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INEQUALITY



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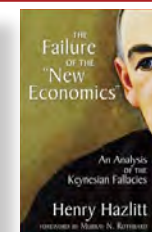
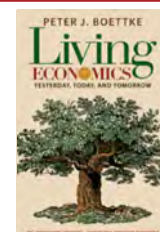
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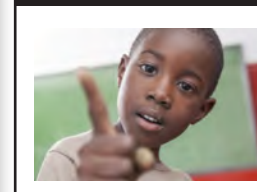


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Editor Philip Booth

Creative Director Glynn Brailsford

Design Marian Hutchinson

Review Editor Andre Alves

Editorial Adviser Richard Wellings

IEA

2 Lord North Street Westminster SW1P 3LB

020 7799 8900 www.iea.org.uk

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INTRO

WELCOME

...to the **first EA of the new academic year**. And if you're reading **EA** for the first time, welcome aboard.

In each edition of **EA** we examine some of the **key economic issues of our time** and feature the work of **eminent economists** from **around the world**.

This **global outlook** is reflected in our cover story (starting on **page 12**), which looks at one of **today's most contentious issues – INEQUALITY**.

Some of its findings may surprise you. What it shows is that **the world** is a much **healthier, wealthier and happier** place **than it's ever been** – and **not just for the rich**.

It's a theme also reflected in **CHRISTOPHER SNOWDON's** article on **page 56**. He concludes that In the UK it's **not a case of the rich getting rich and the poor getting poorer**. Instead there's **a growing gulf between the rich and the super-rich**.

Not so much the **haves versus the have-nots**... more a case of the **haves versus the have-yachts**.

I trust you'll find this issue of **EA** **enlightening and essential reading**. And – if you are a new reader – you can find **all previous issues of EA free to download** at www.iea.org.uk/publications/eamagazine•

Professor Philip Booth
Editorial and Programme Director
IEA
pbooth@iea.org.uk

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CLOUDING the FUTURE

The internet is a great engine of innovation – but this is threatened by proposed regulation in the US, says **FERNANDO HERRERA-GONZÁLEZ**

The internet probably provides us with the most exciting developments in education and entertainment. The regulation of the internet, however, is hardly a hot topic amongst its users! However, we ignore this issue at our peril.

Last February, the US telecommunications regulator decided that the internet should be regulated as if it were a public utility. This decision followed President Obama's declaration that he intended to 'protect a free and open internet'.

By that he made quite clear he meant an internet in which internet service providers (ISPs) could not restrict the best or fastest access to the network or pick winners and losers in the online marketplace for services.

To achieve this, Obama called for a set of rules which he described as 'simple, common-sense steps that reflect the internet you and I use every day', including:

- **'No blocking.'** If a consumer requests access to a website or service, and the content is legal, your ISP should not be permitted to block it.
- **No throttling.** Nor should ISPs be able to intentionally slow down some content or speed up others based on the type of service or your ISP's preferences.
- **Increased transparency...**
- **No paid prioritisation.** Simply put: No service should be stuck in a "slow lane" because it does not pay a fee [...] So, as I have before, I am asking for an explicit ban on paid prioritisation and any other restriction that has a similar effect.'

The internet has remained 'open' so far, not because of

any regulations or supposed in-built principles, but because, for the moment, its users prefer it to be so, and are prepared to pay for it to be so.

Any internet provider who wants to stay in the market has to offer 'open' access to all content, otherwise they would have been expelled from the market. It was due to the absence of regulation that the internet reflected the

assumption seems to be that telecommunication capacity is infinite – its use is therefore a form of 'club good' with a zero marginal cost.

As such, leaving its management in the hands of ISP owners would run against social welfare if they excluded some content. However, telecommunication capacity is limited, especially in the case of mobile networks, and it requires management just like

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desires of its users.

But, from now on in the US, any internet provider will have to comply with the above principles in order to avoid sanctions, disregarding the changing preferences of individuals.

What if users decide they do not want an 'open' internet in the future, for good reason? There are plenty of platforms which are not 'open' and yet are still favoured by consumers, such as iTunes and the Apple ecosystem.

In this 'walled garden', Apple 'picks winners and losers' (to use Obama's words) and nobody complains. It is in Apple's interest to choose the right 'winners and losers' if they want to retain their customers.

Obama's underlying

any other scarce resource.

The management of a resource consists essentially of blocking or prioritising uses. Buses can enter some parts of Oxford, but not cars; pedestrians are separated from motor vehicles; we can choose whether to fly business class or economy class and whether to fly from expensive and congested Heathrow or cheap and more distant Stansted. Such prioritisation happens in every walk of life.

Indeed, the same is true with retail space. Shops decide what to sell (thus 'blocking' other goods), which price to charge for them (thus 'throttling' or 'speeding up' their sale) and where on the shelf to put each good (thus 'prioritising' some goods over others). If the shop had

infinite capacity, the owner would not have to do that. But it doesn't. Space has to be managed. The question is who should manage it: shop owners, or politicians? Few people would advocate 'shop neutrality' regulations.

Net neutrality regulation is not fundamentally different. It is not a matter of whether capacity should be managed, but of who should allocate the available capacity for data transmission.

If an operator were to arbitrarily block content desired by users, these users would switch to a different operator. There are no economic reasons why an operator should block desired content: after all, they are in the business of carrying traffic, not of blocking it.

A similar analysis applies to the other practices that Obama proposes to ban: throttling, speeding up or paid prioritisation. Once again, these would not be required in a world of unlimited telecommunication data capacity.

But, in the real world, throttling or speeding up things is necessary to provide services with a reasonable quality in a congested environment.

If an internet provider tries to do these things against the preferences of their consumers, it will be punished by a loss of revenues. It may be tempted to do so, for example, by favouring its own TV service against other similar services. But if its customers do not want to watch that content, and start having problems with their preferred services, they are likely to move to alternative internet providers.

So, in order to get a small temporary increase in

THE MORE LIMITATIONS THE GOVERNMENT PLACES ON HOW THEY MANAGE CAPACITY, THE LESS WILLING THE OWNERS WILL BE TO INVEST

revenues, the operator would be risking its whole customer base. It is difficult to see why they would do this unless compelled by the need to manage a limited resource.

These regulations will probably hurt the poorest most, just as the poorest would be hurt most if 'no-paid prioritisation' regulation was applied to airlines and required all seats in an aeroplane to be provided at the same prices and with the same legroom. Cheap economy seats would disappear.

If the providers of more complex services could not pay more for faster access then either the more complex services will not develop or there will be higher prices for all services.

The case against net neutrality regulation becomes stronger when adopting a dynamic perspective. When demand outstrips supply, and when supply is constrained by a lack of capacity, the owner of a shop would probably consider expanding their capacity, for example by acquiring additional premises. But the more limitations the government places on how they manage capacity, the less willing the owners will

be to invest. Furthermore, the greater the uncertainty there is around regulation the higher the returns investors will demand.

The same logic applies to telecommunication networks. If operators anticipate they will not be able to freely manage the telecommunication capacity they build, they will invest less.

So, amid the current explosive growth in smartphones and video services, we would start experiencing a decline in quality, both because management of the scarce resource is not left to those who would benefit most from managing it, and due to reduced incentives to increase capacity.

With the regulation of the internet imposed in the USA, we may achieve an open internet, but we should not pretend that forcing it open will not come at a huge cost to individuals and society. The EU still has time to avoid this pitfall.

Fernando Herrera-González
Regulatory Economics
Manager
Telefónica S.A.
fherrerag69@yahoo.es

IN GOOD HANDS?

The NHS is something of a sacred cow in the UK. Its supporters suggest our health care isn't safe in the hands of the private sector. But evidence from overseas would suggest quite the opposite, says

KRISTIAN NIEMIETZ

Hinchingbrooke Hospital has had a history of ups and downs. In the 2000s, the Cambridgeshire hospital lost control of its finances, running up debt of £40m. It also slipped in the hospital rankings of clinical outcomes.

By 2009, Hinchingsbrooke was on the brink of collapse, and its desperate situation led the then government to a highly

unconventional (by British standards) response: the management of Hinchingsbrooke was outsourced to a private company.

Initially, it was a success story. Under the management of Circle Health Ltd, Hinchingsbrooke's finances were consolidated, and clinical outcomes improved. The healthcare consultancy CHKS rated it as the best hospital trust in England in the category 'quality of

patient care'.¹

But in 2015, Circle's rate of return fell drastically, prompting Circle Health to pull out and hand back the management of the trust to the NHS.

THESE SYSTEMS EASILY OUTPERFORM THE NHS ON A BROAD RANGE OF OUTCOME MEASURES...THEY ALSO SCORE HIGHER ON EFFICIENCY AND EQUITY MEASURES

In the media, this was widely presented as the proof that the worlds of medicine and business do not mix well, and are best kept apart. The BBC argued: "It is difficult to imagine a more significant moment in the whole debate about the provision of health care in Britain. [...] [T]here is a pretty simple answer to the question can a private business run an acute hospital. And it's no."²

The *Guardian* called the event "a heavy defeat for an ideological solution that can work well in manufacturing or retailing, but runs into problems in healthcare".³

Private healthcare options are the norm in much of Europe
What the episode really showed was how parochial and inward-looking our healthcare debate still is. There is a general political appetite for learning from international best practice: all major political camps are prepared to look abroad for policy solutions that have

worked elsewhere, and that are compatible with their values. But healthcare remains the exception.

You would not be able to guess this from the way the issue is covered in the British

press, but in other developed countries there are literally thousands of examples of hospitals that are owned and run by private organisations, and which are nonetheless open to everybody. In France and Italy, two countries which hardly have an exaggerated faith in markets and private business, the private for-profit

sector accounts for about a quarter of the hospital sector. In social-democratic Germany, for-profit providers hold a market share of nearly one third.

This combination of public funding and private provision is not particularly difficult to arrange. All you need to do is pay private companies in the same way in which public sector organisations are paid, and give patients free choice of provider.

In principle, this can be arranged within a single-payer system such as the NHS as well, and to a limited extent, it is already happening. In the mid-to-late 2000s, patients were given a choice of providers at the point of referral, and a payment system under which 'the money follows the patient' was devised (Niemietz, 2014, pp. 24-27).

But facilitating private provision of healthcare is

Figure 1: % of hospital beds owned by the independent sector

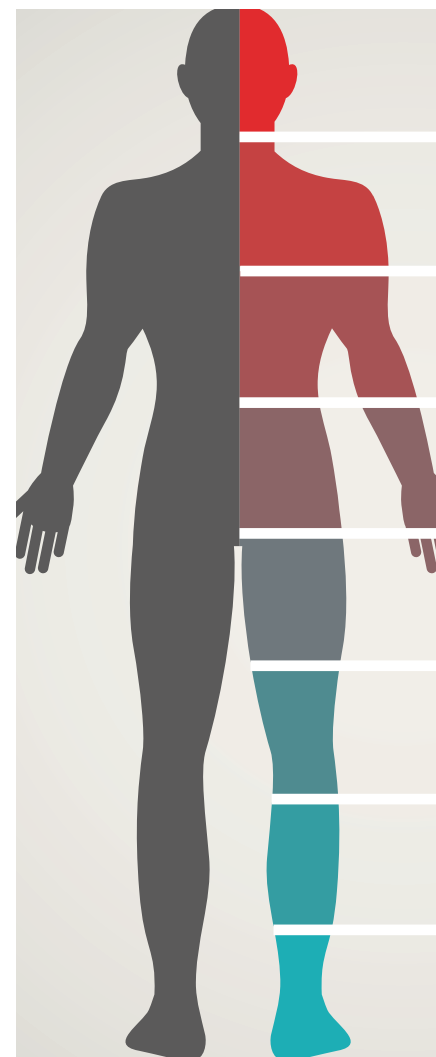


based on data from OECDStat.Extracts (2015)

¹ NHS Choices: 'Hinchingsbrooke Hospital', available at <http://www.nhs.uk/Services/hospitals/Overview/DefaultView.aspx?id=1429>

² Ahmed, K.: 'Can a private business run a hospital?', BBC Business News, 9 January 2015. Available at <http://www.bbc.co.uk/news/business-30742845>.

³ Owen, D. (2015) 'Lesson one from the Hinchingsbrooke hospital scandal: beware the 'mutual'', *The Guardian*, 19 January 2015. <http://www.theguardian.com/commentisfree/2015/jan/19/hinchingsbrooke-hospital-scandal-mutual-privately-run>



- Hinchingsbrooke hospital was a rare example of an NHS hospital that was managed, temporarily, by a private company. When that company pulled out, the media portrayed it as 'proof' that healthcare provision cannot be left to the private sector.

- This episode illustrates how parochial and insular our healthcare debate is. Hinchingsbrooke 'proves' no such thing. There are thousands of examples of publicly funded, but privately provided healthcare in comparable countries.

- In 'statist' France and Italy, the private for-profit sector accounts for about a quarter of all hospital beds.

- In social democratic Germany, most hospitals are privately owned and run, and the for-profit sector holds a market share of almost a third.

- The idea of combining statutory funding with independent sector provision (not just of hospital care) has been taken furthest in the countries which run social health insurance (SHI) systems.

- Those countries achieve consistently better outcomes than the NHS, whilst still guaranteeing universal access to healthcare.

- The Commonwealth Fund study, which has rated the NHS the 'best system in the world', does not show what NHS supporters think it shows.

- The collective hysteria about an imagined 'NHS privatisation' is entirely misplaced. Pluralistic health systems are nothing to be afraid of.

most easily achieved in social health insurance systems, in which the funding and the provision of healthcare are not just notionally split (as in the NHS), but performed by entirely separate organisations.

A social insurance system looks, at first sight, similar to a private health insurance system: people pay regular premiums to an insurer, consult healthcare providers when they fall ill, and their insurer then reimburses those providers for the cost of treatment. But the key difference is that social health

insurers are not permitted to turn down applicants, to vary premiums in accordance with individual health risks, or to rule out coverage for pre-existing conditions.

These systems also run risk structure compensation funds: insurers pay into a common fund when they take on people in good health, and receive money from that fund when they take on people in poor health. This means that insurers with very different risk profiles can compete on a level-playing field and people can get cover at the same cost regardless of their

medical conditions. There are also various different ways of ensuring that all citizens have cover regardless of income.

Social insurance systems perform well

The systems come in different shapes and sizes, but the 'purest' examples can be found in the Netherlands, Switzerland and Germany. These systems easily outperform the NHS on a broad range of outcome measures. They generally record higher cancer survival rates, lower stroke mortality rates, fewer incidences of

hospital infections and other complications, and lower rates of avoidable mortality. They also score higher on efficiency and equity measures (Niemietz, 2015, pp 17-24).

Supporters of the NHS counter by citing the UK's lower level of healthcare spending and its higher

bound to perform superbly in these categories.

However, the absence of those barriers does not mean that British patients enjoy unlimited access to everything that is medically possible. It just means that the NHS rations healthcare in other, more subtle and covert ways,

IN HEALTH INSURANCE SYSTEMS, HEALTHCARE IS STILL TO A LARGE EXTENT PUBLICLY FUNDED, AND ACCESS IS UNIVERSAL. BUT THE STATE PLAYS A MUCH MORE LIMITED ROLE IN THE PROVISION OF HEALTHCARE

ranking in the Commonwealth Fund study (Davis et al, 2014). These arguments are not incorrect, but they require some context.

The Commonwealth Fund study places a high emphasis on equity, which it defines as the absence of financial barriers and coverage restrictions set by insurers. Since the NHS is not an insurance system, and since it does not use co-payments or other financial levers, it is

which the Commonwealth Fund study cannot measure.

Despite biases of this kind, the social health insurance countries have come out in the top five in every previous edition of the Commonwealth Fund study in which they have been included. Indeed, the Commonwealth Fund study does not consistently rank the NHS above the social insurance systems, though it does in some years.

