen as a political aim, not a requirement of economic policy.

Gold plating

The irony is, however, that the UK government often makes the EU regulation that we so often complain about worse. There is considerable anecdotal evidence of the "gold plating" of EU regulation by UK regulatory authorities. But, worse than this, successive British governments have often accepted, or sometimes even encouraged, costly regulation at the EU level. The clearest recent example of this is the regulation of the insurance industry (Solvency II). These rules impose detailed capital requirements, based on a complex risk-weighting system, on insurance companies. They have been driven by the UK and it is reported that they have so far cost British insurers £3bn – and the regulations have not even been implemented yet!

The whole approach is strongly at odds with the way in which the financial services industry in the UK has historically developed. Up until the 1980s, there were no explicit minimum capital requirements for banks and insurers. Banks and insurance companies were required to publish information on the risks they were incurring, and the provisions they were making to cope with them. Investors had an incentive to monitor financial service providers and penalise excessive risk-taking. This was therefore a largely self-regulating system. The current EU approach to regulation, which is built on the assumption that regulatory agencies can determine the 'optimal' level and composition of capital requirements through mathematical models, is very far removed from this tradition. But it is not an imposition by the EU on Britain. To a large extent, it has been driven by Britain which has moved away from its tradition of lightly-regulated financial markets in the last 30 years.

THE IDEA THAT EMPLOYMENT REGULATION SHOULD BE HARMONISED RUNS COUNTER TO EVERYTHING WE KNOW ABOUT THE FUNCTIONING OF LABOUR MARKETS

Is there another way?

When the single market was first proposed, the British expected that a process called "mutual recognition" would dominate. This involves the different countries developing their own approaches to regulation, subject to some minimum level, and then trade taking place freely on that basis. Somebody in the UK could buy a product from a life insurance company domiciled in Holland and regulated by the Dutch regulator, for example. Countries would still be able to unify their regulatory systems through multi-lateral agreements outside EU structures if they wished – but this would happen through evolution.

Mutual recognition has been more or less abandoned and replaced by the centralisation of regulation in Brussels. This is regrettable and damaging for business. However, it is also very clear that we need to get our own regulatory house in order. Westminster can hardly complain about Brussels if it just rolls over and accepts everything Brussels produces and, indeed, is often cheering on those who wish to wind up our businesses in red tape•

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ISLAM and free markets: *Can they co-exist?*

The Arab Spring gave rise to much hope, though progress since has been traumatic. Can Muslim countries embrace their faith and a free economy?

BENEDIKT KOEHLER

A political chain reaction was set off in the Arab world in 2010 when Mohammed Bouazizi, a young Tunisian stall-owner, was denied a licence to ply his trade and in desperation driven to suicide.

That his immolation might ignite mass protests in his home country was to be expected, but not that protest movements would erupt across the Arab world that still have not burned out. Popular movements in Muslim countries gained traction by invoking the promise of reviving Islamic values that authorities were accused of having betrayed. As of now, the roadmap leading to an Islamic society is as vague as the outlines of what that destination would look like. However, reformers can take heart that early Islamic society promoted entrepreneurs and banned kleptocrats. In fact, the pro-business approach of Mohammed and his successors helped turn early Islamic societies into the most dynamic economies of their time. A revival of Islamic values should incline policies to a pro-business stance. Islam, after all, is the only world religion founded by an entrepreneur.

THE KORAN EXHORTED BELIEVERS THAT GOLD SHOULD BE PUT TO PRODUCTIVE USE.

Islam and entrepreneurship

Mohammed was an orphan who had to pay his way in life. Whilst Buddha and Jesus were conspicuously indifferent to acquiring wealth, Mohammed encouraged his adherents to engage in business and deemed acquisition of wealth meritorious. He was born in Mecca, a city located in a barren valley whose population had as its sole useful natural endowment a black rock that attracted pilgrims from all over Arabia because it was believed that Abraham had built an altar on that cube, the kaba. The coming and going of pilgrims offered opportunities to trade and do business. This communal business had been operational for many generations when Mohammed was born in 570.

Mohammed was born into a family of leading Meccan traders. He was around ten years old when his uncle took him on his first caravan journey and married an entrepreneur when he was 25. When Mohammed found his calling as Allah's Apostle, he emigrated to Medina to set up a community on Islamic lines. One of Mohammed's first actions in Medina was to set up a market. Raising the standard of living through trade, after all, was what he was familiar with. Indeed the Koran exhorted believers that gold should be put to productive use.

Mohammed died in 632 and the boundaries of the Islamic empire expanded within decades to encompass the entire Middle East and most of North Africa. A large trade zone emerged governed by Islam's ruler, the caliph. Long distance trade became easier once borders fell away. By the end of the seventh century, the caliphs introduced a gold standard that powered investment activity. The caliph's mints used bullion from Arab gold mines, church treasuries in former Byzantine lands, and Pharaonic gravesites in Egypt.

Islam and the rule of law

Market economies cannot thrive without a supportive legal framework and respect for private property. Mohammed's first successor, the caliph Abu Bakr, made clear in his acceptance speech that his authority was that of a deputy to Mohammed (caliph means deputy) and he did not assert the right to construct laws arbitrarily. He would forfeit his right to govern were he ever to deviate from what the teachings of the Prophet. Abu Bakr thus set a precedent – a ruler is bound by laws too. Medieval Arab lore abounds with anecdotes about Abu Bakr's and his successor Umar's integrity. Both were extremely conscientious in avoiding conflicts of interest and pre-empting accusations of nepotism. Umar personally punished his sons in public to show they had to comply with the same laws as every other citizen. Indeed, Umar asked each senior government official to disclose his personal assets before taking up a senior appointment and to explain any sudden increase in wealth. Umar fired corrupt officials on more than one occasion, including the army's commander-in-chief Khalid al Walid.

Early Islamic judges were known not to countenance even the appearance of accommodating the government. Exemplary anecdotes of judicial independence from the executive were passed from generation to generation reading the classic collection of tales in Arabian Nights. In one such story, the famous jurist Abu Hanifa declined an invitation to work for an administration where he might compromise his standard of integrity, because, as he made it known to the caliph, "how can I enter the water without getting wet?". The Arabian Nights gather many other instructive anecdotes explaining a nuanced understanding of the interdependence between low taxes, entrepreneurial freedom and political liberty. The Arabian Nights' narrator Shahrazad told her royal husband (and all her readers) how good governments are run: "Religion depends on the king, the king on his troops, his troops on money, money on prosperity, and prosperity on justice." The Arabian Nights feature many other examples of good and bad governments, showing that early Islamic societies had a very articulate educated class voicing opinions on public affairs. Islam's fundamental pro-business stance was not controversial. Mohammed was remembered to have given sound investment advice: "There is nothing wrong in wealth when a person is God fearing, but health is better than wealth for the God fearing, and cheerfulness is a blessing."

A REVIVAL OF ISLAMIC VALUES SHOULD INCLINE POLICIES TO A PRO-BUSINESS STANCE. ISLAM, AFTER ALL, IS THE ONLY WORLD RELIGION FOUNDED BY AN ENTREPRENEUR

The rise and fall of the Islamic empire

The early Islamic empire grew very quickly and Arab Muslims were a minority that was vastly outnumbered by Christian and Jewish subjects. The early caliphs had no option but to rely on non-Muslims to staff their administration, collect taxes and negotiate treaties. The integration of a vast region, and the scope for professional advancement of a vast talent pool, engendered dynamic economies and spawned rapid urban growth. Baghdad in the tenth century was the world's largest city.

Some Islamic scholars and lawyers pined for a return to the simplicity of Islam's early days and had reservations about the luxurious lifestyle of the Muslim upper classes. But they could not point to a single Koranic injunction to compel Muslims to stop pursuing business opportunities and enjoying the rewards of successful investments.

Tenth century Baghdad afforded a much higher standard of living than European cities. Medieval Islamic societies were the most advanced economies of their time and their prosperity seemed assured. Manufacturing and agricultural innovations from Islamic societies found their way to Europe, including manufacturing paper and growing oranges.

Islam's golden age ended after crusaders attacked from the West and Mongols from the East. There were economic reasons for decline, too. Once new trade routes were found, trade no longer depended on traversing land routes across the Middle East. The drive to build new markets overseas sidelined the Arab world.

But the long-term effect of these external shocks was not as pernicious as the enfeeblement of entrepreneurial energy wrought by a combination of self-inflicted factors. Islamic societies lost the ambition to lead the world in scholarship and science and the loss of integrity of ruling classes was even more damaging. Entrepreneurs had no incentive to build a business once more money could be made from seeking favours from whoever happened to be in power. Rent-seeking became more remunerative than investment. Civil institutions and personal initiative withered.

None of this was inevitable, though. Whilst we look at the Arab Spring today without the same optimism that might have been apparent in its initial stages, there should still be hope. Political and economic freedom are compatible with the best traditions of Islam. It is to be hoped that young people in the middle-east will see that embracing their Islamic faith and developing the policies for a successful free economy are entirely compatible objectives.

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Redefining the poverty debate:

Why a WAR ON MARKETS is no substitute for a WAR ON POVERTY

IEA Senior Research Fellow KRISTIAN NIEMIETZ summarises his acclaimed monograph on poverty. You can download it for free at www.iea.org.uk

In the late 1990s, domestic poverty became a top policy priority in the UK. This manifested itself in the adoption of explicit poverty targets and of a comprehensive set of policy measures, which have not been fundamentally altered after the 2010 change in government. It was a predominantly state-centric approach to poverty alleviation, based on a steady expansion of cash benefits and publicly provided services (see Hills et al, 2009). It was a programme that largely coincided with the recommendations of the vast network of measures, especially among families with children. But, by then, the strategy had reached its zenith. Since 2004, living standards of the least well-off have made no further progress, and according to some measures they have even fallen again. The turning point preceded the onset of the great recession. For the

ATTEMPTS TO COMBAT POVERTY THROUGH EVER-INCREASING LEVELS OF SOCIAL SPENDING HAVE BEEN TAKEN AS FAR AS THEY CAN GO

of poverty campaign groups active in this field, sometimes loosely described as the 'poverty industry'. The large-scale income transfer programmes which the poverty industry had long demanded became a reality.

