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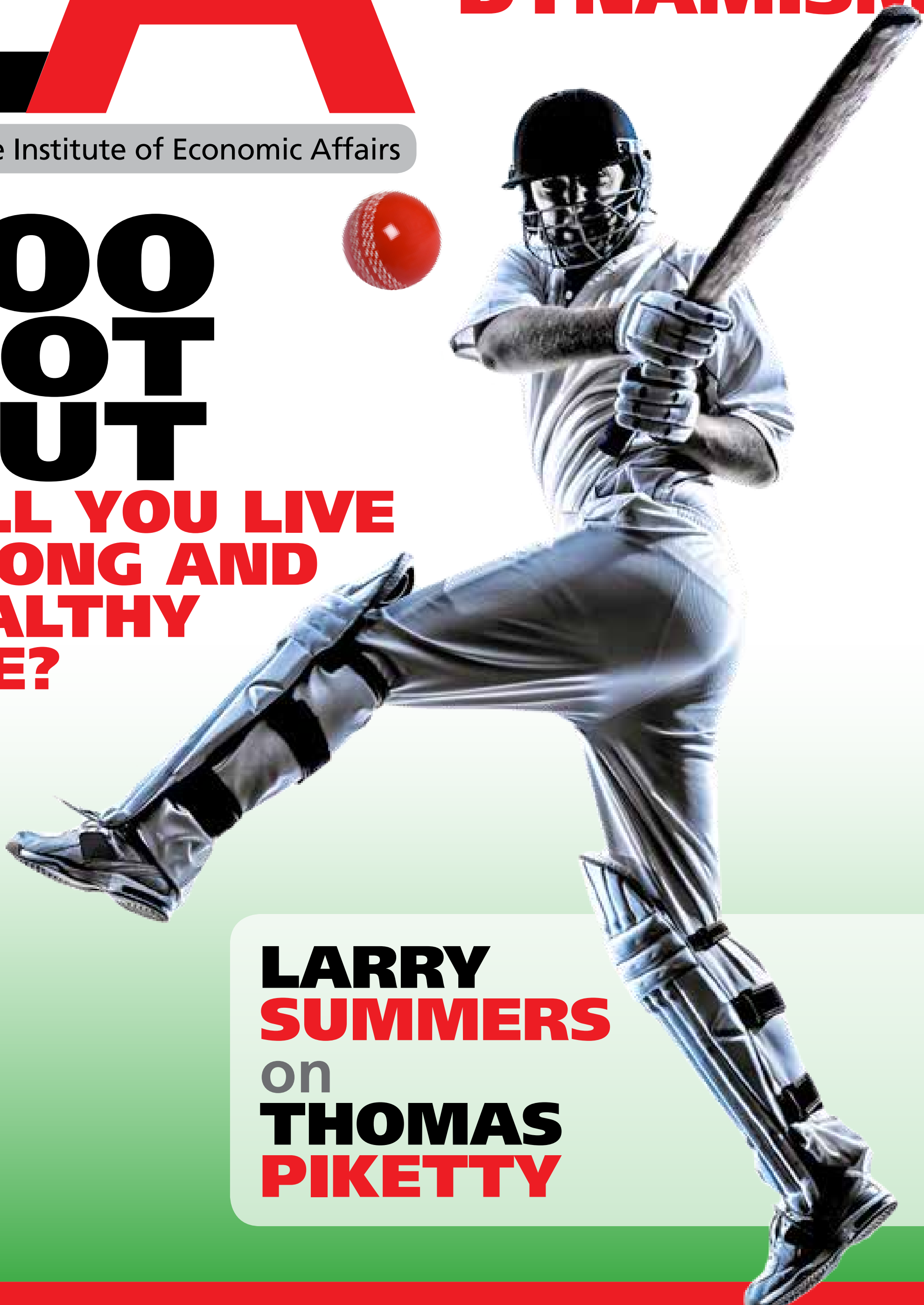
ED PHELPS on ECONOMIC DYNAMISM



100 NOT OUT

WILL YOU LIVE A LONG AND HEALTHY LIFE?

LARRY SUMMERS on THOMAS PIKETTY

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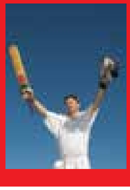

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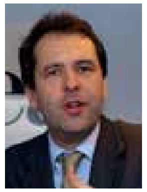

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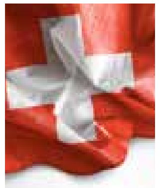

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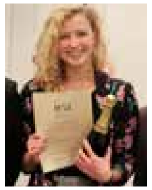

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Editor Philip Booth
Creative Director Glynn Brailsford
Design Marian Hutchinson
Review Editor Andre Alves
Editorial Adviser Richard Wellings

IEA
2 Lord North Street Westminster SW1P 3LB
020 7799 8900 www.iea.org.uk

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WELCOME

… to this **first EA of 2015** – an issue in which we tackle some of the **key issues facing your future**.

And, to help us, we bring you some of the **most eminent names in economics today**.

On page 22, **Nobel Prize** winner **EDMUND PHELPS** explains **how economies flourish** and examines the **long-term economic outlook for the UK and Europe**.

AUTHOR LAWRENCE H. SUMMERS analyses the impact and contribution to today's economic debate of **THOMAS PIKETTY** on page 14.

And our cover story – **100 Not Out** – takes a fascinating look at the way over-regulation of medicines and health care could jeopardise your longevity.

Elsewhere we uncover more issues facing the future: **Should Britain stay in the EU? What next for the BBC? Is the world really becoming a more unequal place?**

And in our new **WORKSHOP** feature on page 8, we take a look at more immediate concerns: **How can you achieve an A* in your Economics A level?** Senior examiner **SAMUEL SCHMITT** gives you some invaluable advice.

One other glimpse into the future: The next edition of **EA** will be with you in September.

In the meantime, be sure to check out our extensive range of **films** on **ieaTV**, or catch up with our latest **books and papers** at **www.iea.org.uk**, where you can also sign up for our **weekly e-newsletter.** You can follow us on facebook and Twitter, too.

I hope this issue of **EA** makes **essential and enlightening reading**•

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

facebook.com/pages/Institute-of-Economic-Affairs

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The RICH get RICH and the POOR get... RICHER!