As for the difference in

spending, this is at least partly due to the fact that social insurance systems make it easy to top up statutory healthcare privately, which is not permitted in the NHS. Almost by definition, allowing additional private spending leads to higher overall spending, but it is voluntary spending, which should not be held against these systems.

In health insurance systems, healthcare is still to a large extent publicly funded, and access is universal. But the state plays a much more limited role in the provision of healthcare, which has been partly, or (in the Netherlands) fully transferred to the independent sector.

The outcomes suggest that these arrangements are able to deliver high quality healthcare without compromising equity. They are nothing to be afraid of.

Those who are interested in better health outcomes should abandon their inward-looking, insular perspective, and look around for examples of international best-practice•

Kristian Niemietz
Senior Research Fellow
IEA
kniemietz@iea.org.uk

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The fall in global poverty has gone hand-in-hand with a fall in global inequality. Yet this important fact is largely omitted from contemporary discussions of inequality which are remarkably parochial, says **MARIAN L. TUPY**

THE WORLD IS BECOMING MORE EQUAL



Is inequality increasing or decreasing? The answer depends on our point of reference.

In America, the income gap between the top 1 per cent and the rest has grown appreciably. It is true that most of us see our standards of living continue to improve through, for example, the falling prices of consumer goods: in 2002, a 42" plasma TV cost \$13,126 in 2014 dollars. Today, you can buy a substantially better 42" flat screen TV for \$380 – a price reduction of 97 per cent. However, the very richest have got richer more quickly than the rest.

If our reference point is the whole world, inequality is decreasing. Strictly speaking, declining global income inequality is no news. A number of scholars, including Xavier Sala-i-Martin of Columbia University, Surjit Bhalla of the Brookings Institution and Martin Wolf of the Financial Times, identified a declining trend in income inequality over a decade ago. However, there is so much talk about apparently increasing inequality that the issue deserves further attention.

Recent work by Paulo Liberati of Roma Tre University confirmed the trend of falling inequality. Even Angus Deaton of Princeton University, who is generally sceptical about international income data, acknowledges that global inequality is "probably" declining. "We are witnessing," as Branko Milanovic of the World Bank wrote, "the first decline in global inequality between world citizens since the Industrial Revolution."

To understand the rise and fall of global inequality, it is important to remember that, for most of human history, incomes were more equal, but

terribly low, throughout the world.

At the time of Caesar Augustus, incomes in the most advanced parts of the world ranged between \$1,100 and \$1,400 per person per year (in 2014 dollars). Progress was painfully slow. As late as 1820, average global income was still about \$1,300.

That said, by the early 19th

economics that has led to global inequality falling.

The narrowing of the income gap between the West and the rest is also not a function of declining Western incomes. Due to the Great Recession, to give one example, US GDP per capita decreased by 4.8 per cent between 2007 and 2009. It rebounded by 5.7 per cent over the next four years and stands

FOR MOST OF HUMAN HISTORY
INCOMES WERE MORE EQUAL
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THROUGHOUT THE WORLD

century, a pronounced income gap emerged between the West and the rest and this grew over time. For example, take the United States. In 1820, the US was 1.9 times richer than the global average. By 1960, it was 4.1 times richer and, by 1999, 4.8 times richer. By 2010, the US was only 3.9 times richer. During this period, some countries did very well and developed and others did not.

The lack of development of many countries and the level of inequality in the world as a whole became an important political issue in the 1960s and 1970s, especially amongst Marxist and socialist development economists whose views formed the consensus. But, it was not this kind of development

at an all-time high today.

Rather, the narrowing of the income gap is a result of growing incomes in the rest of the world. This period of rapid growth of incomes in many non-Western countries is consistent with the period of globalisation that started with economic liberalisation in the 1980s.

Consider the spectacular rise of Asia. In 1960, the US was 11 times richer than Asia. Today, the US is only 4.8 times richer than Asia.

China is, of course, the most important Asian success story. Between 1958 and 1961, Mao Zedong attempted to transform China's largely agricultural economy into an industrial one through the "Great Leap Forward." His stated goal was to overtake

the UK's industrial production in 15 years. Industrialisation, which included building factories at home as well as large-scale purchases of machinery abroad, was to be paid for by food produced on collective farms.

But the collectivisation of agriculture resulted in famine that killed between 18 and 45 million people. Industrial initiatives, such as Mao's attempt to hugely increase production of steel, were equally disastrous. People burned their houses to stoke the fires of the steel mills and melted cooking wares to fulfil the steel production quotas. The result was destruction, rather than creation of wealth.

Deng Xiaoping, Mao's successor, partially privatised the farmland and allowed farmers to sell their produce. Trade liberalisation ensured



that Chinese industrial output would no longer be dictated by production quotas, but by the demands of the international economy.

Since liberalisation in 1978, China's GDP per capita has increased 12.5 fold, rising

from \$545 in 1980 to \$6,807 in 2013. Over the same time period, the Chinese poverty rate fell from 84 per cent to 10 per cent.

What is true of China is also true in much of the developing world. As Laurence

Chandy and Geoffrey Gertz of the Brookings Institution wrote in 2011, "Poverty reduction of this magnitude is unparalleled in history: never before have so many people been lifted out of poverty over such a brief period of time."

At the heart of the income gap that arose between the West and the rest was the Industrial Revolution in Britain, Europe, and America in the early 1800s. Unfortunately, by the time the benefits of industrialisation were fully understood elsewhere, many countries in Africa and Asia opted for the wrong kind of industrialisation – one that was based on deeply inefficient Soviet-style central planning, rather than a free market. In recent decades, most of those countries abandoned state-driven routes to economic development and grew. This reduction in poverty has led to the shrinking of global inequality.

The shrinking income gap between the West and the rest masks even greater advancements that developing countries have made in other areas. Take life expectancy: between 1960 and 2010, global life expectancy increased from 53 years to 70, while in the US over the same period it rose from 70 to 78.

Put differently, the life expectancy gap shrunk at a faster pace than the income gap. Similar stories can be told about child and maternal mortality, treatment of communicable diseases, the spread of technology, and so on. Human progress is not only marching forward; it is also becoming cheaper.

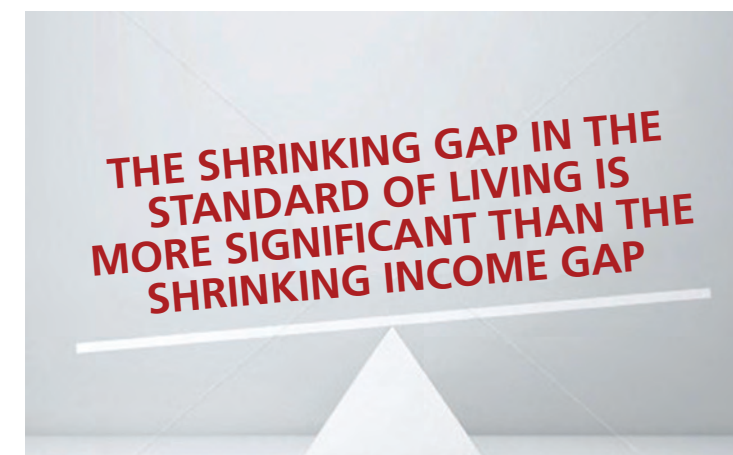
Clearly, technological advances made by the West (for example, transport, medicine and communications) raised standards of living in the rest of the world. The shrinking gap in standards

of living is arguably more significant than the shrinking income gap.

As the Nobel prize-winning economist Friedrich Hayek noted, "The benefits of freedom are... not confined to the free... There can be no doubt that in history unfree majorities have benefited from the existence of free

irony that the same people who lamented the extreme poverty in many parts of the world in the 1970s, and who proposed misguided solutions, now talk about the problem of "increasing inequality".

Inequality is increasing in many individual countries but not in the world as a whole.



minorities and that today unfree societies benefit from what they obtain and learn from free societies."*

The narrowing of the gap between the West and the rest could stop or be reversed by war, trade protectionism or onerous caps on energy use in poor countries. Looking into the uncertain future, let us hope more of our leaders realise the benefits of technological innovation, entrepreneurship, free trade and peace.

It is something of an

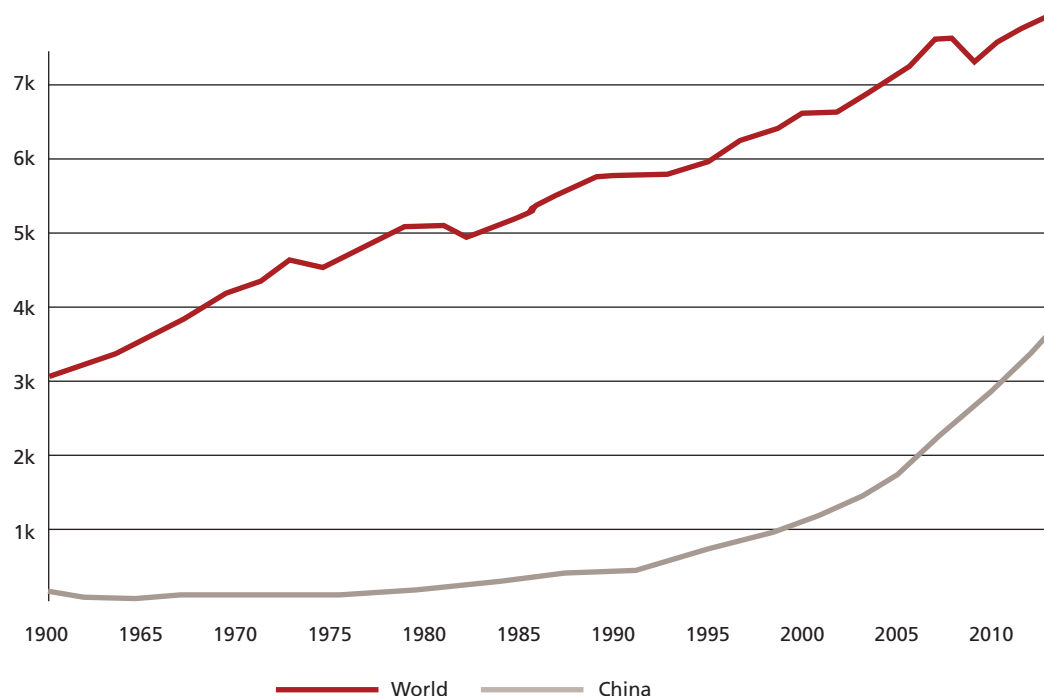
Why have they shifted their focus from the international to the national stage? If their focus were still international, and on the position of the world's poor, they would have to admit that huge strides have been made.

Marian L. Tupy

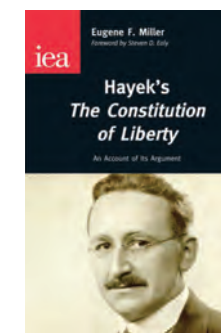
Senior Policy Analyst
Center for Global Liberty
and Prosperity
Cato Institute
Editor of

www.humanprogress.org
mtupy@cato.org

Figure 1: GDP, per person, 2005 international dollars, PPP



Source: HumanProgress.org



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FLANDERS FIELDS OUR QUESTIONS

STEPHANIE FLANDERS is Chief Market Strategist at JP Morgan and was previously Economics Editor at the BBC. During her time at the BBC, Stephanie – educated at Oxford University and Harvard – presented documentaries on the work of Marx, Keynes and Hayek. Here, she discusses her interest in economics and contemporary economic debates, with the IEA's **PHILIP BOOTH**

Many economists admit to having had an interest in economics from a very early age. When did you become aware that you were interested in economics?

My grandmother tells me I had a lengthy conversation with her, aged 6, about decimalisation. That would have been in the mid-70s, a few years after Britain got rid of its old pounds shillings and pence.

I hope I wasn't quite that nerdy at such a young age, but coming from a family of writers and journalists I was always interested in the world

of current affairs.

By the time I was in secondary school, Margaret Thatcher had come to power and the air was thick with arguments about the role of the state and the pros and cons of her pro-market reforms.

I wanted to understand all of those arguments and that led me to take and enjoy economics at A level and to continue with economics at Oxford on the PPE programme.

Intellectually I've always been drawn to all three – Politics, Philosophy and Economics. But once you start

to look at the world as an economist it's difficult to stop.

Whilst Economics Editor of BBC News, you made films on Hayek, Keynes and Marx. Yet, arguably, it was Friedman who had the most influence on economic policy in the 1980s by persuading the vast majority of the economics profession that a rise in inflation only led to a fall in unemployment in the short run. Why did you choose Hayek, Keynes and Marx, and not Friedman, for that series?

Interestingly, the original series proposal included both

Hayek and Friedman: the production team intended the second programme to be about them, because in their mind it made sense to put the "free market" thinkers in one episode.

But when it comes to the understanding of financial crises, I don't think it is really Friedman and Keynes who are on opposite sides of the divide – but Friedman and Hayek.

Like Keynes, Hayek focused on the complexity of markets and their inherent unpredictability, but he did not think policymakers could master those complexities well enough to guide the economy in the right direction. More often than not, he thought they would make things worse. That puts him in a different camp from both Keynes and Friedman.

Friedman was actually a fan of Keynes early in his career. Now they are considered to be poles apart, but I think a lot of those differences come down to the time in which they lived and the policy challenges they faced.

It is an over-simplification – but Keynes was responding to a situation in which governments had done too little. In Friedman's heyday, in the 1960s and 1970s, economic policy-makers were trying to do too much.

But, ultimately, they both thought economic policy could make things better. I could have put Friedman and Keynes in the same programme, to make that point, but covering all of Keynes' thinking in one hour was difficult enough!

F. A. Hayek's Nobel Laureate lecture described how he believed that economists were often attracted to theories that could be easily tested with data even if they were fundamentally wrong.

He was also very sceptical of economic forecasting. How much value do you think that economic forecasting adds?

Paul Krugman, another Nobel Laureate, said economists "mistook beauty for truth" in the years before 2008, especially in their theories of the financial sector, which made all kinds of vital assumptions about the functioning of asset markets which turned out to be wrong.

The assumption that these markets were always perfectly liquid was probably the most important. We know from

IN 140 CHARACTERS

Who is more important and why, Hayek, Friedman or Coase?

Coase had most influence on economics by forcing us to think more rigorously about the firm and how property rights can dictate outcomes.

experience that markets can simply seize up in the event of a panic.

It is a demonstration of Hayek's basic point, that economists are sometimes more interested in having a testable theory than in having something that actually resembles reality.

In the last few years we have seen economists developing very complex "now-casting" models which are probably an improvement on what we've had in the past. You're not going to get absolutely reliable forecasts for the economy – any more than for the weather. But an "educated guess" is better than an un-educated one.

The sadness for me is that economics as a profession is so often judged by the accuracy of its forecasts, when it has so many more important things to offer.

You recently reviewed Piketty's book on inequality. There are rather a lot of conflicting trends in the data. Within countries, inequality is generally increasing, but within the whole world it is decreasing. Sweden has one of the lowest levels of income inequality, but one of the highest levels of wealth inequality. In the UK, inequality by most measures has fallen slightly in the last 30 years, but the top 1 one per cent has pulled away. Is the world quite as simple as Piketty seems to imply?

I was once chairing an event featuring the Nobel Laureate Joseph Stiglitz and suggested to him that historians might consider the fall in inequality between countries to be the more important feature of this time. He said "maybe, but we don't get to live in the world, we live in individual countries. So it matters in most of those countries... the gap between rich and poor is going up."

The rise in incomes at the very top of the distribution – for the celebrated 1 per cent – is fairly clear and I think does have troubling consequences at a time when a large part of some countries' populations has seen falling real incomes.

One fact from Thomas Piketty's book that no-one seems to have questioned is his claim that 60 per cent of the increase in US national income in the 30 years after 1977 went to just the top one



IN 140 CHARACTERS

Who is more important and why, Marx, Keynes or Galbraith?