For a while, it seemed to work rather well. Up until about 2004, living standards of the least well-off were rising according to a variety 'poverty industry', the only permissible explanation was that the government was still not doing nearly enough. They approved of the general direction of travel, but maintained that it was no more than a good start (e. g. CPAG, 2009).

This raises the question of what level of public spending, if any, would qualify as 'enough' for the poverty industry. It is worth bearing in mind how far the use of income transfers has already been taken. For households in the bottom quintile of the income distribution, the government is the main breadwinner, with cash benefits representing by far the most important income source. In the second quintile, cash transfers officially contribute almost as much to total income as market earnings, and probably more, given the extent

[1]Polly Toynbee: *'It's full-steam ahead for George Osborne's inequality drive', The Guardian, 19 March 2012.*

	Net social spending in % of GDP (public & publicly mandated)	Family Benefits in % of GDP
Denmark	23.9	3.3
Finland	22.6	2.9
Norway	20.0	2.9
Sweden	26.0	3.4
UK	22.7	3.6

OECD (2011) and OECD (2012)

Table 1: Summary measures of welfare provision in the UK and the Nordic countries, 2007

to which transfer income tends to be under-reported. Even households in the middle quintile receive at least a quarter of their income directly from the state (ONS & DWP, 2012, p. 36). The expansion has been strongest among families with children. At least 68 per cent of all children now live in a household receiving at least one major income transfer, not counting the quasi-universal child benefit (ONS & DWP, 2012, p. 110), and not counting benefits in kind.

Social expenditure in the UK has reached Nordic proportions. In 2007, net social expenditure in the UK amounted to just under 23 per cent of GDP, which would be a perfectly normal figure for a Scandinavian country. Looking at spending on family-related benefits in particular, the UK has overtaken all the Nordic countries.

It is remarkable how little all this has affected the social policy debate. Polly Toynbee continues to claim: "Nations can choose to be high tax, high social service, high social solidarity nations like the Nordics or they can choose to be the devil-take-the-hindmost US. Britain is heading down the American path."[1]

This type of rhetoric clearly indicates a strategy of denial. At least in the British context, the conventional textbook distinction between a high-spending 'Nordic model' and a low-spending 'Anglo-Saxon model' has become completely obsolete. Attempts to combat poverty through ever-increasing levels of social spending have been taken as far as they can go. A future anti-poverty policy must move beyond this agenda.

However, the impulses for a different type of anti-poverty strategy cannot come from within the current poverty industry, or those who share their mindset. The poverty industry consists mostly of single-issue campaigners. They insist that the poverty rate is almost exclusively a function of the level of benefits, and refuse to consider alternatives outside this framework.

This is a shame, because there are promising alternatives. There is one elephant in the room which the poverty industry prefers to ignore, and that is the UK's extremely high level of basic living costs. The poverty industry mentions living costs, but only insofar as it underpins their call for higher benefits. They are wholly indifferent to the causes of this unusually regressive cost structure.

THE POSITION OF THE POVERTY INDUSTRY IS TO DENIGRATE THE ROLE OF PAID EMPLOYMENT, AND INSISTING THAT WORK DOES NOT OFFER A ROUTE OUT OF POVERTY

Living costs, not benefits

Housing costs in the UK are probably the highest in the world. The most straightforward measure of this is the 'median multiple' (MM), the ratio of median house prices to median annual incomes. In most English-speaking countries, historical long-term average MMs used to cluster around values of just below three. Today, MMs in most UK regions exceed a value of five, and values above seven are not unusual. Food prices are almost a fifth above Dutch or German levels, and almost a third above the Irish level (uSwitch, 2011), which are unambitious benchmarks because food prices in these countries are themselves inflated by the EU's Common Agricultural Policy.

Childcare costs can eat up about a quarter of an average family's income, despite the fact that childcare subsidies are just as extensive as in the Nordic countries. The cost of the government's green agenda accounts for 10 per cent of gas prices and 16 per cent of electricity prices (DECC, 2010). For households in the bottom quintile of the income distribution, alcohol and tobacco duties account for at least 5 per cent of their budgets, and probably a lot more given how heavily alcohol and tobacco consumption is under-reported in expenditure surveys. Duties on road fuel are also among the highest in the developed world.

Taken together, this leads to a situation in which the incomes of the least well-off are highly subsidised by government transfers (indeed, they often consist of little else), while at the same time, their cost of living is grossly inflated by government policies. This is akin to turning up all the heaters in a building to full power while leaving the windows wide open. Ignoring the systematic cost inflators and pumping more resources into the transfer machinery is just about the least cost-effective anti-poverty policy imaginable

And yet, the low level of cost-effectiveness of the benefits system is not the worst problem. We also have a policy mix that destroys work incentives. Many transfer payments are directly or indirectly linked to some aspect of the cost of living so, as the latter increased, more and more people needed income transfers to top up their budgets. As rents increased, more people came to rely on housing benefit; as childcare costs increased, more people came to rely on the childcare element of the Working Tax Credit, etc. As a result, more and more people became subject to means-testing in one form or another. Increases in these people's earned income are counted against their transfer income, weakening incentives to progress in the labour market. This can be seen by the high effective marginal tax rates (EMTR) which are common among groups with a weak labour market attachment. The majority of single parents, for example, face EMTRs in excess of 70 per cent (Adam et al, 2006).

And last but not least, as long as low-earners are so heavily reliant on government support, their living standards will always be a political football. The poverty industry is aware of this latter problem in principle, but cannot do anything about it, except accusing the tabloid press of 'manipulating' the public by writing about welfare abuse.

Slashing the cost of living through supply-side measures

So what could an anti-poverty agenda based on supply-side reforms look like? It would, have to start with a wholesale reform of the land-use planning system. The econometric literature on the determinants of housing costs shows conclusively that, in the long run, land use restrictions are the most important factor. For low-income households in rented accommodation, rent payments represent around 40 per cent of their total budgets, giving reforms in this area a high 'leverage'. The immediate first step should be the institution of a general presumption in favour of development: not 'sustainable' development, but development. But, on its own, this would be an unstable solution, because it would not address the incentives that make 'nimbyism' so attractive at the local level. In order to overcome this, the costs and benefits of residential development need to be significantly better aligned. This is best achieved in a system of fiscal localism in which local authorities can keep most of their residents' tax payments and thus have to compete for taxpayers. By the same token, local authorities should have to fund housing-related expenditure, such as housing benefit payments and the cost of maintaining a social housing supply, from locally raised taxes. This would internalise some of the costs of nimbyism. All the fiscal incentives would then point towards permitting more housing development. If MMs could be brought back to the levels which prevailed until the early 1980s, house prices would fall by nearly half, dragging rent levels down with them. This would dramatically decrease dependency on housing benefit, improve work incentives and reduce taxes. Prices in space-dependent industries such a retail and catering would also decrease.

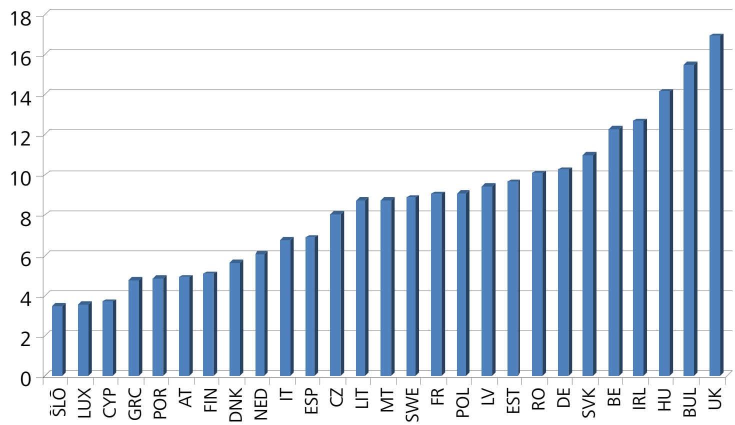

Figure 1: Percentage of children in workless households, EU-27, average 2000-2010 – based on data from Eurostat (2012)

THE SECOND MAJOR PLANK OF A SENSIBLE ANTI-POVERTY STRATEGY HAS TO BE TO INCREASE LABOUR MARKET PARTICIPATION AMONG THE LEAST-WELL-OFF

Further, in the process of renegotiating the division of competences between the UK and the EU, agricultural policy should be a candidate for repatriation. However, the purpose of this should not be to replace the Common Agricultural Policy by a similar 'British Agricultural Policy', but to replace it with nothing – to allow unhampered free trade in foodstuffs. Farm-gate food prices in the EU are more than one tenth above world market levels, a situation which could not persist under conditions of free trade. In abolishing agricultural protection, the UK would do no more than follow the lead of New Zealand and Australia, where agricultural producers are expected to operate under market conditions. Food prices in these countries are almost identical to world market prices.

Childcare is another candidate for deregulation. The detailed input regulations that guide the day-to-

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NO OTHER EUROPEAN COUNTRY HAS SUCH A HIGH PROPORTION OF CHILDREN IN A HOUSEHOLD WITH NO ADULT IN WORK, ONE OF THE MANY FACTS THAT THE POVERTY INDUSTRY CONVENIENTLY IGNORES

day operation in this sector should be largely abolished. It should be up to childminding agencies to find out what kind of quality signals parents expect, and find ways to acquire these traits and signal them. As a first step, details such as minimum staff-to-children ratios should be abolished, and the funding stream should also be rationalised.

Sin taxes should be slashed. Given the low price elasticity of demand for the taxed 'sin products', this would not lead to a massive increase in 'sinning'. It would, above all, liberate resources in low-earners' budgets for other uses.

Strengthening labour market attachment

Taken together, these supply-side measures would slash the basic cost of living and raise low-earners' living standards. The second major plank of a sensible anti-poverty strategy has to be to increase labour market participation among the least-well-off. This is an area where the poverty industry's position is not just unhelpful, but actively counter-productive. Their work mainly consists of denigrating the role of paid employment, and insisting that work does not offer a route out of poverty. They argue the way to overcome poverty is benefits, not work. They use two major arguments to back up this position:

1. *More than half of all children in (relative) poverty already have a parent in paid work.*
2. *The parental employment rate is already among the highest in Europe.*

Both arguments are true when taken literally, but they do not show what the poverty industry claims they show.