Is inequality increasing? Has social mobility hit reverse? Are the poor really getting poorer? Quite the reverse, says CHRISTOPHER SNOWDON – author of the IEA publication *Selfishness, Greed and Capitalism*

The general secretary of the Trades Union Congress, Frances O'Grady, said last year that Britain is a country in which 'inequality soars' and 'social mobility has hit reverse'.

The *Guardian* tells us that Britain is 'Europe's sweatshop', a country where workers put in the longest hours in the EU.

And it is a perennial lament that 'the rich get richer while the poor get poorer'.

Taken together, these assertions encourage a counsel of despair about the prospects of workers in the UK today, but they are all empirical claims and can be tested against the facts.

The well-worn assertion that the rich get richer while the poor get poorer echoes Karl Marx's theory of immiseration which said that capitalists could only become richer by lowering wages, thereby reducing the living standards of workers until they had no choice but to revolt. Marx was wrong.

Today, no one seriously argues that the poor are poorer than their Victorian counterparts, but some claim that they are poorer - and that there is more poverty - than twenty, thirty or forty years ago. It is not true.

There has been a steady increase in wage rates for more than 150 years. Average earnings have risen more than four-fold since the start of the twentieth century despite two world wars and intermittent recessions.

Wages declined or stagnated in the mid-1970s, early 1990s and, above all, during the recent economic downturn: average earnings for full-time workers were 7.5 per cent lower in 2013 than they had been in 2009.

Initially (2009-11), the poorest 10 per cent - but not the poorest 2 per cent - saw a larger than average fall in wage rates, but this pattern was reversed in 2011 and 2013 when the richest decile saw their earnings fall by more than four per cent while the poorest decile saw earnings fall by less than two per cent.

As painful as these pay cuts have been in recent years, it is unlikely that posterity will view them as anything more than a blip in the upward march of progress.

The bigger picture is quite clear. Since 1975, average real wages have more than doubled for full-time workers and nearly doubled for part-time workers.

Amongst the poorest decile, full-time wages rose from £3.40 to £6.67 between 1975 and 2013 (in 2013 prices) and part-time wages rose from £2.83 to £5.83.

Put another way, whilst only two per cent of full-time workers earned the minimum wage of £6.19 in 2013 45 per cent of full-time workers in 1975 earned less than £6.19 (in 2013 prices).

NOT ONLY HAS POVERTY REDUCED… INCOME INEQUALITY IS FALLING TOO

And, whilst 30 per cent of full-time workers earned less than £10 an hour in 2013, 85 per cent earned less than the equivalent of £10 an hour in 1975.

Wage rates do not tell the full story. Many people do not work and many workers have their incomes supplemented by benefits.

If we look at household disposable incomes (i.e. income after direct taxes and benefits have been taken into account), we see a similar story of rising prosperity.

Between 1977 and 2011/12, the incomes of the poorest twenty per cent (the bottom quintile) rose by 93 per cent in real terms. Those of the top quintile rose by even more - 149 per cent - so it is true that the rich have got richer, but it is clear that the poor have also got richer.

State benefits play a major role in cushioning the poor from the impact of declining wages.

The post-2007 fall in earnings has been due to inflation rising at a faster rate than nominal wages, but, since benefit payments tend to be tied to inflation rather than wages, those who depend on benefits for most of their income have been protected from much of the decline in pay.

The Office for National Statistics records that average real disposable incomes fell by four per cent between 2007/08 and 2012/13 but that 'the largest fall in incomes over this period has been for the richest fifth of households, whose disposable income has fallen by £3,300 (or 5.2 per cent) in real terms'.

By contrast, the ONS says, 'the average income of the poorest fifth has risen by £400 (or 3.5 per cent) since 2007/08.'

It is inarguable that the poor have become richer in the long-term and doubtful whether they have become poorer even during the recent economic slowdown, despite incomes falling amongst every other group.

Whether measured in cash or real terms, whether looked at in terms of hourly, weekly or annual earnings, and whether taken before or after housing costs have been deducted, the last forty years have been an era of rising prosperity across the board.

Is income inequality rising?

Because it is difficult to maintain the notion that the incomes of the poor have been falling in the long-term, critics of capitalism often base their argument regarding poverty around concepts such as 'relative poverty'. However, reductions in relative poverty typically coincide with periods of general impoverishment.

The official (relative) poverty line is generally understood to be 60 per cent of the median income, but this is essentially a measure of inequality and does not tell us whether or not the poor are getting poorer.

In 1979, thirteen per cent of the population was living below the relative poverty threshold. By 2005, the real disposable incomes of the poorest fifth had risen by more than fifty per cent and yet eighteen per cent of the population was now officially living in poverty.

In other words, raising the incomes of Britain's poorest people by half did not prevent the official poverty rate rising by half.

Just as the relative poverty rate can rise despite the poor becoming richer, so too can the relative poverty rate fall as long as the wages of the poor fall less sharply than those on median incomes.

This is precisely what happened during the recent financial crisis. In 2010/11, Britain's (relative) poverty rate fell to 16 per cent and the child poverty rate fell to 18 per cent. Both figures were the lowest they had been since the mid-1980s, despite - or rather because of - wages falling across the board.

THERE IS SOME DEBATE ABOUT WHETHER FLUIDITY BETWEEN THE CLASSES HAS INCREASED… BUT THERE IS CERTAINLY NO EVIDENCE OF A DECLINE

In short, the poverty rate has very little to do with how much money the poor have.

The UK's official poverty rate in 2012 (16 per cent) was higher than that of Bangladesh (14 per cent), Azerbaijan (2 per cent) and Namibia (0 per cent). But, where would you like your children to be born?

Not only has poverty reduced but income inequality, as measured by the Gini coefficient which is the standard measure of inequality, is falling too: it peaked in 1990. By 2011/12 it had dropped to 32.3, the lowest since 1986.

Contrary to popular belief, the modern peak of income inequality was twenty five years ago. There was a significant rise in the 1980s, but since then rates have been quite stable except when a weak economy brings them down. It is simply untrue to say that 'inequality soars' in modern Britain.