Marx may've had greater world impact but Keynes had most influence on economics with the insight that markets do not always self-equilibrate.

per cent of earners.

However, Piketty focusses most of his book on inequality of wealth – capital – rather than income. And there the data is less clear-cut. There has been a sharp rise in the share of national income accounted for by profit, and a fall in the labour share in the US.

We saw a similar trend in

the UK for a while but it has reversed since the financial crisis and the share of total income going to workers is now back to where it was in the 1970s.

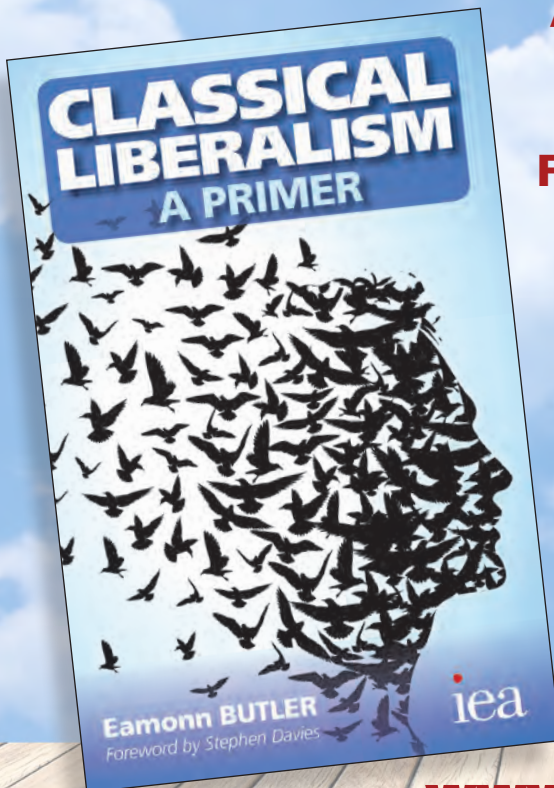
The latest official survey of UK household incomes and wealth shows that around a third of all UK households has either negative net worth – debts greater than their assets – or net financial assets worth less than £5,000.

Personally, I am more worried about that lack of wealth at the bottom than

about the squillions being amassed by a very few.

To what mundane everyday decision do you apply economic reasoning?

I suspect I don't apply economic reasoning enough in my daily life but I have inflicted quite a lot of it on my children. My son was taught the free-rider principle aged 3, while at the playground – and at Christmas we often discuss the law of diminishing returns•



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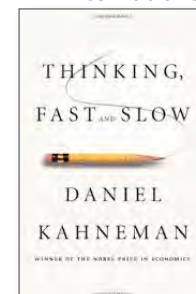
BEST behaviour



Does behavioural economics pose as many questions as it answers, asks **PAUL ORMEROD**

In 2002 Daniel Kahneman was awarded the Nobel Prize for his work in behavioural economics.

His *Thinking, Fast and Slow* is an international best-seller. The foundations of Kahneman's work were built in collaboration with the late Amos Tversky as long ago as the 1970s.



Four decades later, behavioural economics is finally becoming incorporated into economics teaching both at university and, increasingly, school level.

What's it all about?

Behavioural economics involves the application of the insights of experimentally-based behavioural psychology to the analysis of economic decision-making. It has had a substantial impact on policy making.

For example, in 2010 the UK's newly elected coalition government set up the Behavioural Insights Unit. The unit has claimed several policy successes. For example, sending personalised text messages to people to persuade them to pay fines promptly is believed to have saved the Courts Service £30 million a year.

The tax authorities (HMRC) were persuaded to write to late payers of tax to tell them that

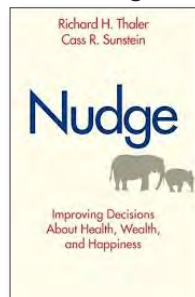
most people paid on time. This is believed to have increased payment rates by at least 5 per cent.

The team discovered that people's lofts were full of junk, and provided low-cost labour to clear them; this caused a fivefold increase in the proportion of installed insulation.

A defender of traditional economic analysis could argue that these examples are compatible with mainstream theory. Economists have long recognised the importance of information in decision-making, and each of these initiatives increased the amount of information available to people so that they could make better choices. The individuals in the examples were not acting irrationally before they received the prompts; their information was simply incomplete.

Bigger claims

More dramatic claims for the policy impact of behavioural economics insights are made by two leading American behavioural economists,



Cass Sunstein and Richard Thaler.

In 2009 they published a best-seller entitled *Nudge: Improving Decisions About Health, Wealth and Happiness*. In an interview on amazon.com, they suggested that behavioural economics can solve almost any problem, by giving 'nudges' to

people by designing the way their choices are structured – for instance by offering people the opportunity to 'opt out' of something (such as organ donation) rather than simply the choice to 'opt in'. The following dialogue illustrates:

Amazon: 'What are some of the situations where nudges can make a difference?'

Thaler and Sunstein: 'Well, to name just a few: better investments for everyone, more savings for retirement, less obesity, more charitable giving, a cleaner planet, and an improved educational system. We could easily make people both wealthier and healthier by devising friendlier choice environments, or architectures.'

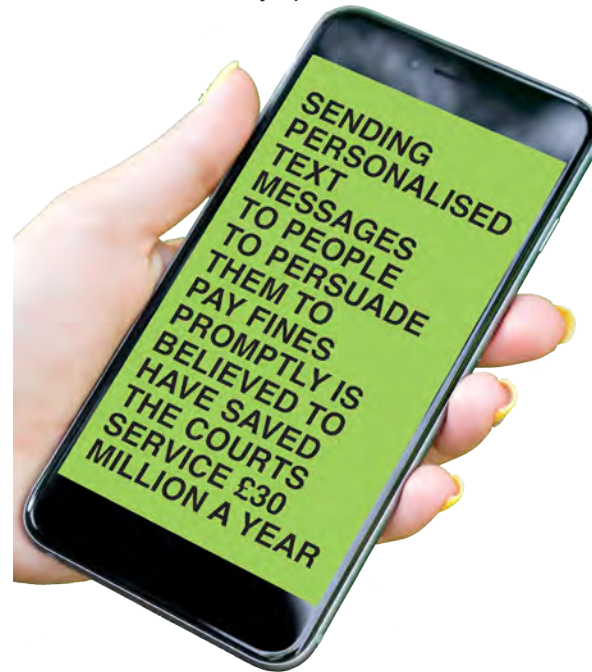
Big claims, though we might wonder whether policy-makers can be trusted to be any more rational than the consumers and investors they seek to nudge.

To be fair, Sunstein and Thaler have carried out very distinguished work in behavioural economics – for example Thaler's 1980 article 'Toward a Positive Theory of Consumer Choice', described by Daniel Kahneman as 'the founding text of behavioural economics'.

Thaler argues here that 'in certain well defined circumstances, many consumers act in a manner that is inconsistent with economic theory. In these situations economic theory will make systematic errors in predicting behaviour'.

This is the scientific aspect of the concept of behavioural economics. Many nudges used in practical contexts by policy-makers, and described as being 'behavioural' can, as we've seen, be potentially reconciled with mainstream economic theory.

From a scientific perspective, behavioural economists are claiming much more. They are saying that, in certain contexts, the standard theory of economic behaviour does not tell us how the world actually operates.



What's wrong with orthodox theory?

The orthodox theory of decision making in economics is based on utility maximisation. Like any scientific theory, it needs to make simplifying assumptions about the world. Some key assumptions are that the tastes and preferences of each individual are fixed, and are not susceptible to being altered by the preferences of others.

When making a decision, people are able to gather and process all available information about the various alternatives. Comparing these with their personal preferences, and subject to any constraints such as income, they make the best possible decisions.

The theory is both a description of how

rational individuals ought to behave, and at the same time one of how people actually behave in practice.

Behavioural economics, by contrast, identifies situations where people take decisions deviating systematically from those predicted by standard theory. It does so by using experimental techniques lifted from psychology.

An experiment is set up, in which the decision which would be taken by a rational agent is known.

People are then paid small sums to take part in the experiment. Decisions which they actually make are contrasted with the predictions of economic models.

The conclusions drawn from such experiments can be criticised.

The participants are not paid very much to take part, and so their incentives to arrive at the 'correct', rational choice are not very high.

They are often recruited from the academic researcher's students, and so may not be representative of the population as a whole.

These are fair points. However, the sheer volume of empirical evidence which has now been obtained within behavioural economics suggests that, whilst any individual study might be criticised, it is hard to dismiss the overall findings.

An example is work by British economists Graham Loomes and Robert Sugden on the assumption of standard theory that choices are transitive (consistent). In other words, if I prefer A to B and B to C, then I prefer A to C. It sounds very plausible, but Loomes and Sugden have shown repeatedly that individuals may not behave like this at all.

But rational behaviour is still the benchmark

A potentially more important point is that behavioural economics remains firmly anchored in the rational choice model of economics.

This is still deemed to be able to identify the best decision, and the purpose of experiments is to observe deviations from it, such deviations being deemed irrational.

In 1955, Herbert Simon (a subsequent Nobel Laureate), published one of the most brilliant papers in economics in the whole of the 20th century.

The subject matter was rational choice theory, and the paper inspired the entire corpus of work on behavioural and experimental economics.

Yet the key theme of Simon's paper was an attack on the very principle of maximising behaviour.

Simon argued that in many circumstances,

people cannot gather or process the sheer amount of information required in order to make the best possible decision.

Even after the event, it is often impossible to identify what the optimal choice would have been.

The literature has been inspired by Simon, but behavioural economics does not take on board this point.

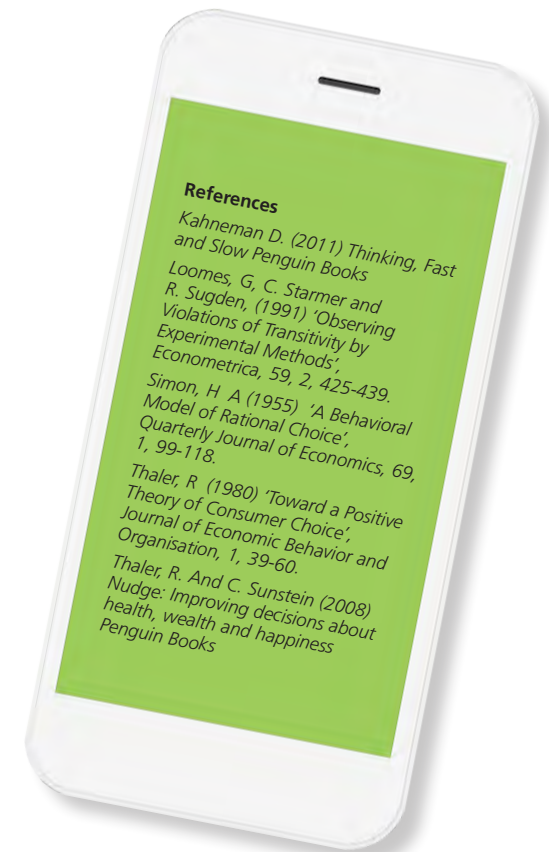
It is, for all its interesting results, ultimately based upon the rational, optimising model of decision making of mainstream economics.

Experimental behaviour which deviates from this model is seen as irrational, with the orthodox model still being seen as the way one ought to make choices.

Simon's work does not tell us whether free market approaches to economic problems or other approaches might be better – after all, politicians, voters and regulators come from the same stock of humanity as consumers.

However, it should lead us to consider whether behavioural economics poses as many questions as it provides answers.

Paul Ormerod
Volterra Partners
pormerod@volterra.co.uk





SURPRISING SECRETS of the **SWEDEN SMELL OF SUCCESS** (and the rest of Scandinavia...)

Nordic countries are celebrated for combining economic dynamism and a generous welfare state. But much of their modern-day success rests on the region's entrepreneurial instincts and long-standing market reforms – as **NIMA SANANDAJI** reveals in his new IEA book, **SCANDINAVIAN UNEXCEPTIONALISM**



During a tour to Paris, Bruce Springsteen explained that his dream was for the US to adopt a Swedish style welfare state. The famous musician is far from alone in idealising Scandinavian policies.

The four Scandinavian nations (Denmark, Finland, Norway and Sweden) are often regarded as prime role-models and it is suggested that other countries should emulate their policies.

Internationally, advocates of left of centre policies view these countries as examples of how high-tax social democratic systems are viable and successful. Economist Paul Krugman, for example, has said: "Every time I read someone talking about the 'collapsing welfare states of Europe', I have this urge to take that person on a forced walking tour of Stockholm".

The high regard for Scandinavian countries comes as no surprise. Nordic

countries are uniquely successful. They enjoy high living standards, low crime rates, long life expectation, even income distributions and high degrees of social cohesion.

However, a question few have bothered to ask themselves is what exactly makes Scandinavian countries unique. In fact, what is remarkable if you look at Scandinavian history is that these countries had the same outcomes long before the welfare state was born. Perhaps we should look elsewhere for explanations of their success.

WEALTH-CREATING SOCIAL DEMOCRACY?

It is sometimes claimed that Sweden's high growth rate is a result of social democratic policies. In fact, between 1870 (when Sweden began to develop what could be described as a modern market economy) and 1936 (the start of the era dominated by social democratic rule) Sweden enjoyed the highest growth rate in the industrialised world. However, between 1936 and 2008, the growth rate was only 13th out of 28 industrialised nations.

Even more telling is the fact that the social democrats did not develop an extensive welfare state until the 1960s (until that point, Swedish welfare spending was at roughly UK levels). Taxes were kept low and regulation of the economy was not onerous. When the size of government really started to grow in the 1960s and 1970s, there was economic stagnation.

THE NORDIC FREE MARKET SUCCESS STORY

It is true that Scandinavian countries combine an even

income distribution with high levels of prosperity. This is often viewed as a unique achievement, which should be emulated abroad. But how exactly did high living standards evolve?

Already in 1943 the Irish historian James Beddy asked a simple question: how come Denmark had grown so much more prosperous than Ireland? The two countries were both trading with England, and natural factors such as average temperature, hours of sunshine, rainfall and abundance of natural

A QUESTION FEW HAVE BOTHERED TO ASK THEMSELVES IS WHAT EXACTLY MAKES SCANDINAVIAN COUNTRIES UNIQUE

resources all favoured Ireland.

Yet it was Denmark that at the time had a national income per head that was almost 50 per cent higher than that in Ireland. Beddy found the answer to be a more free market approach in Denmark.

Denmark's closest neighbour to the north was more of a late-bloomer. However, few other nations have demonstrated as clearly as Sweden the phenomenal economic growth that comes from adopting free-market policies.

Sweden was a poor nation before the 1870s, resulting in huge emigration to the US. However, as a capitalist system evolved out of the agrarian society, the country grew richer. Property rights, free markets, and the rule of law combined with large numbers of well-educated engineers and entrepreneurs. These factors created an

environment in which Sweden enjoyed an unprecedented period of sustained and rapid economic development.

So, it is very clear that high growth and high incomes pre-dated the development of the welfare state in Nordic countries. Perhaps this is not surprising, though it should be noted that growth then stalled in the 1970s and 1980s. After all, the Nordic countries had scope for catch-up growth.

It would be more surprising, perhaps, if the social outcomes for which

Scandinavia is famed predated the development of the welfare state. In fact, that is exactly what we find.

LIFE-SPAN AND WELFARE

A common belief is that the high living span of Nordic countries is a direct result of large welfare states.

In fact, Norway, Sweden and Denmark were topping the global ranking of long life-spans already in 1960, before the shift towards high taxes and large public sectors.

Indeed, by 2005, after a long period of extensive state welfare, Nordic countries had slipped somewhat in international rankings (see *figure 1a*). There is simply no evidence that the welfare state caused good health and longevity in Scandinavia.