The first point is simply explained by the high prevalence of part-time employment among parents. More than one in ten children live in a household with (at least) one adult in part-time employment, but nobody in full-time employment. 'Part-time', in this context, mostly means a working week of 16-hours, the threshold at which parents qualify for Working Tax Credit payments.

The second point is explained by the high proportion of dual-earner households, which drives up the aggregate parental employment rate. Nevertheless, no other European country has such a high proportion of children in a household with no adult in work, one of the many facts that the poverty industry conveniently ignores.

In order to overcome this situation, recipients of in-work benefits should be required to increase the number of their weekly working hours over time, eventually towards a level approaching full-time employment. The option of subsidised part-time employment should be available for those just (re-) entering the labour market, to smooth the transition, but not as a permanent alternative for full time employment. In-work benefits should act as a wage supplement, not as a wage substitute.

Support systems for the workless, meanwhile, should be devolved to the local level, and funded from local tax revenue. This would result in a variety of different welfare systems within the country. In all likelihood, most of these would tend towards some version of conditionality. Local funding would imply a much higher level of transparency. Local voters could see how much the system costs them, which would give them a much stronger incentive to monitor policy performance and demand 'value for money'.

With a combination of high work levels, high rates of work retention and work progression, and competitive product markets which make the basics of life easily affordable for everybody, the UK has the potential to truly eradicate poverty.

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The IEA's Shadow Monetary Policy Committee...

is a group of independent economists drawn from the City, academia and beyond.

It meets at the IEA to discuss the state of the UK and international economies and makes rate recommendations on monetary policy.

It was formed in July 1997, immediately after the formation of the Bank of England Monetary Policy Committee was established.

SMPC meetings are held once a month, and the decisions and minutes of the committee are published a few days ahead of the Bank of England's own interest rate decisions – and can be found on our website:

www.iea.org.uk/smpc/minutes

Currently, the SMPC is concerned by slow growth, with most members believing that this is caused by serious supply-side problems in the UK economy. The size of the state has expanded, both in terms of increased taxation and increased regulation – especially of the banking sector. In this environment, it is not surprising that growth is slow and inflation persistently above target. Although most members of the SMPC believed that interest rates should have been reduced more sharply after the financial crash and supported quantitative easing (QE), a majority now want rates raised and QE put on hold.

The SMPC has now called for a rate rise for four consecutive months.

Decisions

March
Raise interest rates by 0.25% – five votes to four

April
Raise interest rates by 0.25% – five votes to four

May
Raise interest rates by 0.5% – six votes to three

SMPC membership

Prof. Kent Matthews (secretary); Prof. David B Smith (chairman); Philip Booth; Roger Bootle; Tim Congdon CBE; Jamie Dannhauser; Anthony J Evans; John Greenwood OBE; Graeme Leach; Andrew Lilico; Prof. Patrick Minford CBE; Prof. Akos Valentinyi; Peter Warburton; Prof. Mike Wickens; Trevor Williams.

STATE occasion

Around 60 students were among the audience for the IEA's showpiece State of the Economy Conference, courtesy of kind donations from IEA supporters. The event – held at the Institute of Directors in London – featured a host of eminent speakers including the Deputy Governor of the Bank of England and the Director of the German Finance Ministry•

Watch our report on the conference at: www.iea.org.uk/multimedia/video/state-of-the-economy-conference-2013

Eventful...

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Each year our annual intern programme attracts scores of students from all over the UK and beyond. If you'd like to be a research intern, undertake a supervised research project and take part in a packed programme of lectures, seminars and debates, then this is for you!

To apply, or discover more about our year-round programme, contact IEA Education Director Dr. Stephen Davies at academicinterns@iea.org.uk

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The IEA's annual Hayek Memorial Lecture is one of the flagship events of our year. This public lecture features eminent speakers on major questions of public policy and in recent years we've featured Nobel Laureates Gary Becker and Elinor Ostrom•

Our speaker this year is **GROVER NORQUIST** of ***Americans for Tax Reform.*** He'll speak on Wednesday July 3rd at Church House, Westminster. If you'd like to come along, book now at ***hayek@iea.org.uk*** Places are much in demand!

To register for this lecture please email hayek@iea.org.uk

Calling all ECONOMICS TEACHERS…

We've just introduced a series of one-day economics conferences for students and teachers around the country. The first took place at Sherborne School in April, with the second scheduled for Cheltenham Ladies' College in June, with speakers including PROFESSORS TIM CONGDON and PATRICK MINFORD•

Later this year, we'll be staging conferences in Croydon, Manchester and Edinburgh.

If you're interested in hosting one of these events contact Christiana Hambro at

chambro@iea.org.uk

Over 200 delegates gathered for the third Freedom Forum of the UK Liberty League in London in April – attending a wide range of workshops and lectures and meeting like-minded freedom lovers.

Planning for next year's Forum is underway – it will be held in in Manchester in April•

Watch out for details at www.iea.org.uk and www.uklibertyleague.org

The HARD FACTS about HARD MONEY

In the first of a regular series, TIM CONGDON stresses the importance of the invisible...

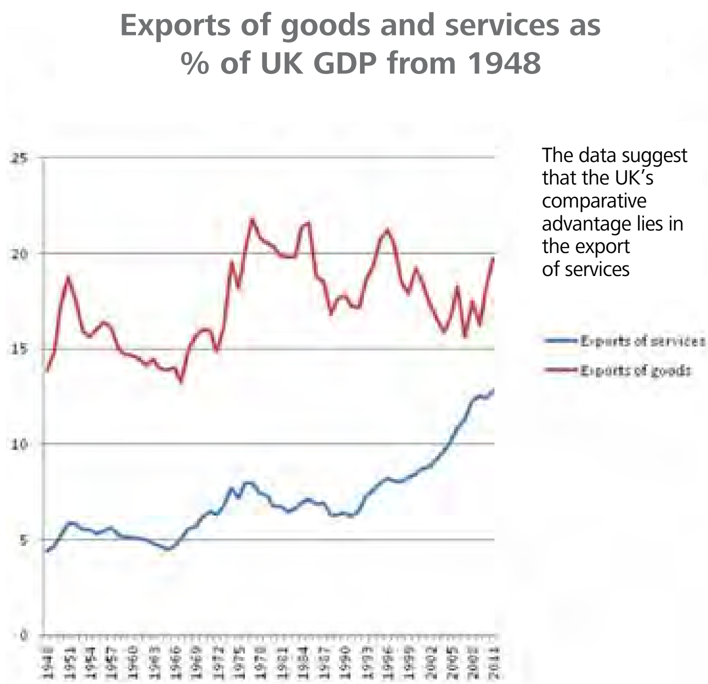
Economists sometimes claim that their subject is scientific. Thus, the London School of Economics describes itself as "unique in its concentration on teaching and research across the full range of the social, political and economic sciences". The scientific status is intended to put economics on a pedestal. Its principles are meant to be established objectively on empirical foundations, and to be free from the biases and preconceptions that clutter so much public policy discussion. Meanwhile its vocabulary purports to be rigorous and definite, and so to avoid the ambiguities that mar debates in the humanities.

The truth is different. Economists have prejudices, often rather silly prejudices, and they use words carelessly in order to maximise rhetorical effect. One particular habit seems to be deeply ingrained, to approve of "things", in the broadest sense, that can be seen and touched. Such things are tangible and "hard". This habit comes through in two ways that matter to public debate, the veneration of money that can be felt and weighed (i.e., of money that is "hard") and the endorsement of activities that produce goods rather than services (i.e., products that come from "hard industry").

The hard-money school has been vocal in the monetary policy debate of the last few years. In order to offset the contraction in money balances due to official attempts to make banks hold less risky assets, central banks around the world have created money by so-called "quantitative easing" (QE). The mechanism involved has been artificial, even tacky, with large sums added to banks' cash reserves and the resulting balances spent on purchases of assets from the private sector. Of course, the cash reserves can be exchanged for notes that come from the printing presses. QE has therefore been widely characterised as "money printing".

In the kindergartens of economics one lesson is that too much printing of money causes inflation. The hard-money school (represented, for example, by Liam Halligan in his Sunday Telegraph column) has claimed that QE is inherently inflationary and hence a sign of modern civilisation's financial debauchery. In a recent speech Lord Turner, chairman of the Financial Services Authority, argued that QE – to be understood as the monetisation of budget deficits – should become a permanent feature of monetary policy. His proposal was thought to be shocking, in that it appeared to

INFLATION IS CAUSED BY EXCESSIVE GROWTH OF THE QUANTITY OF MONEY – BROADLY DEFINED – RELATIVE TO THE QUANTITY OF GOODS AND SERVICES



The data suggest that the UK's comparative advantage lies in the export of services

support a policy that would deliberately stoke inflation.

However, both Halligan and Turner are shadow-boxing. Inflation is caused by excessive growth of the quantity of money relative to the quantity of goods and services, and large bodies of evidence demonstrate that the relevant quantity of money is one that is broadly defined to include all bank deposits. Inside a broad money aggregate the printed note issue is nowadays very small compared with bank deposits, and is of little importance in business and financial transactions.

Halligan and Turner are shadow-boxing because they have been unable to rid themselves of the hard money fallacy, the fallacy that money is better the closer it is to a physical commodity. Halligan makes absurd conjectures about hyperinflation because he is worried about the excessive printing of money, when in fact growth rates of the quantity of money are low or moderate across the industrial world. Turner feels that he has to soften up his audience to the alarming idea of permanent debt monetisation, when in fact the critical influence on inflation is not the degree to which a deficit is monetised, but the rate of growth of the quantity of money.