Does Britain have the longest working hours in Europe?

In 1900, workers spent around 3,000 hours a year on the job. In most developed societies today, they work fewer than 1,800 hours a year.

Amongst OECD countries, average weekly hours range from 48.9 in Turkey to 30.5 in the Netherlands. Britain fits comfortably in the middle of this range. In 2011, the average number of hours worked by British workers was 36.4 per week, down from 37.7 hours in 2000, which was itself less than the 38.1 hours worked in 1992.

The picture is only slightly different if we look at full-time employment. Full-time workers in Britain put in an average of 42.6 hours per week in 2011, amounting to eight and a half hours a day if we assume five working days per week.

This is only thirteen minutes more than the EU average and it is shorter than the average working week in Australia, Austria, Greece, Iceland and New Zealand, not to mention virtually all poorer countries.

It is a far cry from the '7am to 7pm' shifts that some claim is the British norm and it hardly justifies the *Guardian*'s description of the UK as 'Europe's sweatshop'.

According to the OECD, more than half of UK workers (55.4 per cent) work less than forty hours a week (including unpaid work). On this measure, the UK is more leisurely than both the European average (42.2 per cent) and the OECD average (36 per cent).

Only 11.7 per cent of British employees work more than fifty hours a week. This is more than the OECD average of 9.1 per cent, but much less than countries such as Turkey (43 per cent) and Japan (29.5 per cent). As in most wealthy nations, the proportion of Britons working so many hours has fallen since the mid-1990s.

Average working hours in Britain have been falling for decades and are similar to those in comparable rich countries.

Those who choose to work longer hours than average tend to be employed in well remunerated professions. This is in stark contrast to earlier eras when the poor tended to work the longest hours out of financial necessity.

Has social mobility hit reverse?

'Sadly, we still live in a country where, invariably, if you're born poor, you die poor', says Britain's 'social mobility tsar' Alan Milburn. This assertion reflects a conventional wisdom that is constantly reinforced by politicians, journalists and pressure groups - that accidents of birth rigidly determine people's fate and what little social mobility ever existed is now in decline.

Rafael Behr writes of Britain's 'soul-sapping immobility' in the *New Statesman*. Polly Toynbee tells *Guardian* readers that the British have become 'more hermetically sealed into the social class of their birth' since the 1970s.

This message from politicians and pundits is entirely at odds with the academic literature on social mobility. Consensus opinion in academia is that there is more 'room at the top' than ever before and that movement between the classes is as fluid as it has been since studies began.

There are two aspects to social mobility which are easily conflated. Politicians tend to be interested in increasing 'absolute mobility' which refers to the total number of opportunities higher up the ladder in well-paid professions. Sociologists tend to be interested in 'relative mobility' which refers to how easily people move up and down the ladder. Both are important.

In the 20th century, structural changes to the labour market greatly expanded the size of the middle class. As the working class shrank and the number of white collar jobs rose, there was a revolution in absolute mobility which meant that far more people could be upwardly mobile than ever before.

The odds of working class children becoming middle class adults became significantly shorter by virtue of there being more middle class jobs available.

With regards to relative mobility, there is some debate about whether fluidity between the classes has increased in recent decades, but there is certainly no evidence of a decline.

This was confirmed again last year in a study of people born between 1980 and 1984. It found that about 78 per cent of the men had moved out of the class of their birth by the time they were 27 years old. This is almost exactly the same degree of mobility enjoyed by men born in 1946, 1958 and 1970.

IT IS IMPORTANT TO LOOK BEYOND THE HEADLINES … TO ASCERTAIN THE FACTS

For women, the mobility rate exceeded 80 per cent and is higher than for any generation on record. The authors concluded that 'if intergenerational mobility is considered in terms of social class, then, with relative just as with absolute rates, *there is no evidence at all to support the idea of mobility in decline*' (emphasis in the original).

The important lessons from the social mobility literature are:

- The expansion of white collar work created more 'room at the top'.
- This expansion has inevitably slowed down over time and must eventually stop altogether.
- The great majority of people move out of the class of their birth by the time they are thirty years old
- There has been no decline in either absolute or relative mobility.

All of this runs counter to the conventional wisdom for several reasons.

Firstly, there is one piece of conflicting evidence that has been afforded a privileged position in the debate.

An analysis of one dataset concluded that there had been a decline in income mobility for those born in 1970 compared with those born in 1958. Several similar studies based on the same dataset have been heavily promoted by the Sutton Trust, a think tank which focuses on social mobility.

There has been a vigorous academic discussion about the strengths and weaknesses of this dataset, but the fact remains that the rest of the evidence does not support it.

John Goldthorpe, a sociologist at Oxford University who has published many studies on social mobility, has argued that 'just one piece of research comparing the experience of two birth cohorts only twelve years apart' does not trump 'a whole series of studies using different designs and data sources but covering the experience of men and women within the British population at large from the 1930s through to the 1980s, and producing remarkably consistent findings'.

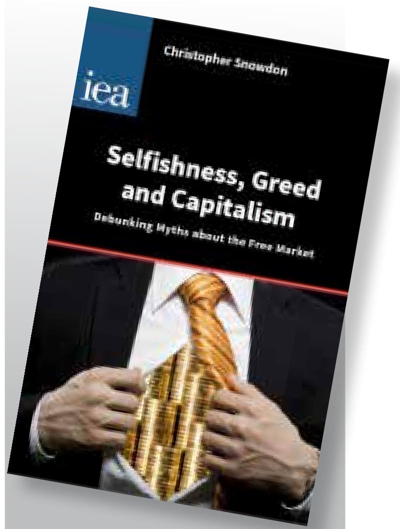
Conclusion

Science is not settled by sheer weight of numbers, but economists should not base policy on mere impressions.

It is important to look beyond the headlines and polemic produced by journalists to ascertain the facts.