It is interesting to look within the Nordic countries too. Iceland – the Nordic cousin which maintained only a moderate-sized welfare

state – managed to surpass the other Nordic countries in life-span during this period. The reason is not that Iceland has a warm and hospitable climate (it doesn't).

Essentially, the differences in lifespan are a function of lifestyle. In Iceland, there is a culture that emphasises healthy eating, moderate

FEW OTHER NATIONS HAVE DEMONSTRATED AS CLEARLY AS SWEDEN THE PHENOMENAL ECONOMIC GROWTH THAT COMES FROM ADOPTING FREE-MARKET POLICIES

drinking and exercise, whereas in Denmark that is not the case. Having the highest tax rate in the world, high spending on welfare and an even income distribution has not helped Denmark have better longevity: other factors are at work.

CULTURE AND WELFARE

Culture has played a key role in Scandinavian success. This is much more important than the welfare state. Economists have not, in general, paid enough attention to studying the impact of culture on economic outcomes but it can be critically important.

Traditionally in Scandinavian societies, it was difficult to survive without working exceptionally hard in a hostile environment. The

Figure 1a

BJÖRN TO RUN

IS IT CULTURE OR WELFARE THAT MAKES NORDIC PEOPLE LIVE LONGER?

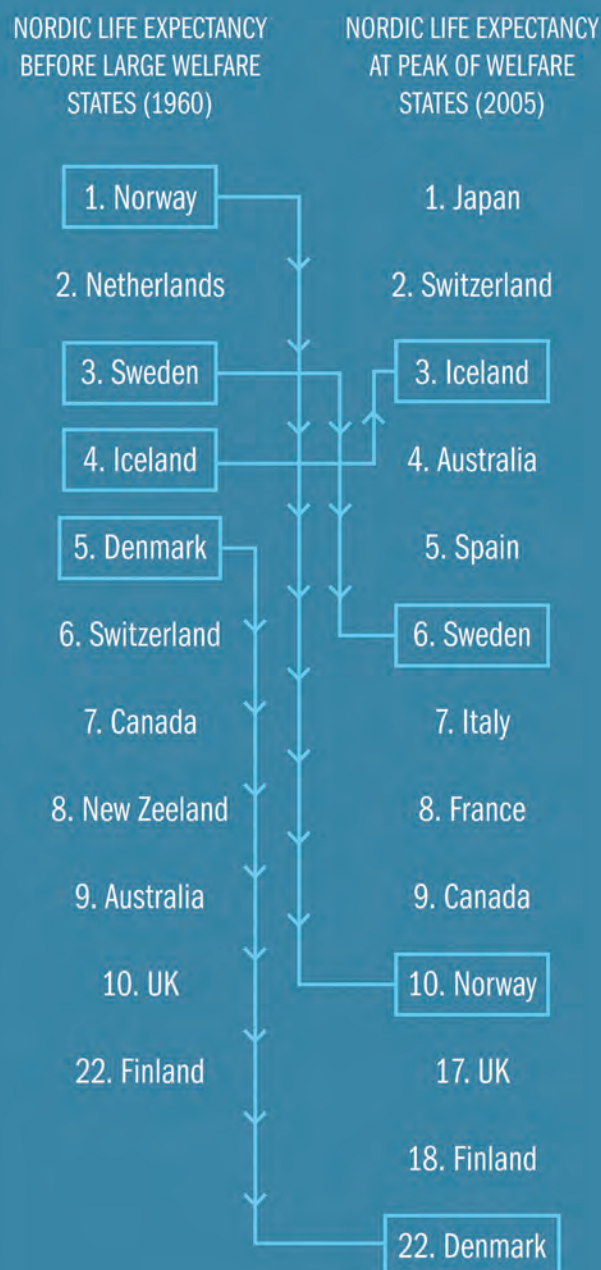


Figure 1b



population, out of necessity, adapted a culture with a great emphasis on individual responsibility and hard work.

When other parts of Europe had feudal systems, where much of the population were serfs who lacked property rights in their land, most of Scandinavia had a system with many individual farm owners. Hard work has historically not only been a necessity in the cold north, but also been clearly rewarding due to the presence of wide spread private ownership.

The homogenous Scandinavian countries, influenced positively in many cases by strong religious norms, also had high levels of mutual trust. Even today, the descendants of Scandinavian immigrants in the US have the highest levels of mutual trust in that country.

The forefathers of these immigrants ventured to the New World well before the

creation of modern welfare states – which provides additional evidence that the Nordic success culture predates the welfare state.

Paradoxically, this strong work ethic and high levels of mutual trust were very helpful as the welfare state was created because high taxes and welfare benefits did not discourage work as much as might have been expected.

Over the generations however, welfare state policies have eroded those strong working norms – fostering a culture of dependency. Other economic evidence on this matter suggests that it is something that happens with a long time lag and the same is true in Sweden. As norms have adjusted to welfare provision, it has become more acceptable to cheat on government benefits (see figure 2).

But the crucial point is that

strong moral norms pre-dated the welfare state, they were not the result of the welfare state.

AN EQUAL INCOME DISTRIBUTION BEFORE THE WELFARE STATE

But what about income distributions within Scandinavian countries? It is, of course, quite plausible that the welfare state reduced growth and that there were high levels of trust before the welfare state which were then eroded but, surely, the one thing we know about big welfare states is that they promote equality.

As it happens, this is not really true. This widespread belief is a consequence of people who hold this view focusing so much on

THERE IS SIMPLY NO EVIDENCE THAT THE WELFARE STATE CAUSED GOOD HEALTH AND LONGEVITY IN SCANDINAVIA

Scandinavia and assuming that their extensive welfare systems have been the cause of their high levels of equality.

But, the situation is more complex. A study by researchers Jesper Roine and Daniel Waldenström shows that already by 1920 – when the country had low taxes and a small government – Sweden had the lowest rates of inequality amongst industrialised countries.

The authors conclude

that most of the continued decrease in inequality took “place before the expansion of the welfare state”.

A recent paper by Anthony Barnes Atkinson and Jakob Egholt Søgaard illustrates that the evolution towards greater equality of incomes in Denmark followed a similar route.

Of course, a large welfare state promotes greater equality through income distribution. It is equally true that welfare state programs can reduce some social ills. But the Swedish welfare state does not redistribute more than the British welfare state.

The reason incomes are more evenly distributed in Sweden is because incomes before taxes and transfers are more equal – and they have been ever since the development of Sweden as a modern economy.

At the same time, Nordic style welfare models have also created social problems by trapping many in welfare dependency. This is not least true in Norway, which due to its oil-wealth has the most generous benefits systems in Scandinavia.

The social poverty that welfare entrapment creates is often inherited by the next generation. This issue is mainly relevant for migrants to the Nordic countries, for which public dependency is a major social challenge.

FORCING PAUL KRUGMAN TO TAKE A WALK

In a sense, Paul Krugman is right: a forced walking tour of Stockholm disproves the idea of the collapsing welfare states of Europe. Such a walking tour also provides evidence that ambitious market reforms of welfare systems can prevent their

Figure 2

BJÖRN TO CLAIM?

IS IT JUSTIFIED TO CLAIM GOVERNMENT BENEFITS YOU ARE NOT ENTITLED TO?



Before norms had adjusted to welfare state (1981-1984)

82% said: never!

After norms had adjusted to welfare state (2010-2014)

55% said: never!

** World Value Survey. Data only exists for Sweden amongst Nordic countries*

stagnation – as has happened in Scandinavia.

More importantly, it will show that Scandinavia is entirely unexceptional when it comes to economic policies. High taxes and overly-generous welfare systems have stifled growth and created dependency, as they also have elsewhere.

Small government and

low levels of regulation before the 1960s stimulated entrepreneurship and widespread wealth creation, again in line with international experience. Deeper social factors such as culture and non governmental social institutions have made Scandinavian societies unique. This is not a secret policy recipe that can be easily



FOR MORE...

Read Nima Sanandaji's *Scandinavian Unexceptionalism*.

Download it for free at:

www.iea.org.uk/publications/research/scandinavian-unexceptionalism-culture-markets-and-the-failure-of-third-way-soc

Figure 3

BJÖRN IN THE USA



NORDIC PEOPLE ARE AFFLUENT, PARTICULARLY IN CAPITALIST AMERICA

GDP of Swedish Americans

39% higher than Swedes living in Sweden



GDP of Danish Americans

37% higher than Danes living in Denmark



GDP of Finnish Americans

47% higher than Fins living in Finland

Norwegian Americans have merely 4% lower GDP than Norwegians living in Norway, which is impressive given that Norway has massive oil-wealth

copied by others.

Indeed, the fact that these cultural factors are so important is illustrated, once again, by the story of Nordics in the US.

It is true that poverty rates in Scandinavian countries are lower than in the US. However, the poverty rates for descendants of Scandinavian immigrants living in the US are at half the levels of the US average – and yet they do not benefit from a large welfare state.

Indeed, the descendants of Scandinavian immigrants are a uniquely affluent group. They have lower poverty rates than their Scandinavian cousins. If Finnish Americans had their own country for example, their GDP per capita would be 47 per cent higher than the GDP per capita of Finns in Finland.

Scandinavian culture evidently works well in combination with US-style capitalism (see figure 3). This is perhaps something for Bruce Springsteen to ponder.

Nima Sanandaji

Researcher in bio-technology and economics
nima@sanandaji.se



HITTING the ROAD

This autumn we'll be setting off on another tour of sixth form conferences around the country.

Attendees will hear from a raft of top speakers on topics such as The Eurozone Crisis, The Living Wage, Austerity in the UK, and Globalisation.

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ITINERARY

2015

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Monday 5 October	Cheltenham College, Cheltenham
Thursday 8 October	The Perse School, Cambridge
Monday 12 October	Westcliff High School for Boys, Westcliff-on-Sea
Tuesday 13 October	Blundell's School, Devon
Monday 19 October	Sir Joseph Williamson's Mathematical School, Rochester
Monday 16 November	Loretto School, Edinburgh
Thursday 19 November	Whitgift School, Croydon
Friday 20 November	Bromley High School, Bromley
Wednesday 2 December	Surbiton High School, Surrey

2016

Friday 29 January	New Hall School, Chelmsford
Tuesday 2 February	Brentwood School, Brentwood
Tuesday 23 February	Portsmouth Grammar School, Portsmouth
Thursday 10 March	Abingdon School, Abingdon

Each conference runs from 10am-3:30pm. To see the topics under discussion, please visit – www.iea.org.uk/students-teachers/a-level-ib

In the last academic year we've held 20 one-day conferences at sixth forms from Edinburgh to Portsmouth. Sir Anthony Seldon, former Headmaster of Wellington College, said of our conference at his school:

*"The IEA arranged a **challenging** and **invigorating** conference for us, exposing our students to **important new ideas** around economics. I'm sure it will be **hugely helpful** to our students when it comes to **preparing for their exams**. They said it was **definitely one of the best** sixth form conferences **they've attended!**"*

It pays to THINK!

This summer, we held our inaugural **THINK** conference at the Royal Geographical Society in London. It brought together some of the best speakers in the world to explain how the creativity and innovation fostered under free markets has helped to halve world poverty in recent decades.

From the conventional to the obscure, we discussed everything from Helping the Poor to the Economics of Game of Thrones.

The conference attracted over 250 students, from sixth formers to Masters students, and next year you could be a part of it. In 2016 we plan to make THINK even bigger and better – to find out more please visit: www.thinkiea.com

And you can watch videos of the sessions from **THINK** 2015 at www.iea.org.uk/tv



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TEACHERS' SEMINAR

On Wednesday 4 November from 9.30am-3:30pm we will be holding another **FREE** Teachers' Seminar at the IEA (2 Lord North Street, Westminster, SW1P 3LB) on the topic of "A new syllabus: How to adapt to changes in A level Economics".

A senior examiner will be joining us to explain the changes, while we have experts in financial and behavioural economics to explain the recent additions to the syllabus.

If you are an A-level Economics teacher and are interested in attending, then please email chambro@iea.org.uk to reserve your place.



EASTERLY DIRECTION...

Professor William Easterly, of New York University and the Brookings Institution, will give our showpiece Hayek Memorial Lecture at Church House, Westminster on the evening of December 2nd.

His bestselling book *White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Harm and So Little Good* fundamentally changed the debate around development aid when it was published in 2006.

His research is cited in classrooms and lecture theatres around the world, so it's no wonder that *Foreign Policy Magazine* named him as one of their Top 100 Global Public Intellectuals.

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MONEY and the GREAT RECESSION

Just as mismanagement of monetary policy is widely believed to have caused the Great Depression, it was also the cause of the Great Recession following the financial crisis, says **TIM CONGDON**

The Great Recession is now being mentioned in the past tense, which is progress of a kind.

During its course critics of capitalism directed their polemics particularly against the US, long seen as the champion of free-market capitalism. But growth has resumed.

If it had not been for bad winters in 2010/11 and 2013/14, the American economy would now have enjoyed uninterrupted quarter-by-quarter expansion for a full six years from mid-2009. American capitalism remains very much in being, if more heavily regulated than ever before.

But the left persists in lambasting the financial system as the source of and culprit for the Great Recession. The economics profession has failed to offer a persuasive analysis, rooted in widely-accepted theory, of the causes of the sharp downturn in demand, output and employment that occurred in the 18 months to mid-2009. This has allowed the critics – such as Philip Mirowski in *Never Let a Serious Crisis Go to Waste* – to pour scorn on neo-classical economics.

Mirowski mentions remarks by Professor Mark Thoma of Oregon University on the shambolic performance of the Nobel economics laureates at their fourth meeting in Landau, Germany, in 2011. In Thoma's words, "the reasons cited for the financial meltdown were all over the map. It was the banks, the Fed, too much regulation, too little regulation, Fannie and Freddie, moral hazard from too-big-to-fail banks, bad and intentionally misleading accounting, irrational exuberance, faulty models and the ratings agencies."¹

The absence of a clear explanatory account of the

Great Recession is peculiar in one respect. In their celebrated 1963 book *A Monetary History of the United States, 1867–1960* Milton Friedman and Anna Schwartz identified a collapse in the quantity of money as the dominant causal influence on the Great Depression from 1929 to 1933.² Even their antagonists concede that the monetary interpretation of the tragic macro-economic outcomes of the early 1930s is cogent, and must be acknowledged

THE MONETARY INTERPRETATION OF EVENTS AGAIN DIRECTS ANALYSTS TOWARDS THE FAILURE OF CENTRAL BANKS, FINANCE MINISTRIES AND REGULATORY BODIES TO MAINTAIN STABLE MONETARY GROWTH

and discussed. By contrast, a comparable interpretation of the Great Recession has not been presented.³

Part of the trouble may be that American monetary economists have been perplexed about which measure of money is relevant to macro-economic outcomes. Some pontificate about the monetary base, as if that by itself could determine spending.

Others – such as Allan Meltzer, who has written the history of the Federal Reserve – believe in narrow money as understood by the M1 aggregate (that is, cash held by the general public and sight deposits). Another influential school advocates so-called "divisia" money measures, which attach weights to different types of money balance.

Unhappily, these approaches have not impressed non-monetary economists. Indeed, a salient feature of the five

years to 2014 was that an enormous increase in the monetary base coincided with the lowest increases in nominal gross domestic product since the 1930s. (That was true in the USA, and also in the Eurozone and the UK.)

An obvious puzzle is economists' apparent reluctance to check what Friedman and Schwartz said about different money aggregates. In their *Monetary History* they were straightforward about their

preference. To quote, "We have found in our work that a concept of money which includes both categories of deposit (meaning both sight and time deposits) often displays a more consistent relationship to other economic magnitudes than a concept which excludes time deposits."

So Friedman and Schwartz favoured a broad measure of the money supply which included bank deposits. The appropriate measure in the US today would be M3, which includes sight and time deposits, and also "money market mutual funds" which have "money-like" properties.