The hard-industry school has started to articulate a case for currency devaluation. The idea here (expressed, for example, by Martin Wolf in his column for the Financial Times on 22nd February) is that devaluation

IT IS NOT AN ECONOMIST'S JOB TO APPLAUD OR CONDEMN PARTICULAR BRANCHES OF THE ECONOMY

would increase the profitability of manufacturing compared with services, and hence promote the expansion of the export-oriented manufacturing sector relative to the assumedly less-export-oriented services sector. By this means the hard-industry argument links up with the topical enthusiasm, in some quarters, for "rebalancing" the economy. Central to this enthusiasm is an implicit belief that manufacturing industry and the regions are good and deserving causes, whereas finance and the City of London are bad and undeserving.

But it is not an economist's job to applaud or condemn particular branches of the economy. With apologies to Gertrude Stein, a pound sterling of marketed output is a pound sterling of marketed output is a pound sterling of marketed output. Over the last 50 years the UK's exports of business services have been far more buoyant than its exports of manufactured goods, which suggests that our country's comparative advantage lies in the services sector. Indeed, exports of services have also been far less cyclical than those of goods, and have even been robust in the wake of the crash (see chart). Pace Wolf, Adam Smith and David Ricardo showed more than 200 years ago that nations should specialise according to comparative advantage, not according to the prejudices of the commentariat.

The doctrines of both the hard-money and the hard-industry schools are misconceived. They arise from a naïve view of the world in which something that can be seen and felt is better than something (a sum in a bank account which is merely a symbol for a quantity of notes, or a service activity such as a dramatic performance which – unless recorded – disappears when completed) that cannot be seen and felt. Ironically, as economies progress, the importance of things that cannot be seen or felt rises relative to tangible "hard" production, and the financial system increasingly dispenses with hard money and relies more on symbolic money•

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The POVERTY INDUSTRY TRAP

KRISTIAN NIEMIETZ scrutinises a Child Poverty Action Group report – and finds it constrained by traditional 'poverty industry' thinking…

'Ending child poverty by 2020: Progress made and lessons learned' is an evaluation of the anti-poverty policy record of the last 15 years or so. The main emphasis is on the measures enacted to meet the targets set out in the Child Poverty Act and their impact on poverty rates.

Regardless of whether or not one agrees with the authors' conclusions, the report offers an informative account of contemporary British social policies, providing an overview and assessment of the most important developments. The report is published by the Child Poverty Action Group (CPAG) but is written by sixteen external authors, which ensures a relatively broad perspective. But, while not all chapters stick to the preferred narrative of what could loosely be called the 'poverty industry', most of them do so.

Judge, L. (ed.) (2012): *Ending child poverty by 2020: Progress made and lessons learned*, London: Child Poverty Action Group (CPAG)

Among other things, the report argues:

- Social policy under Labour was initially heading in the right direction, but the increase in social spending was slowed down far too soon.
- Nevertheless, the reduction in relative child poverty that the government achieved was quite impressive. It could have been better still if Labour had gone further in its welfare expansion.
- Austerity now threatens to undermine this progress.
- Increases in employment do not account for the major share of the decrease in poverty that has been achieved. This shows that the contribution that higher work levels can make is limited. The safest way to combat poverty is to raise benefits, not work levels.

The report's main policy implications are:

- Social policy should return to the welfare expansion approach of Labour's early years in government, but this time it should be pursued with much more stamina.
- Raising work levels among welfare recipients is helpful but not essential. The main focus has to be on benefits.

The general narrative

This narrative suggests that, in 1997, the incoming Labour government inherited catastrophically high levels of child poverty, the legacy of 18 years of 'neo-liberal' politics. They decided to remedy this situation by adopting an ambitious agenda of increased social transfer spending and expanded social programmes. This expansion led to substantial improvements while it lasted but, by 2004, the government began to run out of steam. The expansion in social transfer spending slowed down and, as a result, so did progress in poverty alleviation. From 2010 onwards, the coalition government abandoned what little remained of its predecessor's progressive impetus, and changed into reverse gear. The brutal 'austerity' agenda that has since been pursued risks undoing much of the progress that has been made since the late 1990s.

The phenomenon of in-work poverty is also repeatedly highlighted. Chapter 6 argues that the increase in the employment rate of single parents contributed to the reduction in child poverty, but not nearly as much as the increase in transfer spending. This is taken as 'evidence' that an anti-poverty agenda must, first and foremost, be an agenda of raising income transfers. Raising work levels may have a role to play, but since the British economy produces too many low-paid jobs, it is not a crucially important ingredient.

Policy implications

The report's policy implications involve resuming the policies of Labour's early years, but this time keeping up the firepower for much longer. Benefits must be increased at a rate that exceeds the growth in median incomes for many years in a row. When combating poverty, too much effort should not be wasted in trying to get people into work, which is an unreliable route out of poverty. Raising benefits is much more important than raising work levels.

Strengths

The report succeeds in rebutting some of the more superficial critiques of Labour's record. For example, it is not true that Labour's transfer policy merely lifted families from just below to just above the relative poverty line – the 'poverty plus a pound' argument. Rather, there has been a general narrowing of the lower half of the income distribution, not just around one particular point.

	1998	2007	2010
Relative child poverty: Rate	26.1%	22.5%	17.5%
Relative child poverty: Headcount	3.4m	2.9m	2.3m

Table 1: Relative child poverty in 1998, 2007 and 2010

Weaknesses

On the more substantive points, the report contains a number of major weaknesses. To begin with the simplest one, the actual evolution of the relative poverty rate for children over the period described does not quite fit the narrative which the report spins. The report makes much of the comparison of child poverty rates between 1998 and 2010, during which period relative child poverty fell by almost nine percentage points.

However, at the onset of the recession, the record looked much less impressive. More than half of the decrease has only occurred since then (*see Table 1*), and this is not a coincidence.

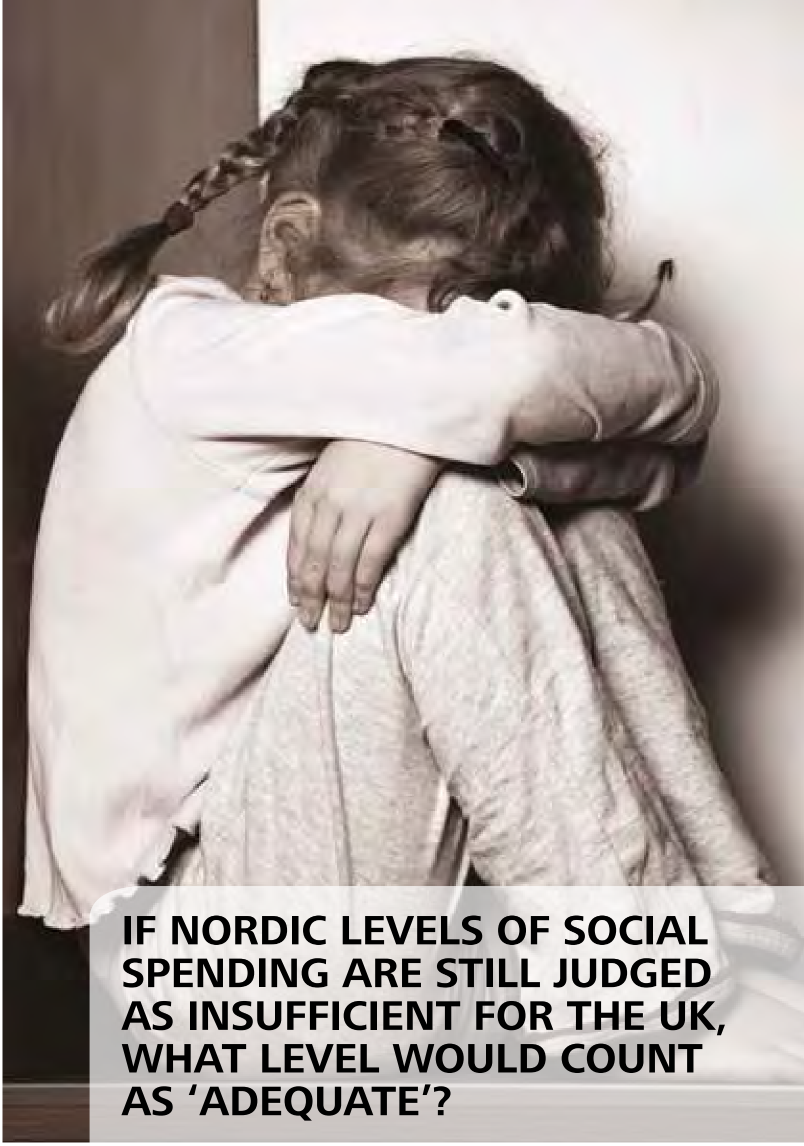
Recessions affect different parts of the income distribution differently. Incomes in the middle of the distribution tend to follow the business cycle more closely than incomes at the lower end, because the former consist mostly of earned income, and the latter mostly of state transfers. This is why recessions frequently lead to falling relative poverty rates. Median incomes fall faster than low incomes, and drag the poverty line down with them. The report alludes to this mechanism, but it does not relate it to the actual numbers. Considerably more than half the reduction in relative child poverty has come about since the recession, largely as a result of median incomes falling towards the income levels of the poor.

More importantly, it is the report's central narrative about social expenditure which is somewhat misleading. It underplays the increase in social spending that took place before the recession, while exaggerating the impact of 'austerity' since then. By 2007, social expenditure in the UK had risen to Scandinavian levels. Yet the CPAG report portrays this as no more than a good start. The so-called 'austerity' agenda, meanwhile, will do no more than return public spending – including welfare spending – to its immediate pre-recession level. Yet the report portrays this as the demolition of New Labour's social policy legacy. Thus, the report fails to grasp the extent to which the poverty industry's traditional demands have already been fulfilled. If Nordic levels of social spending are still judged as insufficient for the UK, what level would count as 'adequate'?

The report also cautions against relying too much on paid work as a route out of poverty. Chapter 6 argues that, even though the employment rate of single parents increased by more than ten percentage points, this development contributed much less to the decline in poverty amongst that group than the increase in transfer spending.