It is wrong to say that 'social mobility has hit reverse'; that people are working longer hours than anywhere else in Europe; that inequality is increasing; or that the poor are getting poorer. A large body of evidence shows otherwise •

Christopher Snowdon
Director of Lifestyle Economics
IEA
csnowdon@iea.org.uk



The IEA's **Selfishness, Greed and Capitalism – Debunking Myths about the Free Market** is available for free download at: *www.iea.org.uk/publications/research/selfishness-greed-and-capitalism*

A* TEAM

How to write an A* ECONOMICS ESSAY at A-Level

A good essay involves planning, a structured approach and evaluation. Developing good essay writing skills now will stand you in good stead for the future, says SAMUEL SCHMITT

Just as the reputation of the 'dismal science' has been damaged by the financial crisis, the study and assessment of economics at secondary school level has been put under the spotlight.

As the joke goes, the essay questions remain the same but the answers are different.

In fact, this may be true on two levels. Schools may have finally stopped using the textbook with the case study on Ireland 'the economic miracle', but equally, as new graduates join the teaching profession, they may find the definitions of economic concepts they teach are deemed incorrect by exam boards or that the advice schools give for writing essays does not satisfy the marking procedures stipulated by different boards and qualifications.

Scoring high marks in economics essays is a combination of exam technique and knowledge. Training students more broadly in the wider skills of logical analysis, required for a compelling and balanced essay, will equip students with more effective intellectual tools for the future.

Firstly, just as central banks and other public authorities are under pressure to increase transparency to explain decisions, exam boards are under scrutiny to increase standardisation and make marking more transparent and consistent.

If this article title was that of an essay set to a year 12 or 13 economics student, the most important step would be to know the required procedure. How many points should be made? Are examples required to score application marks? Is evaluation required? How much time should be spent on this section?

It is vital that both teachers and students understand the requirements of each qualification and exam board. At A-Level, the requirements differ from AS to A2, and will change again under the new specifications that start in September 2015.

FIVE MINUTES THINKING ABOUT THE CRUCIAL POINTS WILL ALLOW A COHERENT AND CLEAR LINE OF ARGUMENT

So the onus is on teachers and students to read the specifications, examiner reports, and any other guidance they may get hold of.

Secondly, students must make sure they plan their answer. As tempting as rushing into an answer can be, when working under exam conditions, five minutes or so thinking about the crucial points and which concepts you will use to analyse and evaluate your points will allow a coherent and clear line of argument.

Part of this process is a careful analysis of the question that has been asked rather than the one you have revised or answered before!

Students must avoid pre-rehearsed answers and avoid missing key words in the question.

Frequent and costly errors in A2 macro-economics essays are often simple mistakes. These might include failing to link micro-diagrams, such as a tariff diagram, to macro-economic effects, such as unemployment levels.

There is often a failure to focus on the key themes brought up in the question so students might focus on growth rather than development or developing rather than developed countries.

Planning has two other important functions. It should lead to a logical structure to your argument, such as points for and against, so that the direction and conclusion of your essay is clear. Planning should also apply and link theory to stimulus material to put analysis and models into context.

It is also important to separate points into well-constructed paragraphs which are clearly focused on the question.

Introduce each paragraph with a topic sentence to signpost how this paragraph and its points answer the question. Then develop a concise and detailed line of analysis, not a description.

Students are often confused by what is expected here, but remember the essay is a chance to show off your economics knowledge and work through a line of reasoning or transmission mechanism of an economic theory, perhaps supported by a diagram.

Analysis must be careful to focus initially on first round effects to ensure a proper understanding is communicated.

For example, focus on the linkages between a reduction in the UK's top rate of income tax from 50 per cent to 45 per cent and tax revenue, before moving onto second round effects and the possible impact of this change on the many areas on which the government spends money.

IT IS IMPORTANT TO SEPARATE POINTS INTO WELL-CONSTRUCTED PARAGRAPHS, CLEARLY FOCUSED ON THE QUESTION

Additionally, essays should use evidence to justify their arguments, which may be from memory in the exam, or produced through independent research and further reading for typical assignments.

Each paragraph must be concluded and evaluated, or evaluation added in an additional paragraph, so that key points are emphasised and balance provided by the use of counter points.

Two of the most popular techniques adopted by students are to consider the size of the change in some variable and time lags, but often there is little analytical depth to these approaches and a proper link to the context of the question.

Using any data given in the title or from your own knowledge can help here, or use the economic definitions of the short- and long-run to add a bit more rigour. Try to choose your best points in the planning process so that you can evaluate in depth rather than just list many possible counter points.

Finally, all essays should have an introduction and conclusion.

Economics requires concise analysis so use introductions for definitions of the terms in the question and do not waste time writing on the wider context or rambling about the topic generally.

Save contextual information for evaluation and instead use an introduction to briefly outline your proposed answer and how you will reach it. Then your conclusion, or recapitulation, should follow and bring the key strands of your arguments together to give them weight.