Oddly, the Fed decided in 2006 to stop publishing data on M3. Nevertheless, M3 estimates are still being put together by private sector bodies, while the International Monetary Fund prepares numbers on "broad money" for the USA, just as it does for the vast majority of its member states.

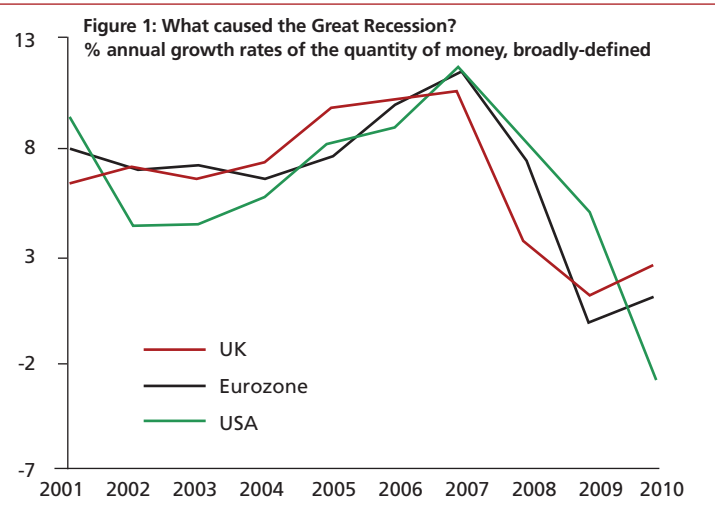


Figure 1 shows the behaviour of broad money. The data are the IMF's broad money measure for the USA, the European Central Bank's M3 measure for the euro zone and the Bank of England's M4x concept for the UK.

The point of the Friedman and Schwartz investigation in the *Monetary History* was that the growth rate of broad money collapsed, and took the American stock market and economy down with it.

Whereas in the prosperous 1920s the quantity of money had been rising by about 5 per cent a year, in the four years to 1933 it dropped by about 10 per cent a year.

If that sort of argument still applied today, a sharp change in the rate of money growth would be expected to precede, or at least to accompany, the Great Recession.

The chart shows the annual change in broad money. In all three of the jurisdictions under consideration, the annual rate of change in

broad money moved up to double-digit growth from the early years of the new century to 2006 or 2007, and then crashed to virtually nil or even experienced an outright decline.

On this basis, a monetary interpretation of the Great Recession fits the central facts of the period. The core message of Friedman and Schwartz's classic therefore continues to resonate.

A common jibe at this argument is that it is "mono-causal". It suggests that only one variable – the quantity of money – determines the equilibrium levels of national income and wealth. The implication is that mono-causal explanations are naïve, incomplete and unsatisfactory.

But a theory is not false because it is mono-causal. In any case, to highlight money is not to deny the relevance of non-monetary forces as well.

Over the long run monetary influences seem to over-power the non-monetary influences in

determining nominal national income, but, in the short run, a host of other variables are in play.

Moreover, for those who value complexity for its own sake, let it be emphasised that the monetary argument can be multi-faceted and convoluted – this is not a simplistic theory.

A striking feature of both the Great Depression and the Great Recession is worth special attention. In 2007 as in 1929, when the rate of growth of the quantity of money started to slide, the earliest effects were not on the prices of goods and services. Instead the big falls were in the prices of key assets such as corporate equity and real estate.

Some of the last century's greatest economists – including Keynes, John Hicks and Friedman – understood that this was important. It is a major weakness of the current generation of Chicago economists that they have forgotten this key insight.

The Great Depression led to disillusionment with free-market capitalism, even though – according to Friedman and Schwartz – the blame fell on incompetent central banking.

The Great Recession has also led to disillusionment with free-market capitalism.

The monetary interpretation of events again directs analysts towards the failure of central banks, finance ministries and regulatory bodies to maintain stable monetary growth.

Tim Congdon
International Monetary
Research
timcongdon@btinternet.com

¹Mark Thoma 'What caused the financial crisis?', Fiscal Times column in www.thefiscaltimes.com, 30 August 2011, as quoted on p. 162 of Philip Mirowski *Never Let a Serious Crisis Go to Waste* (London and New York: Verso, 2013).

²Chapters 7 to 9 of Milton Friedman and Anna Schwartz *A Monetary History of the United States* (Princeton: Princeton University Press, 1963) are the heart of the argument.

³My paper 'What were the causes of the Great Recession?', pp. 1 – 32, *World Economics* (London: World Economics), vol. 15, no. 2, 2014, gives a monetary interpretation of the Great Recession, with a focus on the USA, but also covering other major industrial countries in an appendix.

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

Does **EDUCATIONAL CHOICE** IMPROVE OUTCOMES?

Some studies of school choice programmes have found that they produce relatively small improvements in outcomes on average but significant improvements for vulnerable groups.

This new study also finds that the benefits of school choice programmes are concentrated amongst the most disadvantaged children.

In particular, large benefits are found for African children participating in the programme, though there are smaller benefits for Hispanic children.

The smaller benefits for Hispanic children could arise for a number of reasons (for example, parents of Hispanic children may be wishing to use the vouchers so that they can choose religious schools for their children rather than simply to improve measured educational outcomes).

The benefits from school choice programmes

that were measured in the study included improved college enrolment rates and degree attainment.

Studies of this kind are possible without problems from selection bias (for example, resulting from the most astute parents choosing vouchers) because in this programme vouchers were allocated on the basis of a lottery. There is therefore a randomised control group available to study.

MATTHEW M. CHINGOS
Brookings Institute

PAUL PETERSON
Harvard University

www.hks.harvard.edu/pepg/PDF/Papers/PEPG12-10.pdf

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HOW EFFECTIVE is the **MINIMUM WAGE** at **SUPPORTING THE POOR?**

There is a great deal of work on who might benefit from a minimum wage if there are no effects on employment so that it just leads to a pay rise for the affected people.

There is, however, little work on who pays the cost of increases in the minimum wage, and yet this is crucial if we are to assess the efficacy of the policy.

The costs of the minimum wage can be borne in three ways.

The first is by either reduced employment or reduced fringe benefits for employees. The author of this paper assumes that no costs fall on employees who are subject to the minimum wage in order to make the strongest possible assumptions to support the results of the research.

Secondly, the costs could fall on businesses in terms of reduced returns to shareholders. The author finds this implausible as capital in the businesses affected by the minimum wage is highly mobile and could go to other sectors that offer higher returns.

Finally, prices could be increased for the goods and services produced by employers affected by the minimum wage. The author of this paper assumes that the whole of the cost is passed on to consumers through price increases.

If the costs are passed on through price increases, there will be distributional affects. The author finds that the effect of price increases considerably reduces the benefits that the least-well-off will receive from increases in the minimum wage.

This is particularly so because in the US, which is the subject of this study – as in the UK – many recipients of the minimum wage are actually members of high-income households.

The study suggests that the minimum wage is a highly ineffective anti-poverty strategy.

THOMAS MACURDY
Journal of Political Economy Volume 123
number 2
www.press.uchicago.edu/ucp/journals/journal/jpe.html

SQUARE PEG ROUND HOLE

Why it's time for innovation in competition policy



Old fashioned competition policy is being applied to very new industries.

Here **PHILIP BOOTH** and **ALBERTO MINGARDI** argue that it's time we re-thought how we use competition policy and also how we teach about competition, innovation and the market process.

The economic textbooks often suggest that monopolies should be regulated. A

typical monopolist is said to raise prices and restrict output and thus reduces economic welfare. Economists certainly prefer competition to monopoly, but there are different kinds of monopoly.

Sometimes monopolies are created by governments raising barriers to entry to newcomers or by nationalising provision. Sometimes the technical features of a product are such that monopoly is inevitable, at least for a little while. If we do decide to regulate monopolies, we should appreciate that there are downsides to this too – after all, the competition regulator is a monopolist!

As such, economists have to make judgements about whether a regulated monopoly is better than an unregulated monopoly and these matters are often complex. The European Commission has an important role in EU competition policy and we argue in this article that it is simply applying the wrong principles and could cause a great deal of damage.

Markets are not static

But there is another problem with the way in which we think about competition policy. We tend to assume that the market is static. For example, in a given country there may be only one supplier of milk, with no close substitutes, and things might not change much from year-to-year. Some markets might be like that but in high tech industries there is wave after wave of innovation.

Any monopolist might survive for just a short period

of time and is continually under threat from new entry – especially from a new application of technology that transcends existing products and services. The European Commission simply does not understand this.

Producers of a good or service which is truly innovative and new are likely to enjoy only a temporary monopoly as others try to imitate the product or develop alternative technologies.

Indeed, the availability of short-term monopoly profits can be the stimulus to invest in technologies that are expensive to develop. There can be a “first-come-first-served” aspect to technology markets – but it is precisely this that spurs innovation.

Despite this, the EU competition authorities tend

continuing, the market was moving on and leaving the competition authorities behind.

The first Apple iPod was released in 2001, when Apple also rebranded as “iTunes” an MP3 reader it bought from another software developer.

In 2003, just one year before the EU’s ‘victory’ over Microsoft, Apple brought together iTunes and the iPod. This became the formidable instrument for online-supplied music that made the compact disc almost obsolete in a matter of years.

Microsoft became irrelevant in this area and commercial innovation achieved what competition policy could never achieve. Microsoft’s share of operating systems is now only 20 per cent of the total market (including tablets and smart phones).

THE EU COMPETITION AUTHORITIES TEND TO TREAT HIGH TECH INDUSTRIES JUST LIKE THEY WOULD TREAT THE MILK INDUSTRY

to treat high tech industries just like they would treat the milk industry.



For example, over ten years ago, the EU fined Microsoft £400m, for the alleged abuse of its dominant position (see table). One of the problems the then EU Competition Commissioner raised, was the bundling of Windows Media Player into the Microsoft operating system, which was then Windows XP.

But, even as this case was

If we look at today’s large firms in the tech field, they tend to share one feature – they all do slightly different things. The process of competition leads to new products and possibilities being brought forward for consumers. Each is a monopoly in its own field, but all have substitutes of a kind and every tech business is under threat from potential entry.

The EU versus Google

One reason competition authorities often give for intervention is that companies can use their dominance in one field to try to make

HIGH-PROFILE EC ANTITRUST CASES IN THE HIGH-TECH SECTOR

Company	Date	Fine amount	Grounds	Commitments (if any)
Microsoft	2004	€497.2 million	Interoperability and bundling of Windows Media Player	Release of strategic information and end to bundling of WMP
Microsoft	2008	€860 million (reduced from €899 million)	Non-compliance with 2004 ruling on interoperability	N/A
Intel	2009	€1.06 billion	'Predatory discounts' granted to PC makers for using Intel chips	N/A
Microsoft	2013	€561 million	Failure to promote competing web browsers in Windows 7	Microsoft apology and commitment to correct technical error

Aggregate figures (as well as historically largest cases) for EU cartel fines up to 2015 can be found here: <http://ec.europa.eu/competition/cartels/statistics/statistics.pdf>.

money in a different field. Google is now under attack for this very reason.

On 15th April, the EU filed a complaint against Google for 'anti-competitive' behaviour. The perceived problem is that Google uses its search engine dominance to promote its own shopping service.

Once again, it is a problem of "bundling". The concern is that the company uses its "dominance" in the market for search inquiries, to win customers in the field of e-commerce.

Both the markets for search engines and for retailing are competitive. Google has become the search engine of choice because of its effective algorithms, but alternative search engines are just a click away and there is certainly no

shortage of online retailers.

More fundamentally, Google has found a way of providing search engine services for free by bundling them with services (advertising and shopping) which make money for



Google. The markets for Internet searches, advertising, and shopping were somehow made one.

This was Google's commercial (not technological) innovation. If the services were separated, either the search engine could become non-viable or

we would have to pay for internet searches – a tedious process, to say the least.

In fact, Google is using the same method that commercial television has used down the ages – it bundles a product for which it is hard to charge (in the case of commercial TV, television for which charging technology has only recently become available) with a product that can generate revenue for the provider (advertising). The consumer is hugely better off as a result.

The EU versus Intel

Another example of competition authorities struggling to keep up with the world is the pursuit of Intel.

The European Commission started its investigation of Intel in 2004. At issue were

alleged 'predatory discounts' granted to computer manufacturers including HP and Dell in exchange for buying most or all of their CPU components from Intel (as opposed to its major competitor AMD).



The Commission reasoned that such practices were aimed at driving competitors out of the market, giving Intel a dominant position that would harm consumers.

Yet, competition in the chip market was fierce while the supposed anti-competitive conduct was taking place. Chip prices declined by 66 to 75 per cent in the ten years prior to 2008, while performance improved tenfold. Intel's share of the microchip market remained stable and that of AMD rose slightly.

Crucially, fluctuations in market share for both companies correlated with new product launches, highlighting the continued impact of innovation on the chip market.

Competition authorities need to innovate!

It is time to think seriously about competition policy in a world of continual innovation.

The process of building a house has not changed significantly in decades. If a company were dominant in that industry, the problems shown by the textbook models might well be evident.

However, in innovative

industries each new development adds to consumer welfare. Monopolies tend to be temporary. Companies are not just challenged on price and product quality but by entirely new products.

If we want to encourage innovation, it is important that companies operate in a stable legal environment and not one in which fines of hundreds of millions of euros can be levied according to unpredictable criteria.

Products change and so do modes of consumption.

IT IS TIME TO THINK SERIOUSLY ABOUT COMPETITION POLICY IN A WORLD OF CONTINUAL INNOVATION

Sometimes, we simply do not understand how a business model may develop and make profits. Amazon is a web-giant in e-commerce which looks like a perfect target for a competition investigation. However, it is still by-and-large unprofitable, and its business model is still evolving.

Cool social networks such as Facebook and Twitter need to prove that they will be as good as selling advertising as Google. Google itself is a mysterious machine: it churns together editorial content, but placing them in a hierarchy which is algorithm-driven, and not the result of conscious human actions.

In all these cases, there may be some kind of market dominance. But markets in these areas can be defined quite very widely. Live concerts compete with book reading, TV shows, youtube videos, streamed music and itunes. Facebook and Google compete for

advertising. Twitter and Facebook compete for instant communication and social networking.

Competition policy in these markets could be damaging to the very innovation that keeps companies on their toes.

But, we need to change our teaching of economics too. The textbooks that sixth form and undergraduate students use say very little about creative destruction, innovation and the processes that take place in markets.

Instead, they treat the market as a static entity

with different numbers of producers selling well-defined products at a similar price.

It is quite possible that the textbooks ignore the most important features of markets. This is quite a problem. But, A-level examining is something of a government-protected monopoly (or at least an oligopoly); so perhaps we should not be surprised•

Philip Booth

Editorial and Programme Director
IEA

Professor of Finance, Public Policy and Ethics
St. Mary's University,
Twickenham
pbooth@iea.org.uk

Alberto Mingardi

Director General
Istituto Bruno Leoni
Adjunct Scholar
The Cato Institute
alberto.mingardi@brunoleoni.com

HIGH & DRY

IS CALIFORNIA RUNNING OUT OF WATER?

We are rightly concerned about environmental problems. But many of these problems are man-made – caused by politicians ignoring the fundamental principles of economics, say **CHRISTOPHER J. COYNE** and **RACHEL L. COYNE**

In mid-March, the *The Guardian* ran the headline: “Drought-stricken California only has one year of water left, Nasa scientist warns.”¹

Similar headlines ran throughout the US and led to a national discussion among policymakers about the seemingly dire situation facing the state of California.

A few weeks later, California Governor Jerry Brown imposed mandatory water-rationing guidelines requiring cities and towns to reduce usage by 25 per cent.

The current water crisis in California serves as an excellent opportunity to

revisit two key insights from economics – the role of prices and the distortionary effects of subsidies.