Quite so. But the reason for this is simply that most of these new entrants into the labour market work for little more than 16 hours per week, the minimum number of working hours required to qualify for Working Tax Credit (WTC) payments. The Labour government did manage to encourage some economically inactive parents to access part-time employment. The logical next step would be to encourage them to increase their working hours. The potential here is still huge, especially among single parent households. About half of all children in such households live with a parent who does not work at all, and another quarter live with a parent who works part-time, usually around 16 hours (*see table 2*).

This situation differs radically from that observed in Sweden and Denmark, where almost all single parents work, and the majority of them work full-time. The poverty industry has long argued for Nordic levels of social expenditure. The complement to this is surely Nordic levels of labour market integration among groups with elevated poverty risks, rather than dismissing work as a route out of poverty.



IF NORDIC LEVELS OF SOCIAL SPENDING ARE STILL JUDGED AS INSUFFICIENT FOR THE UK, WHAT LEVEL WOULD COUNT AS 'ADEQUATE'?

Finally, as with most of the poverty industry's publications, the greatest weakness is not in what is included but in what is excluded. The report depicts the living standards of low-earners as determined through the interplay of various transfer instruments and social programmes. Other influences are either confined to the margins, or not considered at all. The period covered in the report also witnessed an explosion in house prices and rent levels, as well as steep increases in energy and childcare costs, and other costs of basic essentials. Yet none of these facts get a mention in the report. Yes, it is broader than a CPAG in-house publication would have been. But ultimately, it retains the poverty industry's narrow fixation on benefits and government programmes, at the expense of everything else.

	Number of children
Parent not in work	1.4m
Parent in part-time employment	0.8m
Parent in full-time employment	0.8m
Total	**3.0m**

Table 2: Children in single-parent households by parental work status

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

FISCAL CONSOLIDATION STRATEGY

In this paper, John F. Cogan, John B. Taylor, Volker Wieland and Maik H. Wolters examine the effects of reducing government borrowing in the US by cutting government spending. Specifically, they look at the case of reducing government spending to pre-crisis levels as a proportion of national income. The spending reductions allow cuts in the trajectory of both taxes and borrowing. The authors use new-Keynesian models for their analysis. The results suggest that a significant reduction in government spending would lead to higher national income both in the short and long term. These positive results arise firstly because lower government spending and lower taxes in the long run encourage more private spending immediately; secondly lower taxes remove distortions and stimulate employment; thirdly, lower borrowing reduces the exchange rate. It is worth noting this last point as the UK is a small open economy with a floating exchange rate and thus we can expect this to be an important channel in our case. This is another contribution to the growing body of research that suggests that fiscal consolidations should proceed through government spending reductions.

***Journal of Economic Dynamics and Control*, Volume 37, Issue 2**
February 2013, Pages 404–421
JOHN F. COGAN, JOHN B. TAYLOR,
VOLKER WIELAND AND MAIK H. WOLTERS
www.sciencedirect.com/science/article/pii/S0165188912002023

THE FED: Success or Failure?

The period since the establishment of the Federal Reserve in 1914 has not been better than the period before its establishment as measured by macro-economic stability. Indeed, before World War II, the Fed presided over a severe bout of inflation and then deflation. Since World War II, the Fed's policy record has been better than its pre-war record but there has been a bias towards consistent but low inflation. However, new research suggests that even the Federal Reserve's post-war record on macro-economic stability is not a clear improvement on the pre-Fed record except in very recent years. That recent good performance record of the Fed, in the 1990s and early 2000s, proved temporary, however. Given this poor record, it is important that alternative monetary arrangements are explored.

***Journal of Macroeconomics*, Volume 34, Issue 3**
September 2012, Pages 569–596
GEORGE SELGIN, WILLIAM D. LASTRAPES, LAWRENCE H. WHITE
www.sciencedirect.com/science/journal/01640704/34/3

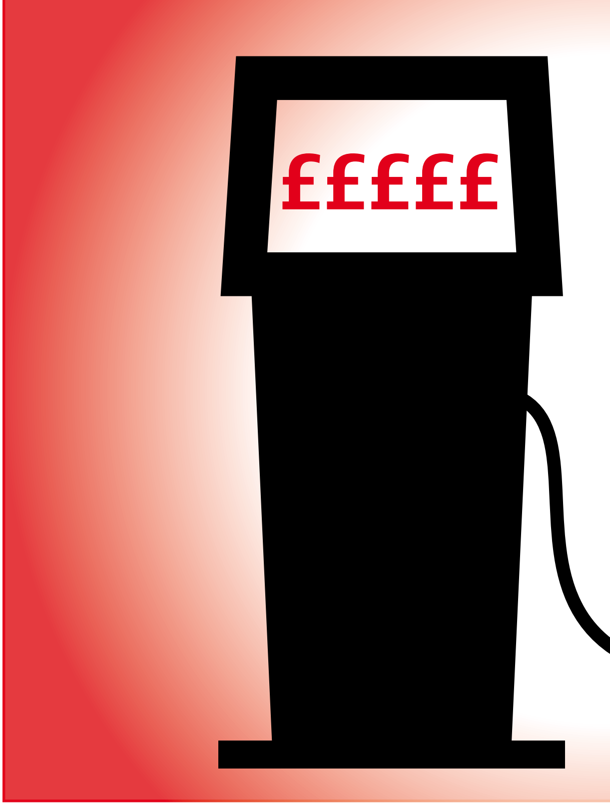
INDEPENDENT SCHOOLS AND LONG-RUN EDUCATIONAL OUTCOMES – evidence from Sweden´s large scale voucher reform

There is vigorous debate about the success of the Swedish education voucher system. The left tend to grasp any piece of evidence that suggests that competition has not improved performance despite the many studies that demonstrate that is has done so. This paper adds to the evidence pile in favour of school choice. The authors show that those areas of Sweden where there is the greatest penetration from non-state schools have seen significant relative improvements in performance. The results are very robust when controlled for a large number of variables. The results also show that competition from non-state schools leads to higher standards in state schools – in other words that there are spillover effects. Improved performance is achieved without additional expenditure implying an increase in efficiency in the use of resources spent on education.

Working paper 2012:19. Institute for Evaluation of Labour Market and Education Policy
ANDERS BÖHLMARK
and MIKAEL LINDAHL
www.ifau.se/en/Research/Publications/Working-papers/2012/Independent-schools-and-long-run-educational-outcomes--evidence-from-Swedens-large-scale-voucher-reform--/

DRIVEN to DISTRACTION

RICHARD WELLINGS on how bad economic thinking leads to bad taxes...



Fuel duty is the UK's most significant 'environmental tax'. In 2012, it raised £32 billion[1], approximately 5 per cent of government revenues.

Tax now makes up around 60 per cent of the price of a gallon of petrol, a much higher proportion than is imposed on most other goods and services. Accordingly, fuel duty would appear to break two principles of good tax policy.

The first principle is that tax rates should be kept low. There is a substantial body of work showing that high taxes suppress economic activity, for example by reducing incentives to work or trade. Fuel duty increases travel-to-work costs, lowering the financial incentives to enter employment. And, since over 90 per cent of domestic passenger traffic and almost 70 per cent of freight goes by road, the negative impact of fuel duty on trade is likely to be substantial. The tax means that many potential exchanges are no longer worthwhile. Benefits of trade are thereby lost, including a more specialist division of labour and economies of scale.

The second good-tax principle violated by fuel duty is that of neutrality – the rule that different economic activities should be treated similarly. If a tax system discriminates against certain activities while favouring others, economic resources will be misallocated. The government's policy of imposing fuel duty on road users while providing subsidies and tax breaks for the rail industry has severely distorted the transport sector, for example. Demand for rail has been artificially inflated, leading to wasteful investment in new capacity.

KEY FACTS ABOUT FUEL DUTY

- **Level of fuel duty per litre in UK (including VAT on duty)** — **70p**
- **Level of fuel duty per litre in Canada** — **24p**
- **Tax as a percentage of retail price: (at £1.40 per litre)** — **58%**
- **Level of fuel duty implied by the Stern Review to deal with climate change:[2]** — **19p**
- **Road spending as a percentage of fuel duty and Vehicle excise duty revenues:** — **24%**

[2] 2006 estimate adjusted to 2013 prices.

Taxing externalities

As might be expected from a highly distorting and discriminatory levy that raises huge sums for the Exchequer, the negative effects of fuel duty are large in magnitude and broad in scope. Nevertheless, economic arguments have been used to justify the tax by the Treasury and some transport economists.

In the early 20th century, Cambridge economist A. C. Pigou developed the concept of externalities – conceived as the costs or benefits imposed on third parties as a result of an economic activity. Road transport is associated with a number of these externalities, including negative ones such as congestion, noise and air pollution.

Market failure is said to occur because, when individuals choose to drive, they do not take into account the wider external costs resulting from their actions. In the absence of state intervention, it is argued, there is more road transport than the socially optimum level. The wider 'social costs' of motoring are said to exceed the private benefits accruing to the individual driver.

Pigou suggested such problems could be solved through the imposition of a special tax set to reflect the costs imposed on others by the activity. In this way, according to the theory, overall welfare would be maximised. Fuel duty is advocated as just such a tax. There are, however, a number of difficulties with the Pigouvian approach to taxation.

Pigouvian taxes – not as simple as they seem

Firstly, it is highly problematic to measure external costs in order to determine the tax rate that maximises welfare. This is partly because individual valuations are time and place specific, as well as highly subjective. For example, living next to a noisy road might bother one person a lot more than another. Policymakers face severe methodological challenges

[1] Including the VAT charged on the duty

obtaining, quantifying and aggregating such information.

Secondly, the situation is further complicated by the relationship between external costs and various state interventions. For example, levels of traffic congestion reflect historical patterns of government road investment amongst other factors. The cost of noise or air pollution will reflect planning policies that influence factors such as population density. The reality is far less simple than suggested by the doctrine of 'polluter pays'. Should drivers be taxed for external costs largely created by politicians and officials?

Thirdly, Pigouvian taxes must be implemented through political and bureaucratic processes. As the Public Choice school has demonstrated, policymakers are likely to consider their own self interest when setting tax rates. Politicians will be influenced by the impact on voter groups, including their need to 'buy off' target groups by increasing public spending on specific programmes. Both politicians and civil servants will also come under pressure from special interests when determining tax rates. The incentives facing policymakers mean that, in practice, they are unlikely to set an optimal rate – even if it could be accurately determined.