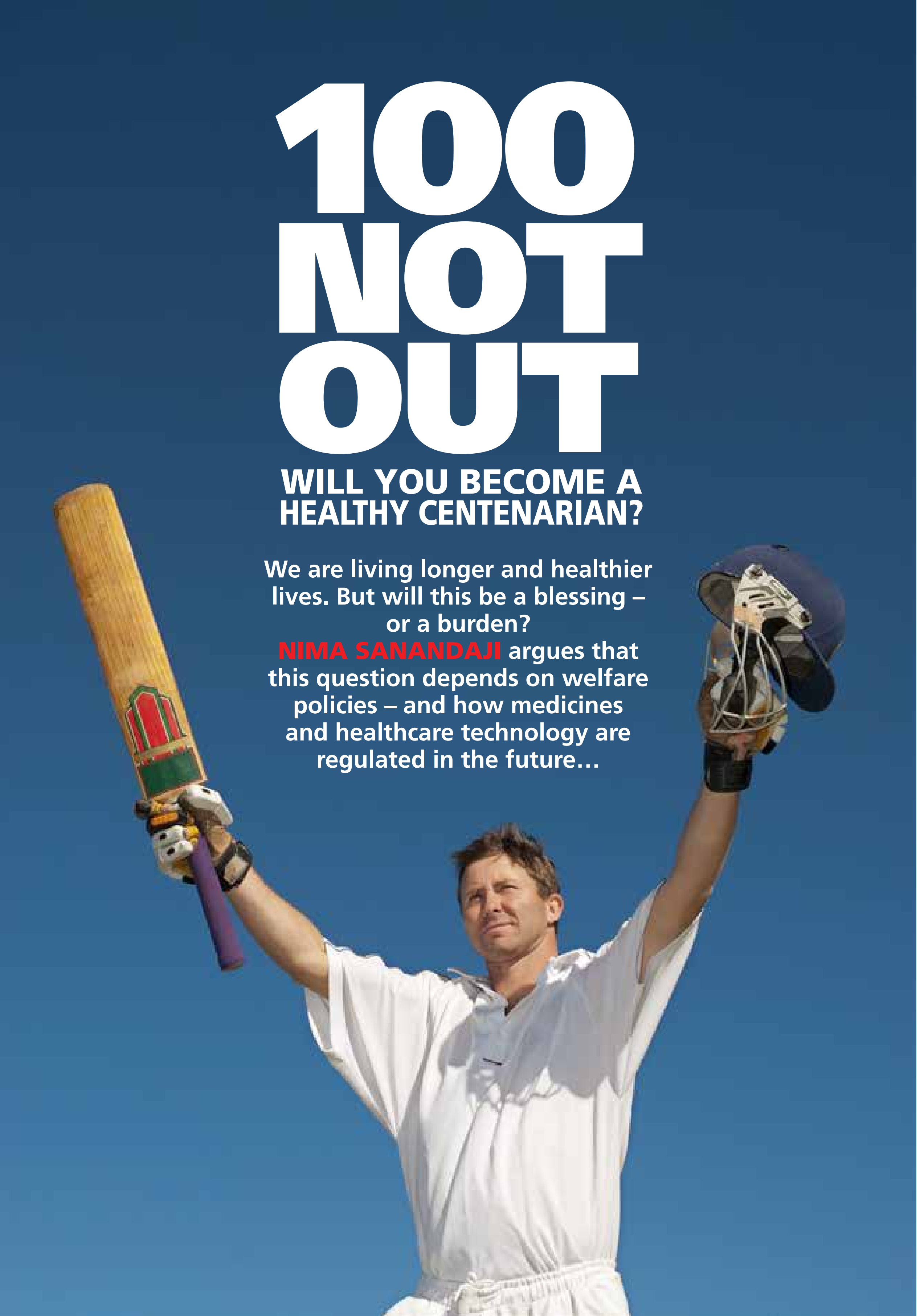
The conclusion shouldn't repeat the content of your arguments but summarise and link the main sections together so you can reach a clear and compelling answer to the question.

There isn't one formula to writing a good economics essay at school, but this advice will help you to show off the quality of your economic understanding.

Knowing the requirements of each exam board may require a few structural tweaks but, if you have a very thorough understanding of the topics, and can produce a balanced and compelling argument, and perhaps even some original interpretations of your own, you will be rewarded with an A or A*.

More importantly, learning to write a good essay will prepare you for university education and teach you, as John Henry Newman wrote, "to think and to reason and to compare and to discriminate and to analyse"•

Samuel Schmitt
Head of Economics
St. Paul's School
Senior Examiner, Edexcel



100 NOT OUT

WILL YOU BECOME A HEALTHY CENTENARIAN?

We are living longer and healthier lives. But will this be a blessing – or a burden?
NIMA SANANDAJI argues that this question depends on welfare policies – and how medicines and healthcare technology are regulated in the future…

Out of 300 men born in the UK in 1912 just one would have expected to reach the age of 100. In contrast, fully a quarter of the boys and a third of the girls born today in the UK are expected to become centenarians.

How has this remarkable increase in life expectancy been possible? The explanation lies in a combination of higher living standards, modern medicine and changes in daily living habits.

In modern society we have vaccines, improved health care, access to better food and safer work environments. There are fewer people dying in wars and from violence more generally. Life-threatening levels of alcoholism and murders are less frequent. So it is not surprising that people are living longer.

What is more striking is how life expectancy has developed in very recent times. For a long time researchers have waited for the increase in life expectation to flatten out: after all, there must be a limit to the life of a person. Perhaps there is. But we haven't reached that level yet.

Almost ten years have been added to the average life expectation in the UK since the early 1960s. Each year we live, we become one year older. But, at the same time, human progress adds more than two additional months to our future life span.

Globally life expectation has increased by 18 years during the last 50 years. As market economies and modern health care have spread around the world, so have the opportunities to live a longer life.

Already one-fifth of the population in Western Europe is aged over 65. Other than Japan there is no other place with as many elderly.

So what will the society of the future look like? Will it be populated mainly by old people, unable to take care of themselves? In some parts of the world, such as Japan, we are seeing such a development. The reason is that the number of the elderly is rising rapidly, whilst fewer children have been born in recent decades.

However, in the long term, there are more grounds for optimism. We are not only becoming older, we are becoming healthier in old age. The 65 year olds of today are much healthier compared with previous generations. And the young people today are expected to be even fitter when they reach older age.

Innovation and a healthier life

In the near future reaching old age without serious health problems may become the norm. But there is a significant obstacle to overcome.

So far much of the progress in medicine has involved curing those with acute diseases and conditions.

If you get a heart attack or cancer, modern medicine is much better equipped to help you than in previous times.

But medical innovations have not had the same success in dealing with chronic diseases that affect us over a longer period of time.

A QUARTER OF THE BOYS AND A THIRD OF THE GIRLS BORN TODAY IN THE UK ARE EXPECTED TO BECOME CENTENARIAN

So, although general health is improving, many people still suffer from chronic diseases in old age. This raises the cost to taxpayers of ageing societies

A good example is Alzheimer's and similar diseases that lead to long-term loss of the ability to think and reason clearly.

Already today the cost of dementia is around £375 billion annually. This amounts to around one per cent of total global gross domestic product. By 2030 this cost is estimated to have increased to £694 billion.

Clearly, there is a great need to push the limits of medical innovation further, so that diseases such as Alzheimer's can be cured. But burdensome regulation stands in the way.

Obstacles to smart medicines

A range of smart new medicines can promote healthy ageing and longer lifespans.

Just in the US, medical companies are currently developing, testing or marketing more than 400 substances that can improve the quality of life of the elderly. This includes 142 medicines for diabetes, 92 for diseases that affect the joints, 82 for Alzheimer's and 48 for heart diseases. Yet, the rate of medical innovation could be greater.