Water use is not priced... Competitively determined market prices reflect the

IF THE PRICE OF WATER WERE DETERMINED BY SUPPLY AND DEMAND FEWER PEOPLE WOULD WASH THEIR CARS OR WATER THEIR LAWNS

relative scarcity of resources. This means that, as a resource becomes more scarce, its price tends to rise.

This price increase has two important effects.

Firstly, it provides a disincentive for people to consume as much of the resource as they previously did, given that the price is now higher.

Secondly, the higher price incentivises suppliers to either bring more of the resource to the market or innovate

and find substitutes which can be offered to consumers who are looking for low-cost alternatives.

In order for this process to work, however, it requires that prices be allowed to rise as resources become increasingly scarce to signal to consumers and producers that they should change their behaviour.

As the example in California illustrates, this is often not the case, as prices are often controlled by government fiat. In California, water prices are capped by government-imposed law such that they are unable to rise above the cost of delivery and many homes do not even have metered water.² This means that when supply and demand conditions change, such that the price of water should be above the cost of delivery, providers are unable to adjust the price to reflect these realities. The result is a water shortage.

Writing about the situation in California, Kathryn Shelton and Richard McKenzie note, “When the annual rainfall is well below the state’s historical average, as has been the case for years, a ‘water problem’ can become a ‘water crisis’—*especially when governments do not allow water prices to rise.*”³

Since the price citizens pay for water does not reflect its true scarcity, they continue to consume water as if it were plentiful. If, instead, the price of water were determined competitively by supply and demand conditions, this would lead people to automatically ration water usage without

government intervention. For example, as the price of water increased fewer people would wash their cars or water their lawns.

Businesses that use water intensively are subsidised The ongoing water crisis in California also illustrates how government subsidies can exacerbate the distortionary effects of price controls.

IF WATER WERE PRICED PROPERLY, CROPS THAT NEEDED A LOT OF WATER WOULD BE GROWN IN WETTER STATES AND MORE DROUGHT-TOLERANT CROPS WOULD BE GROWN IN CALIFORNIA

Subsidies are intended to reward recipients for engaging in a particular behaviour, perhaps if those behaviours are perceived to have additional positive social benefits.

Federal government subsidies are prevalent in the US agricultural industry, and the state of California is one of the top recipient states. These subsidies are

intended to incentivise several behaviours including farming certain crops, protecting the environment, and investing in infrastructure and machinery to reduce water consumption.⁴

Agricultural subsidies have an impact on water usage in a variety of ways. Some of these effects are predictable and obvious. For example, the subsidies provided to farmers to grow certain crops lead to more farming of those crops which, in turn, leads to more water usage.

In a water-thirsty state, water-intensive crops are grown purely because farmers are subsidised to grow them. If water were priced properly, crops that needed a lot of water would be grown in wetter states and more drought-tolerant crops would be grown in California. This would be far more efficient and ensure that water was reserved for more valuable uses.

The Economist reports, for example, that agriculture accounts for 80 per cent of water use in California but only 2 per cent of economic activity and that farmers grow thirsty crops such as rice and alfalfa using heavily subsidised irrigation systems.⁵

California does not have a comparative advantage in rice production any more than, if New York State provided subsidised green houses, that state would have a comparative advantage in growing bananas.

Subsidies for improved farming infrastructure and equipment intended to reduce water usage have not been successful.

¹www.theguardian.com/us-news/2015/mar/16/california-water-drought-nasa-warning

²www.theatlantic.com/business/archive/2015/03/finding-the-right-price-for-water/388246/

³www.econlib.org/library/Columns/y2014/SheltonMcKenziewater.html (emphasis original)

⁴www.sfgate.com/nation/article/U-S-farm-bill-a-bonanza-for-California-growers-5205139.php

⁵www.economist.com/news/united-states/21596955-drought-forcing-westerners-consider-wasting-less-water-drying-west

Consider, for example, the Environmental Quality Incentives Program. Implemented in 1996, the programme provides subsidies to farmers who invest in infrastructure and equipment to reduce water usage.

However, a study found that many of the subsidy recipients actually used more

water resources. This has failed, as the combination of government-imposed price caps, subsidies and regulations has led to a persistent water shortage.

Each intervention into the market has led to subsequent interventions to address the unintended consequences of previous policies, as

would be removed.

This approach is the most effective means of achieving the dual goals of conserving natural resources while satisfying human wants. If water is in short supply, pricing ensures that it is used for its most important ends first (for example, basic household needs). Those economic activities that can be dispensed with (for example, large green lawns, lush golf courses) will tend to be the first to go.

At the same time, the price mechanism is essential in ensuring that water-intensive activity takes place where water is in greater supply and drought-tolerant activity takes place in dry states.

Refusing to price water, whilst subsidising businesses to pursue activities that use more water, is a recipe for turning a drought into a disaster.

Christopher J. Coyne
F.A. Harper Professor
of Economics
George Mason University
ccoyn3@gmu.edu

Rachel L. Coyne
Senior Research Fellow
F.A. Hayek Program for
Advanced Study in Philosophy,
Politics, and Economics
George Mason University
Rachel.coyne@rocketmail.com

A DROUGHT DUE TO REDUCED RAINFALL IS AN ACT OF NATURE... A WATER SHORTAGE IS THE RESULT OF HUMANLY DEvised POLICIES WHICH NEGLECT THE BASIC LOGIC OF ECONOMICS

water than they had prior to the implementation of the programme because recipients used the savings generated by the equipment to expand their farming operations in other areas which increased the farmers' overall usage.⁶ The end result was the exact opposite of the stated intention of the programme.

Command and control or a free market?

A drought due to reduced rainfall is an act of nature beyond the control of man. However, a water shortage is the result of humanly devised policies which neglect the basic logic of economics.

Whether we are discussing water or other resources, the central question that must be answered is: 'what is the best means of allocating scarce resources?'

To date, policymakers in California have relied on government command and control to allocate

illustrated by the most recent government mandate to reduce water usage. The Californian experience offers important lessons when considering how other natural resources are allocated.

An alternative approach focuses on removing policies which block the reallocation of resources in response to changes in natural conditions.

Ideally, prices would reflect actual supply and demand conditions so that a drought would result in higher prices. Similarly, subsidies and regulations which incentivise the over-use of resources



FOR MORE...

on price controls and the damage they cause, read *Flaws and Ceilings*, edited by Christopher and Rachel Coyne.

Download it for free at: www.iea.org.uk/publications/research/flaws-and-ceilings-price-controls-and-the-damage-they-cause



STAGNATIONS HAS GROWTH GONE FOR GOOD?

In the last decade, growth has been disappointing in a range of developed countries. **BRINK LINDSEY** examines possible sources of future growth and concludes that the outlook is bleak – unless we see major policy reform

The Great Recession struck more than seven years ago, but the long-awaited rebound still has not materialised to the extent that might have been expected.



In the United States, GDP growth after the recession has been slower than in any post-recession period since World War II. The unemployment figures give the impression that the US has returned to near full-employment, but only because the labour force participation rate has sunk to lows not seen since the late 1970s.



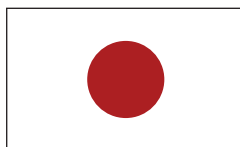
In the United Kingdom, employment has bounced back more impressively, but output has lagged because of dismal productivity growth.



Both the euro zone and Japan stumbled into follow-up recessions. In the euro zone, unemployment remains in double digits.

⁶ See http://www.nytimes.com/2013/06/07/us/irrigation-subsidies-leading-to-more-water-use.html?_r=0

Depending on the location, demand-side factors bear greater or lesser responsibility for the long malaise. In my view, the European Central Bank has been overly restrictive throughout this period. Japan, meanwhile, has laboured under recurrent deflation for two decades and counting.



Astonishingly, Japan's yen-denominated nominal GDP in 2014 was actually lower than it had been twenty years earlier.

In the US and UK, on the other hand, the return of relatively low unemployment suggests that lack of monetary stimulus is not a major problem at present.

A close look at the United States shows that deep-seated structural factors are conspiring to make slow growth the "new normal" for the foreseeable future.

These same factors are at play to varying extents throughout the advanced economies. The grim implications are clear enough: without major policy reforms, economic performance in rich countries generally is likely to remain disappointingly sluggish for some time to come.

To understand what is going on, it is useful to break down economic growth – usually expressed as the annual rate of increase in real, or inflation-adjusted, gross domestic product (GDP) per capita – into its constituent elements. According to conventional growth accounting,

those elements are as follows:

- Growth in labour participation, or annual hours worked per capita
- Growth in labour quality, or the skill level of the workforce
- Growth in capital deepening, or the amount of physical capital invested per worker
- Growth in so-called total factor productivity (TFP), or output per unit of quality-adjusted labour and capital

In the case of the US, these various components fluctuated in their contributions to overall growth over the course of the 20th

A CLOSE LOOK AT THE UNITED STATES SHOWS THAT DEEP-SEATED STRUCTURAL FACTORS ARE CONSPIRING TO MAKE SLOW GROWTH THE "NEW NORMAL"

century. The fluctuations, however, tended to offset each other, so that the long-term trend line of real per-capita growth held remarkably steady at 2 per cent a year. In the 21st century, this pattern of offsetting fluctuations has come to a halt as all growth components have fallen off simultaneously. Let us look at each

source of growth in turn, starting with labour participation.

Labour force participation – as good as it gets

The higher the percentage of the total population that is working, and the more hours a year each worker spends on the job, the higher overall economic output will be.

Accordingly, if annual hours worked per capita are rising, the effect is to accelerate growth: this rise is added to any rise in output per worker-hour (known as average labour productivity) to yield overall growth.

On the other hand, if hours worked per capita are falling, the result is a drag on growth: labour productivity will have to rise by a commensurate amount just to keep output from shrinking.

For the first six decades of the 20th century, annual labour hours per capita fell gradually from over 1,000 to under 800. Although the percentage of women in the labour force grew steadily and that of men held firm (see figure 1), the working week shortened considerably and more and more young people stayed out of the workforce to pursue education. In spite of this brake on growth, labour productivity was improving rapidly enough to keep per-capita growth on track for 2 per cent a year.

Beginning in the mid-1960s, labor hours began moving upwards again. Although the percentage of men in the workforce started to dip slightly, the combination of surging labour force participation by women and the entry of the 'baby boomers' into the workforce propelled annual hours worked per capita back above 950 by the late 1990s. Consequently, per-capita growth held to the long-term trend of 2 per cent a year even though labour productivity growth fell off dramatically in the early 1970s.

Since 2000, however, labour hours have been falling again. Labour force participation for women as well as for men has dropped, in large part because the baby boomers are now ageing and beginning to retire.

The US Bureau of Labor Statistics is projecting the labour force participation rate to continue falling through to 2022. Not only is the proportion of the population that is of working age set to fall, but the participation of those of working age is declining as well.

And, of course, the increase in participation by women is a phenomenon that cannot be repeated.

Will productivity take up the slack? Don't count on it

In light of a declining labour force relative to the population as a whole, could labour

productivity growth take up the slack to enable per-capita GDP growth to stick to its long-term trend? Which brings us to the other three components of growth, all of which serve to boost output per worker-hour: growth in labour quality, growth in capital deepening and growth in total factor productivity. Unfortunately, all three are flagging at present.

Labour quality, or the skill level of the workforce, rose substantially over the 20th century because of a huge investment in mass schooling. The US high school graduation rate was only 6 per cent in 1900, while the college graduation rate was only 2 per cent. By 1970 nearly 80 per cent of American kids were earning high school diplomas, and by 1980 the college completion rate hit 24 per cent.

The big rise in educational attainment has contributed significantly to economic growth: according to Harvard economists Claudia Goldin and Lawrence Katz, it accounted for about 15 per cent of the total rise in real GDP per capita between 1915 and 2005.

But, in recent decades, the rise in educational attainment has slowed significantly. The high school graduation rate actually fell after the early 1970s, although it has picked up again

THE FINAL SOURCE OF GROWTH – AND ULTIMATELY THE ONLY SOURCE OF LONG-TERM GROWTH – IS INNOVATION

in recent years and made up that lost ground. College completion has continued to rise since 1980. However, this is only because more women are going through college (again, such step changes cannot continue forever): the male completion rate is roughly the same today as it was 35 years ago.

According to Goldin and Katz, the mean years of schooling completed by American workers rose at an average rate of 0.8 per cent a year from 1940 to 1980. By contrast, between 1980 and 2005 that growth rate slipped to only 0.3 per cent a year.

Just as workers' productivity can be improved by raising their skills or "human capital", it can be boosted by increasing the amount of physical capital invested per worker. Here again, though, the trend is unfavourable.

The net domestic investment rate (investment net of depreciation as a percentage of net domestic product) has been

Figure 1: Labour force participation rate by gender

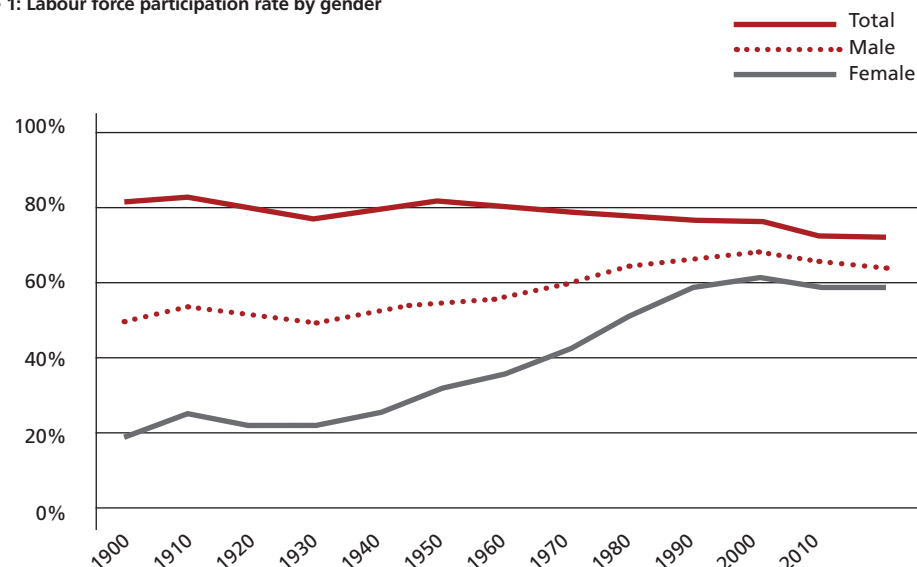
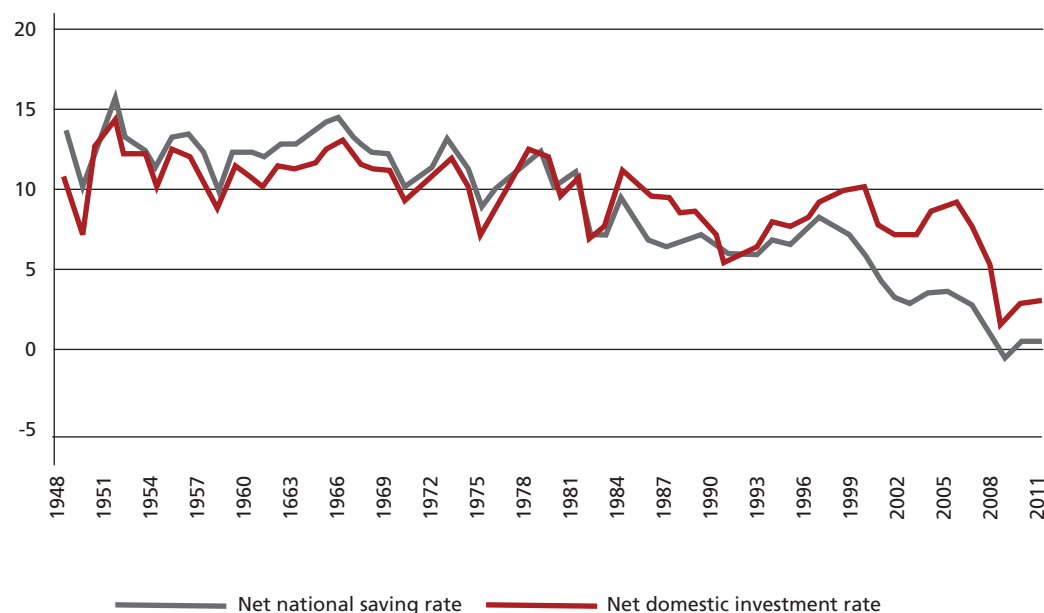


Figure 2: Saving and investment shares



falling steadily for many decades in line with the falling savings rate (see figure 2).