The limitations of Pigouvian taxes are all too evident in the case of fuel duty. Clearly it has proved highly problematic to measure the social costs of motoring and accordingly set a suitable tax rate. There are large variations between the different estimates provided by studies and, given the methodological difficulties, these findings must be treated with a high degree of scepticism.

Furthermore, there can be little doubt that the setting of fuel duty rates has become highly politicised with green campaigners calling for higher rates and heavy users such as farmers and hauliers calling for lower rates. At the same time, the observation that fuel duty receipts are relatively inelastic in the short-term means that rises in the rate have proved a popular method for chancellors to raise additional revenue.

In practice, attempts to introduce an efficient Pigouvian tax are undermined by methodological difficulties, special interests and political expediency. But, given that negative externalities are a genuine problem, is there an alternative approach?

Is there another way?

Another way to view externalities is to see them as resulting from the absence of markets. For example, there is a strong argument that congestion is caused by the state ownership of roads and in particular the absence of pricing and the disjunction between supply and demand. If roads were brought into the market economy and priced, toll rates could be adjusted to ensure free flowing traffic. The rationale for imposing fuel duty to reduce congestion costs would no longer hold.

Markets can 'internalise' many environmental externalities. Buyers and renters of housing next to a busy road might expect to pay less than those in a quieter and less polluted location. The former would effectively be compensated for pollution and noise costs. A land market freed of state planning controls would increase the scope for externalities to be internalised. Environmental amenities such as low pollution levels could be part of the package offered to potential residents of private housing developments. Freed markets would also allow affected parties to negotiate deals to address externality issues, as suggested by Ronald Coase. For example,

...CURRENT RATES OF FUEL DUTY ALREADY FAR EXCEED MOST ESTIMATES OF THE EXTERNAL COSTS OF THE CARBON EMISSIONS FROM ROAD TRANSPORT

a group of residents living near a road could pay its owner to prohibit the noisiest and most polluting vehicles – or the road owner could compensate the residents.

Unfortunately, such solutions are impractical for externalities such as anthropogenic climate change, where, if the hypothesis is correct, billions of individuals are affected and billions are responsible for emissions. Clearly a bargaining process is not plausible given the magnitude of the transaction costs involved. This does not mean, however, that Pigouvian taxes should be imposed. The knowledge and incentive problems facing policymakers are even more severe for highly complex, global issues. In any case, it is clear that current rates of fuel duty already far exceed most estimates of the external costs of the carbon emissions from road transport. Indeed, they even exceed by a large margin the very high estimates provided by the Stern Review.

At first sight, Pigouvian taxes might seem like an efficient way of addressing externality problems. However, the methodological difficulties of calculating the appropriate tax rate, the distortions caused by various state interventions, and the shortcomings of the policymaking process, make it highly likely that the costs of implementing such taxes will far exceed the benefits•

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Time to Excise Fuel Duty?
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A CRUEL CHOICE for politicians: How to fund care for the elderly

The sight of politicians being forced to make tough decisions and frantically trying to do so in a way that upsets nobody would be grimly entertaining if the consequences were not so frequently disastrous. A case in point is the current anguish over the funding of care for the elderly.

In 2011, Andrew Dilnot recommended that a cap be placed on the amount retired people with assets over a given threshold would have to pay towards care. He suggested £35,000 with an estimated cost of at least £1.7 billion as the taxpayer picked up care costs above that. Initially the government seemed to have rejected this but now it appears they will implement it, but with a higher cap and a higher threshold, leaving the total bill about the same.

So, how to pay? One suggestion is to means test Winter Fuel Allowance to save £1.5 billion. This of course has provoked furious responses from the recipients, who are typically also opposed to having to cash in their assets over a certain limit to fund care.

The basic problem is simple. We have an ageing population and a welfare system that is not based on a contributory principle where payment of tax gives entitlement to benefits. As the relative numbers of old people increase and the costs of care increase, so the charge to the working taxpayer must increase unless older people also make a contribution.

THE POINT OF INVESTING IN A HOUSE OR OTHER ASSETS SHOULD BE PRECISELY TO RELEASE THEM AS CASH TO MEET THE NEEDS OF OLD AGE

The obvious way to do this, in the case of social care, is to use savings and assets above a certain limit, built up over a working life, to offset those costs. Why should this be thought morally questionable? The point of investing in a house or other assets should be precisely to release them as cash to meet the needs of old age.

The real problem is that for some people those costs are containable while for others (about 10 per cent) they are large – and nobody can be sure if they will fall into that 10 per cent. The long-term solution should be some kind of insurance. However, given that policymakers did not set such a system up thirty or forty years ago, we now have the choice of asking the current generation of retirees to make a contribution (as at present) or dividing that cost between some retirees and the general taxpaying population. Somebody's ox will be gored, hence the unhappiness of the current generation of politicians.

Dr Steve Davies
IEA Education Director

Full version at: www.iea.org.uk/blog/a-cruel-choice-for-politicians-%E2%80%93-how-to-fund-care-for-the-elderly

CHRISTIAN objections to the NHS

Nigel Lawson once said that the NHS is the closest thing the English have to a religion. Of course, we also have the established church. And, indeed, the established church seems to see the NHS as part of its theology. Archbishop Welby, at his enthronement, said: "Slaves were freed, Factory Acts passed, and the NHS and social care established through Christ-liberated courage." In their response to the Mid Staffordshire NHS scandal the local bishops of Lichfield and Stafford said: "We have now seen what many of us suspected – that the marketisation of the health service has gone too far…This Christian basis has been weakened in recent years and covering the bottom line has become all important."

This is a totally inappropriate response to the deaths of 1,200 people in a state-run health system. By almost every measure, the UK has amongst the least marketised health systems in the world. For example, 4 per cent of UK hospitals are not publicly owned compared with 51 per cent in Germany. If the Bishops were right, surely France and Germany should be experiencing a Mid Staffs scandal each week.

If you look at mortality amenable to healthcare, the UK has one of the worst records in the EU, some way behind countries with more marketised health systems.

Indeed, calling the NHS a creation of Christ-inspired courage is stretching things beyond credulity. Beveridge was a Christian and a friend of Archbishop William Temple who was certainly a supporter of the welfare state. But Beveridge did not propose the NHS as we see it today. He probably favoured state-finance and state direction in a mixed system of provision. He did not propose that all the charitable hospitals, mutual aid societies and so on should be nationalised by the state as happened in practice. He almost certainly had in mind something much closer to the marketised models criticised by the bishops.

THIS IS A TOTALLY INAPPROPRIATE RESPONSE TO THE DEATHS OF 1,200 PEOPLE IN A STATE-RUN HEALTH SYSTEM

Indeed, perhaps we should think more seriously about Christian objections to the NHS, such as:

- Was it appropriate for the state to sweep away charitable, mutual and commercial provision where this met people's needs?
- Is it more noble for health care to be provided and funded via a bureaucracy and compulsory taxation or by commercial, reciprocal and charitable endeavour?
- Is it appropriate for the state to be providing healthcare for all rather than ensuring that all can have healthcare by supporting families, charities and the community in obtaining healthcare from a plurality of sources?
- Is coercive state finance and provision a higher value than personal concern motivated by charity?

Beveridge would probably have answered "no" to those questions – as might Attlee. The person who answered "yes" and created the NHS as we know it was Bevan – an atheist. A man about whom George Brown wrote: "He had a burning faith in whatever seemed good to him at the time but, outside politics, had no personal faith at all." •

Professor Philip Booth
IEA Editorial and Programme Director

Read the full version at: www.iea.org.uk/blog/some-christian-objections-to-the-nhs

TURNING UP the HEAT

Government's energy tariff regulations will exacerbate fuel poverty

The government is regulating the domestic energy market to restrict the number of available tariffs to four per supplier. Energy firms will also be forced to tell customers about the cheapest available deal on the market. David Cameron described the new regulations as 'a huge step towards energy bills that are more fair for everyone.' The prime minister's optimism is misplaced, however. In fact the measures will exacerbate fuel poverty rather than alleviate it. The new rules will increase energy prices and hence fuel bills, rather than reduce them.

As a result of the tariff restrictions, some of the best offers in the market will be withdrawn. In addition, the limits will prevent innovation by making it too risky for a supplier to give up an existing profitable tariff in order to introduce a new one whose appeal would be uncertain. And because the lowest price offers will no longer be available, and there will be less innovation, there will be less competitive pressure on all other prices. The rules on tariff simplification will also encourage coordinated effects by suppliers and lead to narrower price differentials and again less competitive pressure.

The reduced availability of significant price reductions will in turn lead to less customer interest in switching between suppliers. (Ofgem claims that simpler tariffs would increase customer engagement, but Ofgem's own research shows that the availability of savings opportunities outweighs simplicity of information as a determinant of customer switching.)

All these factors leading to a reduction in competitive pressure would lead to further increases in prices and retail profits. Indeed, there is evidence that Ofgem's retail energy policies have already had this effect. Its restrictions on tariff pricing, and its pressure on suppliers to cease doorstep selling and to simplify tariffs, seem cumulatively to have led to an increase in retail profits margins totalling some £10bn over the last four years.

In sum, the government's tariff controls will increase energy prices and make all customers worse off. This will have a particularly adverse impact on vulnerable customers in or near fuel poverty.

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Full version at: www.iea.org.uk/blog/governments-energy-tariff-plans-will-exacerbate-fuel-poverty

Living Economics: YESTERDAY, TODAY and TOMORROW

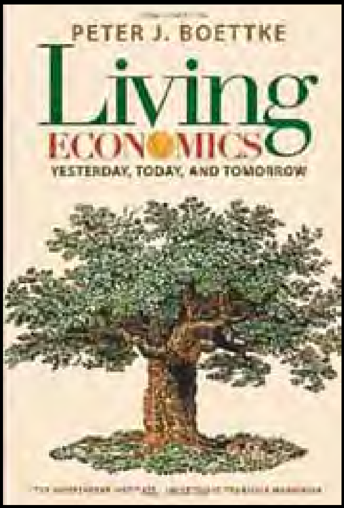
Our recommended read goes back to the roots of economic theory...