Creating new medicines is a painstaking task. It takes many years of laboratory work to identify possible drugs that can improve health. Hundreds of people can spend many years researching until they discover a new medicine that actually works.

Even after new medicines have been identified, an arduous process remains in testing the medicines and getting them approved by government agencies.

This bureaucratic process can sometimes be quite arbitrary. Just because a medicine works, it is not certain to get approved.

The next challenge is that health markets are strongly regulated and often financed by the public sector. Will public sector purchasers actually use new medicines that have been approved? It is not the case in all health systems but in general, where there is only one purchaser, there is less experimentation.

Medical development is, in a sense, the opposite of developments in information technology.

Today successful software, such as electronic games, is often created by major studios with large budgets.

But smaller entrepreneurs have the opportunity to compete with

GLOBAL RANKING OF EXPECTED LIFE EXPECTANCY AT BIRTH (YEARS)

1.	Hong Kong	83.4
2.	San Marino	83.3
3.	Switzerland	82.7
4.	Japan	82.6
5.	Iceland	82.4
6.	Spain	82.3
7.	Italy	82.1
8.	Malta	82.0
9.	Faroe Islands	81.9
9.	Singapore	81.9
11.	Australia	81.8
11.	Sweden	81.8
11.	Israel	81.8
14.	France	81.7
15.	Norway	81.3
16.	Netherlands	81.2
17.	Canada	81.1
18.	Austria	81.0
18.	Luxembourg	81.0
20.	New Zealand	80.9
22.	United Kingdom	80.8

World Bank data, 2011.

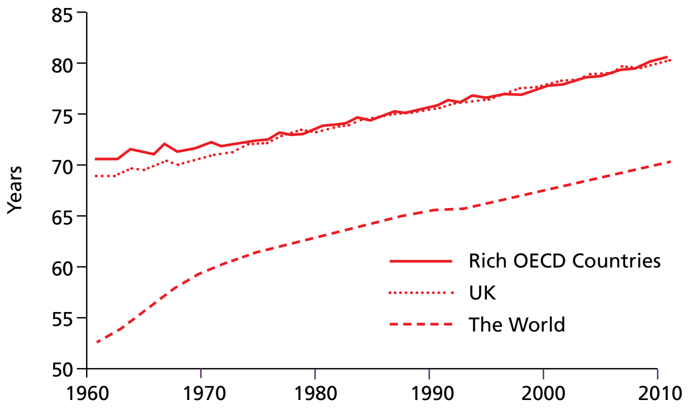


Figure 1: Life expectancy at birth

the giants, and sometimes even beat them at their own game.

Creating new medicines however requires so much capital, and is so strongly regulated, that only a few large companies can muster the scale economies.

Smaller firms can develop new drugs, but the regulatory approval process is a high fixed cost and stops many would-be ventures.

Indeed, a study shows that the innovation processes in the pharmaceutical industry have remained nearly the same since the 1960s. Over-regulation has stifled new ideas.

Those in favour of regulation argue that the risks of medicine experimentation are very high; clearly, informed consent is important.

However, the risks of not experimenting can be higher – those risks are reflected in the lost benefits from those drugs that would work but which are stifled.

Today, one of the most promising ideas in healthcare is to identify diseases before they break out.

So far, medicine has involved observing that someone is sick and then helping them. However, it is possible to look at people's genes and family history and identify the diseases that they are likely to get. The diseases can then be prevented before they break out, either with medicines or life style changes.

A good example is the Google-backed company 23andMe. The idea behind this venture is for people to use saliva-based kits to gather samples of their DNA, which makes it possible to look at the risks of various diseases.

INNOVATION PROCESSES IN THE PHARMACEUTICAL INDUSTRY HAVE REMAINED NEARLY THE SAME SINCE THE 1960S. OVER-REGULATION HAS STIFLED NEW IDEAS

What if we had stopped the first mobile phone?

The Food and Drug Administration in the United States has ordered the company to stop selling its health tests.

In a warning letter, the government agency claimed that 23andMe had not been able to demonstrate that its technology was effective enough.

Also, the agency worries what will happen if ordinary people get information of their personal risks of future health problems.

So the agency is essentially stopping a new innovation because it is not perfect and because the government does not trust people to handle information about their own health.

Imagine if the same approach had been taken with the first computers. The initial personal computers could hardly do anything properly. What if the government had stopped them?

The same goes for mobile phones. The first mobile phones were as heavy as bricks, hugely expensive and barely functional. But, of course, if the market had been hindered from launching the first phones, we would not have smartphones today.

The first kits that offer us the chance to find out the future risks of genetic diseases will not have perfect solutions, but it is enough that the kits work reasonably well.

If a new market is created, over a few years the innovation can be fine-tuned to great effect.

Today a host of entrepreneurs with experience from information technology are looking at the possibility to improve health.

One of their key ideas is to give information, and create new preventive treatments that can enable us to live longer and healthier lives.

But for this to happen, bureaucratic hindrances to new ideas must be reduced.

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

WELFARE STATE PANIC

When welfare states began developing in the early 20th century, a great deal of emphasis was put on providing benefits for the old. Since few actually reached old age, it wasn't difficult to pay pensions from taxation.

Around the 1970s the perspective changed in many European countries. Politicians realised that an increased share of the population was reaching the pension age. The ageing population was seen as a ticking demographic time bomb that could collapse the welfare state.

In countries such as the UK – indeed in nearly all the developed world - politicians have created a system where generous pension and healthcare promises are supposed to be met by taxes on a shrinking younger generation.

This has led to what has been termed a "government debt iceberg" (an unseen but very large government debt).

Drastic tax rises or cuts in spending are needed to deal with this challenge.

But an ageing population doesn't need to be an economic challenge. We are becoming older, but also healthier as we age.

Given the right policies to encourage saving for healthcare and retirement income and to ensure that individuals rather than government face the costs of early retirement, an ageing population can be seen in a more positive light.

Older people are more capable of working and taking care of themselves than they were in previous generations.