There are good reasons to believe that the huge increase in federal spending on entitlement programmes for senior citizens – especially Social Security and Medicare – has played a major role in reducing saving.

People save less because they have less reason to save; meanwhile, the government pays for these programmes by taxing current workers rather than by developing ring-fence funds out of the taxes paid by earlier generations. As a result, fewer funds are available for investment than would otherwise be the case.

The final source of growth – and ultimately the only source of long-term growth – is innovation, which economists attempt to measure with total factor productivity (TFP).

The other sources of growth expand output by increasing inputs: more labour from increased labour hours; more effective labour from higher labour quality; and more capital from greater investment. But increasing inputs is subject to the law of diminishing returns: each added increment accomplishes a little less than the one before, until the marginal impact finally hits zero. Growth, then, ultimately exhausts itself – unless new ways can be found to increase output per unit of inputs.

This is what innovation does: new products

and new production methods overcome the law of diminishing returns by increasing the productivity of a given level of labour and capital.

Our best, if highly imperfect, measure of innovation is TFP. And that measure tells us that the overall pace of innovation has fallen. From quarter-to-quarter, productivity figures can be quite volatile, but over the larger sweep of US economic history a clear pattern emerges. TFP growth accelerated during the first half of the 20th century, peaked in the middle decades, and then fell off sharply in the 1970s. In the mid-1990s, the Internet boom triggered a resurgence in TFP growth that lasted almost a decade. Since 2004, however, TFP growth has subsided again.

What does the future hold for innovation and TFP growth? Pessimists such as Robert Gordon of Northwestern University contend that the best days of innovation are behind us; in a similar vein, Tyler Cowen of George Mason University has written about the exhaustion of growth's "low-hanging fruit".

On the other hand, optimists such as Erik Brynjolfsson of MIT believe that the ongoing IT revolution is poised to deliver another burst of transformative progress.

The truth is that it is anybody's guess. But the fact is that TFP growth is low now, and it has been low for three of the past four decades.

While a productivity rebound would not be shocking, we just cannot count on it.

Overall, the outlook is grim

With unfavourable trends for all four components of growth, the outlook for the foreseeable future is a US per-capita growth rate that falls well short of the historical norm of 2 per cent a year.

At a Cato Institute conference in Washington, D.C. last December, two of the leading experts on productivity growth – economists Dale Jorgenson of Harvard and John Fernald of the Federal Reserve Bank of San Francisco – presented their latest projections for long-term US growth. Jorgenson suggested that average annual growth in real aggregate GDP would be 1.75 per cent, while Fernald was a bit more optimistic at 2.1 per cent.

Once you take account of likely population growth, these projections translate into annual growth in real GDP per capita of around 1.0 per cent according to Jorgenson, and roughly 1.4 per cent according to Fernald. In other words, growth in the years ahead will occur at between a half and two-thirds of its historical pace.

Perhaps the shortfall sounds trivial, but over time the power of compound interest converts small differences in annual growth rates into huge differences in output.

At a 2 per cent annual growth rate, real GDP per capita doubles roughly every 35 years; when growth falls to 1 per cent, it takes 70 years for real GDP per capita to double.

Thus, over a normal human lifespan, the slower growth rate would yield output per capita that is less than half what could have been achieved if the historical norm of 2 per cent growth had been maintained.

I have focused here on the United States, but the same basic analysis applies to the United Kingdom and other advanced countries.

The ageing of the population, with its negative implications for labour participation, is considerably farther along in many rich countries than it is in the United States.

According to a recent report by the Organisation for Economic Co-operation and Development (OECD), the OECD's population is expected to increase by 17 per cent between 2010 and 2060, but the working-age population (defined expansively as 15-74 years) will decline by 7 per cent.

Meanwhile, the same report projects gains in educational attainment to slow down throughout the OECD, just as they already have in the US. If pensions and healthcare were financed by saving, higher levels of capital could lead to higher levels of labour



productivity and compensate for the relative fall in the working population, but this is not how most OECD welfare systems have been designed.

As for productivity growth, the productivity slowdown of the 1970s affected all the rich countries, but the TFP boom from the mid-1990s to the mid-2000s was unique to the United States. Accordingly, continued slow TFP growth in the rest of the OECD seems a relatively safe bet.

But, slow growth is not inevitable

Although disappointingly slow growth for the foreseeable future is clearly possible and even likely, it is not inevitable. It is possible to change policy for the better and improve growth rates.

Indeed, faltering economic dynamism may very well make such a move more likely by exposing to public view and scrutiny the negative impact of anti-growth policies.

In the quest for new sources of growth to prop up the rich countries' flagging dynamism, policy reform now looms as the most promising "low-hanging fruit" available.

Reforms that encourage work, human capital development, investment and innovation, for example by removing impediments to competition and enterprise, have all been demonstrated to increase growth and they can do so in the future.

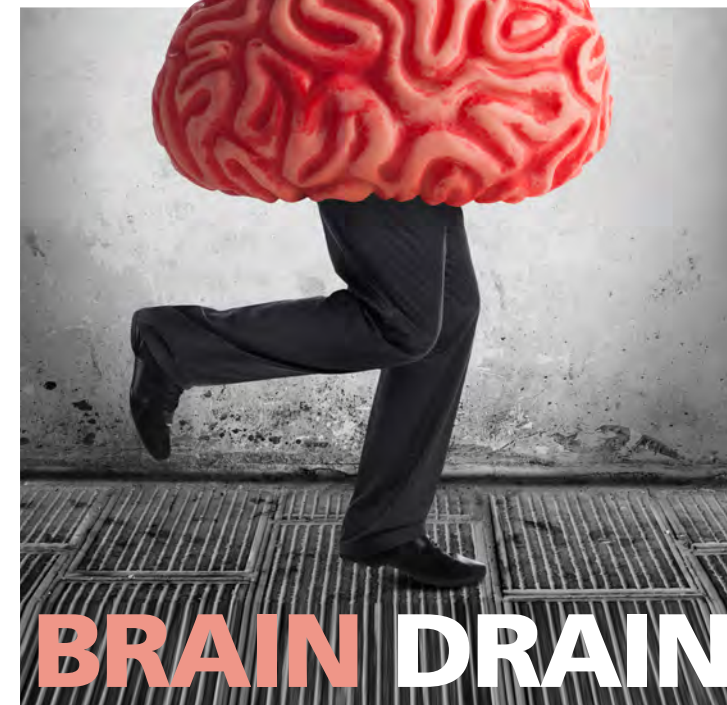
Brink Lindsey
Vice President for Research
The Cato Institute
blindsey@cato.org

FOR MORE...

This piece was adapted from Brink Lindsey's paper *Why Growth Is Getting Harder* (Cato Institute, 2013) Read it in full at:

www.cato.org/publications/policy-analysis/why-growth-getting-harder





The economic impact of higher top tax rates was one of the more contentious themes of the recent general election.

The advocates of higher marginal tax rates for top earners dismissed the idea that an increase in taxes could lead some of the most valuable wealth creators to move abroad, arguing that people do not make relocation decisions based on economic considerations.

The counter-argument, that higher taxes on top earners could lead to an exodus of talent, has often been based on anecdotal evidence of isolated cases. There is, though, an emerging evidence base.

A recent Danish study found a strong correlation between a temporary reduction in the top tax rates on high-income foreigners and the inflow of migrants. Similarly, another study showed that highly paid football stars reacted to top tax rates when choosing where

to work. But, it is difficult to extrapolate estimates for other professions from these two studies alone.

However, recent extensive research extended the previous studies on taxes and the mobility of high-value economic agents.

SUPERSTAR INVENTORS ARE HIGHLY SENSITIVE TO TOP TAX RATES

The study focused on the international migration responses of 'superstar inventors' to top income tax rates for the period of 1977-2003, using data from the European and US patent offices, as well as the Patent Cooperation Treaty. The research studied migration of inventors across eight technologically advanced economies: Canada, France, Germany, Great Britain, Italy, Japan, Switzerland, and the US.

It appears that that many superstar inventors in the top percentile of patent citations are also highly successful migrants. They tend to be more mobile than more 'average' inventors, at least as measured by the number of patent citations, and the superstar inventors are highly likely to be in the top tax bracket and subject to changes in the top marginal rate of tax.

The research finds that superstar inventors are highly sensitive to top tax rates, and that there is a strong correlation between the top tax rates and proportion of those inventors who remain in their home countries.

To measure micro-economic effects, the researchers developed a model that accounted for non-tax factors such as language, distance to home country, and general career prospects.

The results indicate that top inventors are strongly affected by tax rates when deciding where to live. The researchers conclude that given a ten percentage point decrease in top tax rates, an average country could retain 1 per cent

more of its domestic superstar inventors and attract 38 per cent more foreign superstar inventors.

This research makes an important contribution to the emerging evidence that highly skilled labour, like capital, may be internationally mobile and sensitive to tax incentives.

Mikko Arevuo
Senior Lecturer
Regent's University
London
arevuom@regents.ac.uk

Full version at: www.iea.org.uk/blog/the-impact-of-top-marginal-tax-rates-on-the-international-mobility-of-superstar-inventors



COUNTERING KRUGMAN

In his recent attack on 'austerity' in the *Guardian*, economist and Nobel Laureate Paul Krugman goes beyond the normal limits of economic argument.

Many of his key arguments can be easily refuted, or at the very least, the situation is far murkier than he makes out. Krugman the economist has turned into Krugman the polemicist.

Firstly, Krugman's comparison with Germany, which he argues grew faster and had less of a fiscal consolidation than the UK, is not a sensible one.

In 2010 Germany had a budget deficit less than a third of that in the UK.

To compare Britain with Germany in this context is like arguing that there are no great dangers from travelling at 150mph because the increase in speed from 20mph to 22mph yields few extra accidents.

The fact remains that the UK was the fastest growing economy in the G7 in 2014 and we have had extremely buoyant employment growth over a long period of time.

However, it is certainly true that output growth has not been as fast as would have been hoped back in 2010.

But it is difficult to use any widely accepted Keynesian theory to explain a situation of

low output growth caused by low productivity growth. This is surely a supply-side problem.

But, several other issues have been ignored by Krugman.

The first of these is the different effects of austerity in countries with floating exchange rates and in countries that have fixed exchange rates or which share a currency.

Theory suggests that an economy with floating exchange rates will be affected by austerity much less than one with fixed exchange rates.

The reason for this is that capital flows that are necessary to finance high government borrowing raise the exchange rate and choke off private economic activity.

If we reduce government borrowing, this can lower the exchange rate and raise private sector activity.

A NBER paper in 2010 suggested that this effect was very strong. This might explain why Canada in the 1990s and the UK in the 1980s and 1990s managed to combine reductions in borrowing with strong economic growth despite warnings from Keynesian economists that this would not be possible.

Also, Krugman argues: "An economy where interest rates cannot go any lower is an economy awash in desired

saving with no place to go."

Yet it is simply not true that the UK economy is awash with savings.

The UK household savings ratio is around 6 per cent.

That is only enough savings to finance the UK budget deficit, never mind private sector investment.

Krugman's position is that the UK should have increased borrowing from a point where the structural budget deficit was already 8 per cent of national income.

Comparable countries which have, more or less, applied Krugmanite economics are hardly economic success stories.

Japan is probably the closest example. About 25 years on from their initial crisis, the government is borrowing 7 per cent of national income and government debt is well over 200 per cent of national income.

That is not a nice legacy to hand on to the shrinking future generations.

Philip Booth

Editorial & Programme Director
Institute of Economic Affairs

Professor of Finance
Public Policy & Ethics
St. Mary's University
Twickenham.

pbooth@iea.org.uk

GETTING TO THE POINT

It is widely believed that inequality is increasing. This is not true.

Income inequality is usually measured by the Gini coefficient. The Gini goes from 0 to 100, with 0 representing total equality (everybody having exactly the same income) and 100 representing total inequality (one person having all the income).

In the UK, the Gini coefficient rose from 30.0 to 36.8 between 1985 and 1990. Since 1990, it has ranged from 32.3 and 36.2. In 2012/13 (the latest date for which figures are available at the time of writing), the Gini coefficient was 33.2, which is the same as it was in 1987 and more than three points lower than the 1990 peak (ONS 2014: 19).

Other standard measures of inequality tell the same story. Comparing the incomes of the 10th and 90th percentile* (the P10/P90 measure), the 20th and 80th percentile (the P20/P80 measure) and the 50th and 90th percentile (the P50/P90 measure) all show a rise in inequality in the 1980s followed by a modest decline.

International comparisons

Income inequality in the UK is neither very high nor very low by international standards. Most countries have a Gini of more than 35 and few have a Gini of less than 30.

Amongst the countries which are classified by the United

The facts on INCOME INEQUALITY

Nations as having a 'very high' level of development, the Gini coefficient ranges from 25.8 (Norway) to 52.1 (Chile).

The range seen in the UK since 1990 (32.3 to 36.2) is above the EU and OECD averages, but is similar to that of such countries as Switzerland, Canada, Ireland, Spain and Australia (UN 2014: 168-71).

Income distribution

If we look at more detail to see how income has been distributed since 1990, we see that there has been very little change over the past 25 years.

The poorest five deciles have seen their share of income increase by one percentage point, with the exception of the bottom decile whose share has remained constant.

The richest five deciles have lost one percentage point,

apart from the sixth decile which has remained constant and the top decile which has lost two percentage points.

However, it would appear that the top one per cent are becoming richer (though the data here is more sparse). But it is interesting to note that this trend involves the top one per cent gaining whilst the share of the top ten per cent remains the same.

Thus, there has been a rise in income inequality within the richest ten per cent. Insofar as there has been a change in the income distribution since 1990, it has all been within that top decile.

It is not the richest ten per cent who have pulled away from the pack. It is, perhaps, the one per cent who have pulled away from the rest of the top 10 per cent.

Though there has not been much change in inequality in recent years, incomes are much higher amongst all groups today than they were in the 1970s.

Despite the recent recession, average disposable incomes are more than twice as high as in 1977. The bottom quintile (the lowest 20 per cent of earners) have a disposable income that is 86 per cent higher – adjusted for inflation – than in 1977.

Christopher Snowden

Director of Lifestyle Economics
Institute of Economic Affairs
csnowdon@iea.org.uk



LIVING ECONOMICS: YESTERDAY, TODAY, AND TOMORROW

PETER J BOETTKE THE INDEPENDENT INSTITUTE 2012

In this important book, Peter Boettke makes the distinction between “mainline” economics and “mainstream” economics.

Mainline economics consists of positive propositions which can be traced back to Adam Smith. These include the idea of the “invisible hand” and the idea of self-ordering processes.

Mainstream economics, by contrast, refers to the latest fashions and fads which dominate the economics profession and vary over time. It is possible for the mainline and the mainstream to dovetail, but throughout history they have often diverged.

When such a divergence exists, Boettke argues, there is an important role for intellectual entrepreneurs committed to the mainline of economic thinking to “recapture the imagination of mainstream economics” in order to bring the two into alignment.

This framework provides the context for the chapters that follow in which Boettke explores the mainline of economics in several contexts which will be of interest to a wide-ranging audience.

Part I focuses on teaching mainline economics to a variety of audiences. Teachers at all levels will find these chapters of interest, since Boettke discusses teaching economics to the general public and to students of all ages.