Peter Boettke ***Independent Institute, Published 2012***

The title and cover art for Peter Boettke's latest book *Living Economics: Yesterday, Today and Tomorrow* are no doubt symbolic of economic theory as a field of study, and also the history of economic thought as an intellectual tradition. Like the tree on the cover, economic theory is itself like a living entity or tree. It is complex and frequently changing, always adapting to address the unique episodes of social history. But economics is also firmly rooted in a stable foundation of core theoretical substance: subjectivism, the rational choice framework and spontaneous order theory.

The contents of the book enliven this symbolism. Boettke presents a unique and insightful perspective on the history of economic thought. The Classical School sowed the roots of economic theory. Writers such as Adam Smith asked plainly, "how can society function harmoniously without a central designer?" Given all the world's complex diversity, where does social order stem from and how does it operate? In result, like the tree trunk, property rights, prices and profits and losses, all serve as a strong and solid foundation for the branches of social order to grow therefrom.

In the aftermath of the Classical Period, the tree of economic theory grew stronger in some areas but it was also pruned, redirected and, dare one even say, abused in others. Amidst the twentieth century, many theories most fashionable in the mainstream economics profession emphasised supposed weaknesses within



the rooted systems of market economics. Trees may grow from roots to branches, but they must also be guided and directed by marginal regulation, complete central planning, or some form of intermediate interventions. So say many mainstream economics perspectives.

Here Boettke's symbolic metaphor rings true again. Just as it is hubris for individuals or groups of men to expect full control over a mighty oak tree, so it is hubris for teams of "experts" to submit the economy to their will.

Boettke argues that greater attention should be given to the mainline roots and trunk of economic science. Market economies comprised of strongly enforced private property rights, stable monetary regimes and freely adjusting market prices tend to coordinate scarce human and physical resources across time and space in proportionate quantities and qualities unmatched by any alternative institutional arrangement known to human kind.

I disagree with Boettke on two key characteristics of his book. Firstly, that his text is purely useful to the motivated undergraduate considering entering graduate school and a career in the field. Any professional economist would benefit from reading the book. And his writing is clear enough that his essays are approachable to the "econo-novice".

Secondly, I think Boettke's symbolism linking the study of economics to a living tree should be expanded. Reading the biographical sections dedicated to key thinkers (Hans Senholz, Murray Rothbard, Gordon Tullock, Israel Kirzner, Elinor Ostrom, James Buchanan and others) and knowing Boettke's own legacy of guiding original research, one can recognise that the economic way of thinking is not only a tool to be used, put away and redeployed at leisure. The ideas of Living Economics can, and arguably should, be taken as more than mere symbolism. To truly know economics is itself a lifestyle.

In the near and distant future the prominence of mainline economic reasoning will be the result of the efforts of those eager and interested to investigate its history, research its operations and promote its insights. I imagine that this group of supporters will be "Living Economists".

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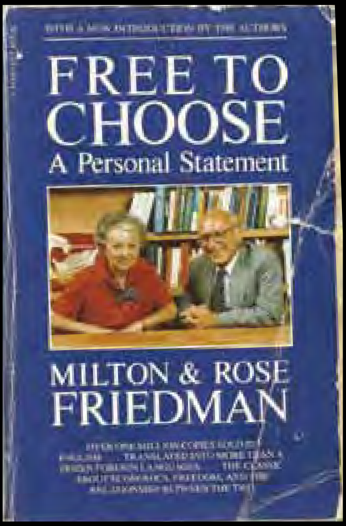
A fresh look at a classic work that influenced a generation of economists...

Free to Choose: A PERSONAL STATEMENT

Milton and Rose Friedman ***Pelican Books, Published 1980***

In times when the rolling tide of public opinion describes the current economic situation as a "Great Recession" – the worst since the Great Depression of the 1930s - and blames the free market and "deregulation" for unleashing Wall Street's "greed", Milton and Rose Friedman's *Free to Choose* is a breath of fresh air. Published in 1980 during times of high inflation and unemployment (much like today) the book challenges common perceptions that, in times of crisis, government intervention is necessary and vital for economic recovery.

The authors' inquiry into the relationship between freedom and economics begins with demonstrating the power of the market. They re-tell Leonard Read's I, Pencil, a story about how millions of people engage in daily interactions that produce pencils without even knowing what the final result of their work would be. This seemingly chaotic system facilitates peaceful social cooperation between individuals pursuing their own interests and is the foundation of the market as voluntary exchange. Prices arise as the driving mechanism and are essential in three ways. They act as a coordination device; they serve as an incentive to adopt efficient methods of production; and, finally, prices determine the income distribution. No one needs to supervise. People trade, lives improve and prosperity settles. The market system is a product of human action that is the opposite to the human design of a central planning system. To Milton and Rose Friedman the main problem is not to question the planning stage, but rather to determine who is in "charge" of planning: is planning made by the many or the few? To an economist understanding the market as a process of voluntary exchange and a system of social co-operation the failure of central planning is unavoidable. Government authorities may attempt to control market forces, but people will always find ways to enter into voluntary exchange. Stories of moonlighters offering their services on the black market were very common in the Soviet bloc.



A well thumbed classic...

The chapter "The Tyranny of Controls" moves the case for voluntary exchange onto a higher scale. Government protectionism in the form of tariffs and subsidies intended to achieve "balance of trade" are inconsistent with free societies. The authors destroy the myth that a country cannot afford to open for trade without receiving reciprocity from other countries. Their arguments for the efficiency of free trade – both economic and political – build on the earlier argument that voluntary exchange is not only beneficial to all engaged parties, but that it also fosters harmonious relations between countries.

Milton and Rose Friedman's compelling argument in support of market forces takes quite an unusual turn when they look at ways to solve the problem of inflation. They acknowledge that inflation is "a monetary phenomenon arising from a more rapid increase in the quantity of money than in output", and despite their firm belief that prosperity is a result of free people acting in self-interest, they look at ways to establishing controlled inflation, instead of looking for ways to eliminate the cause of inflation.

Free to Choose is a timeless classic in the classical liberal tradition of explaining economics. In the 33 years since publication the book continues to have a profound influence on generations in the way they perceive economics. Milton and Rose Friedman show that economics is not a static science, but rather a living organism of studying human action in the market place.

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TOP CLASS

EDUCATION + BUSINESS = INNOVATION

In the global education industry there is now increasing talk of 'inclusive business models', especially with reference to investment opportunities across the developing world. The concept originates from the international development community which, after half a century, has finally realised that for-profit companies not only serve the rich but also have a lot to offer the two-thirds of the world's population (4 billion) that lives on less than $3,000 a year. An inclusive business model is therefore simply defined as a sustainable business that increases access to goods and services to low income communities, while, at the same time, providing them with new sources of revenue and employment.

While examples of these models have already been documented in numerous other sectors such as banking, housing and health, it is only in the last few years that they have started to appear in education. For example the International Finance Corporation (IFC) has documented the growth of the 'Value for Money Degrees' model which makes university education accessible to all through a combination of innovations that increase affordability and value. An example is Anhanguera in Brazil which educates 650,000 students a year on its campuses and 100,000 students online. The Monitor Group has also documented the 'Private Vocational Training at the Seam' model, which enables private vocational colleges to provide low cost, no-frills, quality further education courses.

In India, Sudiksha Knowledge Solutions is one of a growing number of innovative and ambitious for-profit ventures which provides pre-school education for children living in poverty. A woman from each local community is responsible for the daily management of each school and, in return, they receive a profit share, thereby providing school managers with an incentive to continually improve the services which they offer. Sudiksha is now hoping to develop one million pre-schools across India based on a new curriculum that children can actually enjoy.

In Zambia a different innovation has emerged under the brand name of iSchool, Zambia. This for-profit company offers a comprehensive online multi-media e-learning package which covers the whole of the Zambian school curriculum, including both lesson plans for teachers and interactive learning for students. Schools can purchase the 'iSchool in a Box' package which provides all the resources necessary to make full use of the materials, including laptops and tablets for staff and children, secure storage, power supply, internet access, teacher training, mentoring and technical support. The average cost per pupil is approximately £19 per child per year.

NEW MODELS FOR THE WORLD'S POOREST COUNTRIES

So why is the emergence of these new inclusive business models across the developing world relevant to the future development of education in the UK? The rate of innovation being experienced in these markets is both rapid and potentially very disruptive. This is because, to make products and services affordable to the poor, significant and not piecemeal innovations are required. Furthermore, the lack of government intervention and control in some education sectors is providing a conducive environment for innovation.

A relevant example is mobile education – enhancing educational outcomes using mobile technology, which is still in the very early stages of development in most schools in the UK. However, in a 2012 report by GSMA and McKinsey, the global market for mEducation products and services is already estimated to be worth approximately $3.4 billion and is expected to increase dramatically to $70 billion by 2020. For example in the Philippines over 500 schools are experimenting with a programme called Text2Teach which uses Nokia's Education Delivery (NED) technology to deliver video content to teachers via their mobile phone. Another mEducation innovation is Tutor on Mobile (TOM) which connects people who want to learn and acquire knowledge with experts in India through their mobile devices. This is a 'knowledge marketplace' that encourages the sharing of knowledge, and provides an opportunity for people to earn money at the same time by providing learning content.

With portable devices now rapidly evolving, capability is increasing and costs are reducing. The UK company Datawind has recently launched the world's cheapest tablet in India at a cost of only £40 (or £25 if purchased in bulk by the government). These innovations, combined with the emergence of a new technology-literate generation, mean the possibilities are now endless. Any UK-based company involved in any aspect of education would therefore do well to keep an eye on these developments.

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A sobering thought – why the poor will pay for minimum alcohol pricing

It has been estimated that a 50p minimum unit price for alcohol will cost consumers £2 billion a year. This has been described as a "bonanza" and a "windfall" for retailers. In fact, this is an example of a policy that will make some people poorer without making anybody richer.