The IEA's **The Government Debt Iceberg** is available for free download at *www.iea.org.uk/publications/research/the-government-debt-iceberg*

WHERE DO PEOPLE LIVE LONGEST?

A common belief is that countries with high taxes have longer life expectancy than countries with low taxes. This isn't necessarily the case.

Iceland, a country with a cold and harsh climate, has lower taxes and more market based policies than the other Nordic countries. Yet Iceland has a higher life expectancy than the large welfare states in Scandinavia.

Low-tax Hong Kong has the highest life expectancy in the world and low-tax Australia, with a small welfare state, has caught up with high-tax Sweden.

A number of factors, such as demographic differences, immigration, living standards, obesity, smoking and how well healthcare systems work influence life expectancy.

THE INEQUALITY PUZZLE

Thomas Piketty's tour de force analysis doesn't get everything right, but it's certainly made us ponder the right questions, according to LAWRENCE H.SUMMERS

Once in a while, a heavy academic tome dominates for a time the policy debate and, despite bristling with footnotes, shows up on the best-seller list.

Thomas Piketty's *Capital in the Twenty-First Century* is such a volume. Every pundit has expressed a view on his argument. Piketty's tome seems to be drawn on a dozen times for every time it is read.

This should not be surprising. At a moment when our politics seem to be defined by a surly middle class and the US President has made inequality his central economic issue, how could a book documenting the pervasive and increasing concentration of wealth and income among the top 1 per cent, 0.1 per cent and 0.01 per cent of households not attract great attention?

Especially when it goes on to propose easily understood laws of capitalism that suggest that the trend towards greater concentration is inherent in the market system and will persist in the absence of radical new tax policies.

Piketty's work richly deserves all the attention it is receiving. This is not to say, however, that all of its conclusions will stand up to scholarly criticism from his fellow economists in the short run or to the test of history in the long run.

Nor is it to suggest that his policy recommendations are either realistic or close to complete as a menu for addressing inequality.

Piketty's immense contribution

Let's start with its strengths. In many respects, *Capital in the Twenty-First Century* embodies the virtues that we all would like to see but find too infrequently in the work of academic economists.

It is deeply grounded in painstaking empirical research. And it finds that, even in terms of income ratios, the gaps that have opened up between, say, the top 0.1 per cent and the remainder of the top 10 per cent are far larger than those that have opened up between the top 10 per cent and average income earners.

Piketty provides an elegant framework for making sense of a complex reality. His theorising is bold and simple and hugely important if correct. Whether or not his idea is ultimately proven, Piketty makes a major contribution by putting forth a theory of natural economic evolution under capitalism.

His argument is that capital or wealth grows at the rate of return to capital, a rate that normally exceeds the economic growth rate. Thus, he argues, economies will tend to have ever-increasing ratios of wealth to income, barring huge disturbances such as wars and depressions.

Since wealth is highly concentrated, it follows that inequality will tend to increase without bound until a policy change is introduced or some kind of catastrophe interferes with wealth accumulation.

Piketty writes in the epic philosophical mode of Keynes, Marx, or Adam Smith rather than in the dry, technocratic prose of most contemporary academic economists.

Does Piketty help us understand inequality?

All this is more than enough to justify the rapturous reception accorded Piketty in many quarters.

However, I have serious reservations about Piketty's theorising as a guide to understanding the evolution of American inequality.

And, as even Piketty himself recognises, his policy recommendations are unworldly – which could stand in the way of more feasible steps that could make a material difference for the middle class.

Piketty's argument is straightforward, relying on a simple inequality in which the rate of return on capital exceeds the economic growth rate.

Slow growth is especially conducive to rising levels of wealth inequality, as is a high rate of return on capital that accelerates wealth accumulation.

According to Piketty, this is the normal state of capitalism. The middle of the twentieth century, a period of unprecedented equality, was also marked by wrenching changes associated with the Great Depression, World War II, and the rise of government, making the period from 1914 to 1970 highly atypical.

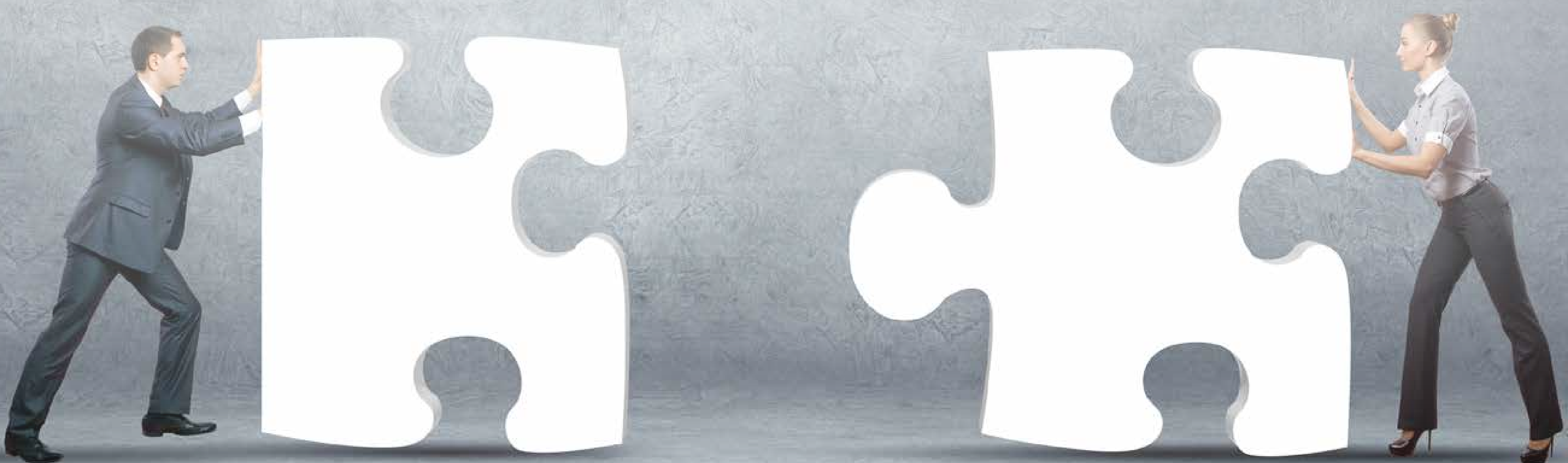
This rather fatalistic view can be challenged on two levels. It presumes, first, that the return to capital diminishes slowly, if at all, as wealth is accumulated and, second, that the returns to wealth are all re-invested.