Part II shifts from the art of teaching economics to a discussion of several important teachers of economics. These teachers, include Ludwig von

Mises, Israel Kirzner, James Buchanan and Gordon Tullock, among others, who shaped Boettke’s own thinking.

As such, these chapters provide insight into the author’s own journey and evolution as a scholar and teacher. The main lesson emerging from these first two parts is that teaching mainline economics is a task of the utmost importance for the flourishing of human civilization.

This is not mere hyperbole. Citizens’ understanding (or misunderstanding) of economic principles will directly influence what they expect from politicians and policymakers.

Misguided demands on the part of citizens can lead to devastating consequences in terms of human wellbeing. A key task of the economist as teacher, Boettke emphasises, is to inculcate students to understand economic realities and fallacies so that they can be informed citizens.

The third part of the book focuses on the practice of economics. In these chapters, Boettke explores how the economics discipline has evolved over time and documents numerous instances where the mainstream has deviated from the mainline.

A key theme which emerges from these chapters is the importance of appreciating the limits on the knowledge of economists as “experts.” Economists are often called upon by policymakers to serve as experts both in suggesting

and designing policies.

Unfortunately, as Boettke makes clear, economists have often ignored the limits of their own knowledge, resulting in failed and damaging policies.

The central lesson that emerges from these chapters is that, instead of attempting to reshape the world to correct perceived failures, a central task of the economist is to appreciate the limits of human reason.

Boettke makes clear that economics is a humbling discipline precisely because it puts parameters on imagined utopias.

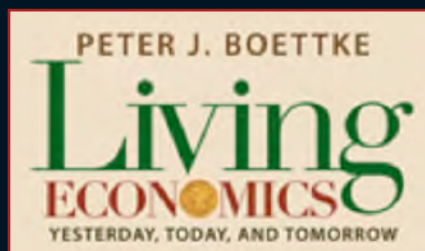
Living Economics is written in an engaging style, making it accessible to a wide range of readers.

It is scholarly in its content but, unlike many scholarly books, the material is not presented in a dry and convoluted manner. The book is a tour de force which illuminates the power of the mainline economic way of thinking for understanding all aspects of life.

Readers will walk away with a better understanding of the crucial importance of the ideas and writings of those working in the tradition of mainline economics. They will also be inspired to spread and advance these ideas.

Christopher J. Coyne
George Mason University
ccoyne3@gmu.edu

Rachel L. Coyne
George Mason University
Rachel.coyne@rocketmail.com



THE FAILURE OF THE “NEW ECONOMICS”

HENRY HAZLITT VAN NOSTRAND 1059

Hazlitt’s book is a detailed chapter-by-chapter analysis of Keynes’s famous *General Theory*, a complex work published in 1936 that nearly all students have heard of but few have read. (The same may well be true even of many of their teachers!)

There are three serious recurring problems with Keynes’s approach that Hazlitt’s analysis helps us identify. Firstly, he employs equations based on the fallacious notion that there are constant relationships in economics. As a result many of Keynes’s main theories (for example, his influential ‘multiplier’) are highly dubious. Adding to that problem, Keynes seems to confuse marginal spending with average spending.

Secondly, Keynes often fails to be consistent in his definitions of key concepts such as ‘wages’, or ‘savings’ and ‘investment’. Because of this, the book’s logic can be slippery.

Thirdly, Keynes is fond of talking in aggregates, but in economics it is not the relationships between aggregates that cause outcomes, but individual human action and choices.

It is only fair to make two points in mitigation. Keynes was trying to get away from some of the views he expressed in his previous book, *A Treatise on Money*; and sometimes, understandably, he finds that difficult.

Secondly, there is no reason to suppose that Keynes was

deliberately trying to deceive his readers: it seems far more likely that he sometimes inadvertently manages to confuse himself.

Only in chapter 18, for the first time, does Keynes explain that the basic model for his system omits virtually all the dynamic social forces. He writes: ‘We take as given the existing skill and quantity of available labour, the existing quality and quantity of available equipment, the existing technique, the degree of competition, the tastes and habits of the consumer’.

He also seems to assume a permanent pool of unemployed resources, in particular labour. This led Hayek – his main intellectual opponent in Britain in the 1930s – to call Keynes’ system one of ‘permanent unemployment...which makes the whole price mechanism redundant, undetermined and unintelligible.’

In chapter 19, Hazlitt points out that Keynes challenges a key principle in economics – that if the price of anything is too high some of it will tend to remain unsold. This is true of eggs or cars or labour. When wage-rates are too high there will usually be unemployment. This is the elementary truth that Keynes tries to refute without explicitly facing it.

He implicitly admits this, when he asserts: ‘It is only in a highly authoritarian society, where sudden, substantial, all-round changes could be decreed, that a flexible wage-

policy could function with success.’ But, as a rule, it is individual relative wage-rates that may need to change to deal with unemployment, not all wage-rates.

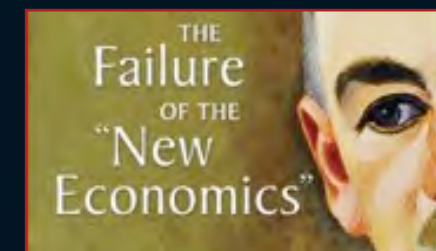
Here, as so often, Keynes unhelpfully talks in terms of aggregates and averages. As an alternative, Keynes advocates a ‘flexible money policy’, that is inflation, which will reduce the purchasing power of money (and thus reduce all ‘real’ wage-rates by stealth).

Keynes would have enjoyed being alive today, because he always hankered after very low nominal interest rates. And today they can hardly get any lower. Keynes wrote: ‘...the remedy for the boom is not a higher rate of interest but a lower rate of interest! For that may enable the so-called boom to last.’ Just like those in charge of monetary policy today, Keynes, it seems, would never think conditions right to increase interest rates.

Hazlitt was a fine economist in his own right, and a famous columnist for Newsweek. He provides many shrewd insights into Keynes’s work, in undertaking the difficult task of explaining what Keynes was trying to say.

For anyone who wants to understand Keynes’s *General Theory*, Hazlitt’s book, even though it’s now more than half a century old, is highly recommended.

D.R. Myddelton
Emeritus Professor
Cranfield University





POINTING THE WAY...

Malala Yousafzai, the girl the Taliban tried to murder, is the youngest person ever to win the Nobel Peace Prize. Curiously, however, whenever her work is discussed an important detail is omitted.

Summarising her 16th birthday talk to the UN, for instance, the BBC highlighted 'her campaign to ensure free, compulsory education for every child'. 'Free' and 'compulsory' are words associated with government schooling.

But it wasn't to government schooling that Malala's family turned for an education. The school she attended was in fact a low-cost private school, set up by her father. This reality gets hidden in all reports.

Not untypically, the global teachers' union, Education International, describes her father as 'headmaster', while Time described him as 'school administrator'. Neither title captures the reality: her father was in fact an educational entrepreneur.

Malala's situation is far from unique. Low-cost private schools are ubiquitous in the developing world. I wrote about them first in 2000 – in the IEA's journal Economic Affairs. Then it was hard getting anyone to take them seriously. Kevin Watkins, erstwhile director of UNESCO's Education for All Global Monitoring Report, wrote in 2004: "Professor Tooley and

his colleagues are ploughing a lonely furrow. Nobody, it seems, is listening to them. Long may it stay that way".

The sheer number of low-cost private schools is staggering and development experts now acknowledge their extraordinary significance.

In India alone, there are 400,000. In one state of Nigeria, Lagos, there are at least 8,000, while a similar number is reported from rural Kenya.

Our research typically shows the majority of schoolchildren in poor urban communities attend low-cost private schools

THE SUCCESS OF LOW-COST PRIVATE SCHOOLS IN THE DEVELOPING WORLD

– usually between 64 and 75 per cent. For example, in some of the poorest slums in the world, in Monrovia, Liberia, our household survey showed that, for children aged five to 14, 71 per cent were in private schools 8.2 per cent were in government schools and 21 per cent were not in school. In rural communities, a significant minority of children are in private schools.

Children in low cost private schools do better than in

government schools. For instance, in Western Area, Sierra Leone, we tested a stratified sample of 3,000 grade 4 students in English and mathematics, controlling for family background and IQ. For English (reading), in a government school an average boy was predicted to achieve 15.5 per cent, while a girl would achieve 10.8 per cent. In a low-cost private school, the boy's result would nearly double, while the girl's result would nearly triple.

Low-cost private schools are also affordable to the poor – this is not surprising given their ubiquity in poor areas.

I have defined affordability based on the amount that poor families could afford for all their children if they were to spend a maximum of 10 per cent of their income on school fees and associated costs. "Lowest cost" and "low cost" private schools are those affordable to families on, respectively, the internationally recognised \$1.25 and \$2 per person per day poverty lines.

In the slums of Monrovia, Liberia, the vast majority (73.7 per cent) of private schools were "lowest cost", while 66 per cent of for-profit private schools in our Sierra Leone study were "lowest cost".

Whenever you hear of Malala campaigning for the right to education remember it is not mediocre government education that has motivated her, but educational freedom, expressed as a right to attend private school.

It is a wonderful success story that is taking place across the developing world, as parents vote with their feet to exit inadequate government provision to find a better education for their children in the private sector.

James Tooley
Professor of Education Policy
University of Newcastle
james.tooley@ncl.ac.uk



SINGAPORE THE HOUSE THAT LEE BUILT...



Lee Kuan Yew, the founding father of modern Singapore, died in March aged 91. He was Prime Minister for 31 years and oversaw Singapore's extraordinary transformation "From Third World to First" – the sub-title of his memoirs.

Singapore has a population of 5.5 million packed into 700 square km. Its GDP per capita is over \$60,000 (at PPP), the seventh highest in the world.

It has virtually full employment and low

inflation. The government has run consistent budget surpluses since the 1980s and accumulated huge official reserves.

Singapore has no natural resources. It is the most globalised economy of significant size in the world: trade is about 400 per cent of GDP.

But Singapore was poor only two generations ago. Its GDP per capita was just over \$500 at independence in 1965.

It has taken maximum advantage of the global economy at every stage of its modern development.

This has unfolded in four stages.

Firstly, starting in the late 1960s, it attracted multinational enterprises for labour-intensive, export-oriented light manufacturing.

Then it moved into capital-intensive production, and later to high value, knowledge-intensive goods and services.

Since the late 1990s, Singapore has become a "global city", alongside London, New York, Hong Kong and Dubai – one in which business is conducted in several languages and currencies, and across several jurisdictions and time zones.

It specialises in high-end services, including niche financial services such as wealth management and offshore finance, and high-end manufacturing.

Singapore's success lies in the building up of excellent institutions and policies.

Strong leadership, political stability, a multi-ethnic society based on meritocracy, lean, efficient government, a strong rule of law for commerce – these are all institutional features of the "Singapore story".

Along with Hong Kong, Singapore got the policy

basics right.

These include: prudent fiscal and monetary policies and a stable exchange rate; low and simple taxes; a flexible labour market; a basic safety net that eschews the middle-class entitlements of a Western welfare state; simple, efficient regulation of business; world-class infrastructure; and, not least, the wholehearted embrace of

**SINGAPORE HAS TO KEEP ADAPTING
FASTER AND MORE NIMBLY THAN
"NORMAL" CITIES OR COUNTRIES IF IT
IS TO STAY ON TOP**

globalisation.

Singapore is a free port, fully open to trade and foreign investment. It is also unusually open to migrants and foreign workers.

But Singapore has its weaknesses.

It has a conformist culture that discourages entrepreneurship.

This is the result of a social-engineering mentality and "nanny-state" interventions since the 1960s, which have entrenched the power of government-linked companies, sovereign wealth funds and the Central Provident Fund (the state monopoly that manages citizens' mandatory savings).

This has crowded out the domestic private sector, which is stuck in a low-productivity trap – and will remain there without a major reduction of the public sector.

Unusually for a global city, Singapore has a large manufacturing base, supported by tax incentives. But one wonders how much manufacturing will be left by the 2020s.

The government has recently restricted entry for migrant workers.

But Singapore needs more

foreigners to provide the world-class service culture of a global city.

Finally, the social safety net is being expanded. This could be the slippery slope to middle-class entitlements.

Singapore, like Hong Kong, faces the dilemmas of a highly successful global city-state.

It has to keep adapting faster and more nimbly than "normal" cities or countries if

it is to stay on top.

But Singaporeans, now overwhelmingly middle class and with rising expectations, have increasingly "normal-country" aspirations.

They chafe at the constant pressure to adapt to the demands of a global city.

As the political system becomes more plural and competitive, critics call for the government to be more activist and redistributive.

But Singapore's overwhelming advantage is as a global city, not as a "normal", parochial country.

Veering in a European social-democratic direction is a recipe for sclerosis.

Rather, the logic of the global city calls for more competition and genuine economic freedom.

That is the best way to boost sluggish productivity and entrepreneurship, and turn a high-end copying city into a genuinely innovative one.

That will be the greatest challenge in the post-Lee Kuan Yew era.

Razeen Sally
Director

European Center
for International
Political Economy
razeen.sally@ecipe.org



THE PROMO PUZZLE

'If advertising doesn't work, why do companies spend so much money on it?' This is the zinger that is supposed to end all argument about whether marketing increases the consumption of certain products.

The products under discussion are usually things that one side of the argument would prefer people did not buy and, to that end, think should not be advertised.

One can reply by saying that advertising is not coercive. One can point out that no amount of advertising can sell a bad product. One can argue that advertising is primarily aimed at making users of a product switch to a different brand. You can explain any of this, but the retort will always be the same. 'Ah, but if advertising didn't work, they wouldn't do it!'

For example, an organisation called Alcohol Action Ireland currently wishes to ban alcohol sponsorship in sports. 'Alcohol sponsorship of sports works in terms of increasing sales and, as a result, alcohol consumption,' it asserts. 'If it didn't the alcohol industry simply would not spend so much money on it.' They assume that the drinks industry hopes and expects advertising to increase consumption.

However, advertisers are not spending their money as an industry, but as rival firms trying to sell their own brands. Their battle for market share may or may not coincide with a growing market for alcohol as a whole.

IF THE AIM OF ADVERTISING IS TO INCREASE THE SIZE OF THE MARKET, IT DOESN'T SEEM TO BE WORKING VERY WELL

Indeed, there are plenty of heavily advertised products in markets that are static or declining.

Secondly, it is an empirical fact that advertising generally doesn't increase the size of the market. The exception is if the entire product category is new. An advertisement for a T-model Ford in 1915, for instance, may have encouraged more people to buy a motor car, but an advert for a BMW today is unlikely to do so even if, as intended, it encourages more motorists to buy a BMW.

Earlier this year, another study confirmed what economists have always known. Looking at sales of alcoholic beverages in the US over 40 years, it found that

'changes are significantly correlated to fluctuations in demography, taxation and income levels – not advertising.

The findings here indicate that there is either no relationship or a weak one between advertising and aggregate category sales. Therefore, advertising restrictions or bans with the purpose of reducing consumption may not have the desired effect.'

The authors of the study found that the amount of money spent on alcohol advertising in the US has increased by almost 400 per cent since 1971. During that time, they noted, 'per capita alcohol consumption has not changed much'.

In the UK, it is estimated that £800 million is spent on alcohol marketing each year and yet per capita alcohol

consumption has dropped by a fifth since 2004.

If the aim of advertising is to increase the size of the market, it doesn't seem to be working very well.

Instead of asking the supposedly rhetorical question 'If it didn't work, why would they spend so much money on it?', single-issue campaigners should look at the evidence from alcohol and other markets and ask themselves the more searching question: 'It doesn't work (as we define "work") so why are they spending so much money on it?' Economists do have some answers to this•

Chris Snowdon
Director of Lifestyle Economics
Institute of Economic Affairs
csnowdon@iea.org.uk



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