Let's say there are three brands of beer. The bottom end brand, Cheapo, retails at 35p per unit; the mid-range brand, Average, retails at 50p; and the high end brand, Premium, retails at 60p. The more expensive beers cost more to produce and are more heavily advertised than the cheaper beers. They taste better and they are perceived to be superior. Let's say the retailers make 5p profit on all three of the brands.

Now consider the effect of a 50p minimum price. Cheapo now sells for 50p and the retailer pockets 20p instead of 5p. That's a windfall for the retailers, right?

Wrong. Consumers will generally switch to higher-quality Average which has the same price. Cheapo's unique selling point was its low price. At a higher price point it can't compete with the other brands on quality, so it no longer has a place in the market. Sales of Average should increase, but that doesn't necessarily provide extra profits for the retailer.

But what if retailers adjust to the minimum pricing regime by selling Average for the higher price of 60p and pocket the extra 10p? That would be unwise since it would force Average to compete with the superior brand. Again, why would consumers pay 60p a unit for a mid-range brand when they could have a top-end drink for the same price? Average will become the new market leader at the bottom end.

Or maybe retailers would increase the price of every brand of beer. If the government forces up the price of the low-end brand by 15p with a mandatory minimum, why shouldn't they increase the price of all beers and pocket the difference? But if it was that easy to generate extra profit, there's no reason for them to wait for minimum pricing. Why don't they do it already? The answer, of course, is competition between retailers. If Tesco raises the price of its beer, people will shop at Asda. As in any competitive market, retailers have an incentive to push prices down, not up. The only way the price of the entire product category could increase would be if there were collusion but there is no evidence that this would happen and it would be illegal.

The alternative scenario is that the drinks industry collects the windfall by raising the price at which it sells beer to the retailers, but this is also implausible for the same reasons given above. The manufacturer of Cheapo could increase its wholesale price from 30p to 45p in the knowledge that the retailer has to sell it for at least 50p, but the onset of minimum pricing has not increased their production costs and a rival company could launch a budget brand and sell it to the retailer for less. There can be no "excess profits" so long as there is competition.

But if there are no excess profits, what happens to the extra £2bn that drinkers have been compelled to spend thanks to the minimum pricing? In our example, drinkers of Cheapo are badly hit by the policy. But the biggest victim is Cheapo itself which sees its customers switch to the superior Average brand.

This is the most likely effect of minimum pricing: the bottom end of the market will simply disappear. The cheapest drinks will become more expensive and they will be of a higher quality, but they will be no more profitable for the manufacturer or the retailer. The only way Cheapo could survive would be to "do a Skoda" and compete with Average on quality. That means higher production costs and a bigger advertising spend. It would no longer be a budget brand – minimum pricing will make budget brands extinct.

MINIMUM ALCOHOL PRICING MEANS HIGHER PRICES, LESS CHOICE, HIGHER MARKETING COSTS AND HIGHER PRODUCTION COSTS

Under some scenarios, it is not impossible to see supermarkets benefit from minimum alcohol pricing, but the most likely outcome is that the government will make a little more money from VAT on more expensive alcohol and that the extra sales revenue will be swallowed up in production and marketing costs for beer that consumers would prefer not to buy.

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Do free trade zones undermine *Capitalism?*

Global free trade negotiations have been stalled for two decades. Most political effort has been on more limited unilateral fixes – notably the creation of free trade zones (FTZ) to smooth the multi-stage, multi-country supply chains that have come to dominate commerce in industrial goods.

There are 3,500 free trade zones worldwide, the majority in emerging economies, where most national regulation is suspended. Policymakers typically promote them as a means of job creation, but the real purpose is to liberalise markets hindered by interest group conflict, local government corruption or ideological rigidity.

Zones are often established in the poorest parts of countries that would otherwise languish for lack of infrastructure. They often become home to multinational manufacturers producing goods such as clothing or consumer electronics, or to firms repackaging products such as cigarettes and pharmaceuticals for re-export. Thus FTZs may speed local development, as well as signaling the advantages of free markets to other localities within the country: think of the "special economic zones" in which Deng Xiaoping introduced capitalism to post-Maoist China.

The downside

FTZs sometimes make it possible for autocratic regimes to perpetuate illiberal societies – for example, North Korea – by using them to generate desperately needed foreign exchange. More commonly, FTZs can become havens for smugglers, money launderers and terrorists in search of hard currency. And these problems can discredit free trade and regulatory reform by equating the free-for-all of cowboy capitalism with free markets.

A few zones in rich countries, such as the St Regis-Mohawk Reservation in New York State that serves as a major transit point for smuggled cigarettes, illustrate the downside. But for the most part, highly industrialised countries manage to maintain civil institutions and the rule of law without undermining their attraction to investors. The same cannot be said for developing countries, particularly those with weak political institutions.

Panama's Colón Free Trade Zone, with close proximity to the Panama Canal, is one of the busiest FTZs in the world and is a beehive of illicit activity. The Panamanian military has been known to collude with importers seeking to evade regulation, getting a cut of the savings on goods otherwise subject to stiff tariffs. More ominously, it has co-operated with smugglers to transport weapons and illicit goods to private militias across South America that mix radical politics with crime. Colombian cartels and Paraguayan criminals use multiple FTZs to funnel cocaine revenues to Hezbollah in exchange for protected access to Middle East drug consumers.

FREE TRADE ZONES MAY SPEED LOCAL DEVELOPMENT BUT CAN ALSO BE A MAGNET FOR CRIMINAL ACTIVITY

Perhaps not surprisingly, organised crime often fills the power vacuum left by the absence of regulation. Aruba became a haven for the Sicilian-based Caruana-Cuntrera family, which controlled 60 per cent of all property on the island in the early 1990s. It was an ideal waypoint in the American-European narcotics trade. By the mid-1990s, Aruba's reputation had also made it a no-go zone for legitimate foreign investors wishing to avoid guilt by association. Under pressure from multinational corporations (and foreign governments) the Aruban government finally had the backbone to overhaul its laws.

The Jebel Ali FTZ in Dubai is one of Europe's largest sources of counterfeit goods. In 2008, the year I visited the zone to investigate the fake-pharmaceutical supply chain, 15 per cent of cases of seized counterfeits at EU borders were in transit from the United Arab Emirates.

FTZs also facilitate the packaging and rebranding of pharmaceuticals not licensed by the patent holder, leading to uncertain provenance and hence concerns about quality. Zones in China are also regularly implicated as transit points for bogus drugs traded over the internet.

It doesn't have to be this way

As noted above, Aruba eventually stood up to entrenched interests, implementing comprehensive background checks, tightening oversight of incoming and outgoing shipments and maintaining better inventory controls. In fact, as Aruba's FTZ became legitimate, it also became more prosperous; it is now the preferred venue for Venezuelan investors seeking relief from their country's corrupt, regulation-bound government. Aruba still has problems with inventory management, but the turnaround shows that developing country FTZs are not beyond the influence of western interests, authorities and multinational corporations•

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IT'S TIME TO TURN OVER A NEW LEAF

Young people in Britain today are rightfully concerned about the economic future that awaits them and the burdens they face thanks to the spending habits of their parents and grandparents.

The scale of public debt in Britain – perhaps as high as £6trillion when off-balance sheet liabilities, such as public sector pensions are taken into account – does not just pose serious economic questions for the United Kingdom, but also substantial moral questions about inter-generational equity.

Collectively – if not consciously – older generations have voted themselves richer than they can afford. The bill for higher state pensions, expensive healthcare and a wide range of other benefits is being passed from father to son, from mother to daughter. Those who are entering the workforce today can reasonably ask whether they are going to end up paying for a wide range of state benefits that they are unlikely to be able to claim themselves in decades to come.

The situation is getting worse, not better. For all the talk of austerity and deep cuts in spending, the coalition government is actually planning to add hundreds of billions of pounds to the national debt over the course of this Parliament. Having originally planned to balance the annual budget by the time of the next election in 2015, the deficit is now being reduced so slowly that – on the present trajectory – the state will continue to spend more than it brings in in taxes for the next several hundred years.

It's not just a debt mountain that we need to worry about. There are other structural economic failings too. Labour market regulation is now so burdensome that we are in danger of creating an "insider-outsider" culture. Those presently in employment might benefit from rises in the minimum wage and enhanced workplace protections – but it prices others out of the labour market altogether. If government policies push up the price of labour, businesses tend to employ less.

Again, it is young people who are feeling the pinch – with youth unemployment now standing at about a million. Given it is illegal for businesses to offer employment to over-21s at less than £6.19 per hour (rising to £6.31 in October 2013), the first few rungs on the career ladder have been removed for many seeking to enter the labour market.

Liberty League – a network of campus-based, pro-freedom organisations supported by the IEA – has grown phenomenally in recent years, its annual gatherings now dwarfing those of the youth wings of the traditional political parties *(see www.uklibertyleague.org).*

The Institute itself runs an extensive research programme for interns, an annual week-long Freedom Week summer school and a substantial range of events aimed at sixth formers and university students. *(see www.iea.org.uk/students-teachers)*

And a vast range of articles and publications are available – and free to download – on our website, covering topics from monetary policy to poverty relief, from immigration to the environment.

IT IS YOUNG PEOPLE WHO ARE FEELING THE PINCH – WITH YOUTH UNEMPLOYMENT NOW STANDING AT ABOUT A MILLION

The IEA exists to educate people about free market solutions to the problems our society faces. Very often, when faced with a challenge, people ask what the state should do to tackle it. Believers in free markets believe that the state should very often do less and that government action very often exacerbates existing difficulties or is even the cause of them.

The global financial crisis, slow growth and a British state sector that accounts for about 50 per cent of national income has led many to consider whether we should seek a different economic path, one in which individual men and women exercise more power and discretion and politicians and bureaucrats wield less.

If you are interested in investigating how a smaller state and a freer market can lead to a more vibrant, dynamic and exciting future for Britain, please get involved. Although recent years have been full of gloomy economic news, there is a better path we can follow. The Institute of Economic Affairs exists to educate and inform so that the next generation will better understand the case for a free economy•

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