Whatever may have been the case historically, neither of these premises is likely to be correct as a guide to thinking about the American economy today.

Economists universally believe in the law of diminishing returns. As capital accumulates, the incremental return on an additional unit of capital declines.

The crucial question relates to what is technically referred to as the elasticity of substitution.

With 1 per cent more capital and the same amount of everything else, does the return to a unit of capital



relative to a unit of labour decline by more or less than 1 per cent?

If, as Piketty assumes, it declines by less than 1 per cent, the share of income going to capital rises. If, on the other hand, it declines by more than 1 per cent, the share going to capital falls.

Economists have tried to estimate elasticities of substitution with many types of data, but there are statistical problems.

Piketty argues that the economic literature supports his assumption that returns diminish slowly and so capital's share rises with capital accumulation.

But I think he misreads the literature by conflating gross and net returns to capital. It is plausible that, as the capital stock grows, the increment to output produced declines slowly, but there can be no question that depreciation increases proportionally.

And it is the return on capital net of depreciation that is relevant. I know of no study suggesting that measuring output in net terms, the elasticity of substitution is greater than one, and I know of quite a few suggesting the contrary.

There are other fragmentary bits of evidence supporting this conclusion that come from looking at particular types of capital.

Consider the case of land. In countries where land is scarce, such as the United Kingdom, land rents represent a larger share of income than in countries such as the United States or Canada, where it is abundant.

Or consider the case of housing. Economists are quite confident that the demand for housing is inelastic, so that as more housing is created, prices fall more than proportionally – a proposition painfully illustrated in 2007 and 2008.

Does not the rising share of profits in national income prove Piketty's argument?

This is only so if one assumes that the only factors at work are the ones he emphasises.

Rather than attributing the rising share of profits to the inexorable process of wealth accumulation, most economists would attribute both the wealth accumulation and rising inequality to the working out of various forces associated with globalisation and technological change.

For example, mechanisation of what was previously manual work quite obviously will raise the share of income that comes in the form of profits: so does the greater ability to draw on low-cost foreign labour.

Do capitalists simply accumulate?

There is also the question of whether the returns to wealth are largely reinvested. I am much less sure than Piketty.

At the simplest level, consider a family with current income of 100 and wealth of 100 as opposed to a family with current income of 100 and wealth of 500. One would expect the former family to have a considerably higher savings ratio.

In other words, there is a self-correcting tendency in that wealth will, in the long run, tend to be consumed, at least to some extent.

A brief look at the *Forbes* 400 list provides only limited support for Piketty's ideas that fortunes are patiently accumulated through reinvestment.

When *Forbes* compared its list of the wealthiest Americans in 1982 and 2012, it found that fewer than one tenth of the 1982 list were still on the list in 2012, despite the fact that a significant majority of members of the 1982 list would have qualified for the 2012 list if they had accumulated wealth at a real rate of return of even 4 per cent a year. They did not, given pressures to spend, donate, or mis-invest their wealth.

In a similar vein, the data also indicate, contra Piketty, that the share of the *Forbes* 400 who inherited their wealth is in sharp decline.

Why has inequality risen?

But if it is not at all clear that there is any kind of iron law of capitalism that leads to rising wealth and income inequality, the question of how to account for rising inequality remains.

In particular, why has the labour income of the top 1 per cent risen so sharply relative to the income of everyone else? No one really knows.

Amongst other things, the rise of incomes of the top 1 per cent reflects the extraordinary levels of compensation in the financial sector.

While anyone looking at the substantial resources invested in trading faster by nanoseconds has to worry about the over-financialisation of the economy, much of the income earned in finance does reflect some form of pay for performance; investment managers are, for example, compensated with a share of the returns they generate.

And there is the basic truth that technology and globalisation give greater scope to those with extraordinary entrepreneurial ability, luck or managerial skill.

Think about the contrast between George Eastman, who pioneered

FEWER THAN ONE TENTH OF THE 1982 FORBES LIST WERE STILL ON THE LIST IN 2012

fundamental innovations in photography, and Steve Jobs.

Jobs had an immediate global market, and the immediate capacity to implement his innovations at very low cost, so he was able to capture a far larger share of their value than Eastman.

Correspondingly, while Eastman's innovations and their dissemination through the Eastman Kodak Co. provided a foundation for a prosperous middle class in Rochester for generations, no comparable impact has been created by Jobs's innovations.

Where does this leave policy?

Piketty argues for an internationally enforced progressive wealth tax, where the rate of tax rises with the level of wealth.

This idea has many problems, starting with the fact that it is unimaginable that it will be implemented any time soon. Even with political will, there are many problems of enforcement.

How does one value a closely held business? Will its owners be able to generate the liquidity necessary to pay the tax? Won't each jurisdiction have a tendency to undervalue assets within it as a way of attracting investment? Will a wealth tax encourage unseemly consumption by the wealthy?

Success in combating inequality will require addressing the myriad devices that enable those with great wealth to avoid paying income and capital taxes.

Beyond taxation, however, there is, one would hope, more than Piketty acknowledges that can be done.

Examples include more vigorous enforcement of anti-monopoly laws; reductions in excessive protection for intellectual property in cases where incentive effects are small and monopoly rents are high; greater encouragement of profit-sharing schemes that give workers a stake in wealth accumulation; increased investment of government pension resources in riskier high-return assets; strengthening of collective bargaining arrangements; and improvements in corporate governance.

Probably the two most important steps that public policy can take with respect to wealth inequality are the elimination of implicit and explicit subsidies to financial activity and an easing of land-use restrictions that cause the real estate of the rich in major metropolitan areas to keep rising in value.

Hanging over this subject is a last issue. Why is inequality so great a concern? Is it because of the adverse consequences of great fortunes or because of the hope that middle-class incomes could grow again?

If, as I believe, envy is a much less important reason for concern than lost opportunity, emphasis should shift to policies that promote bottom-up growth.

At a moment when secular stagnation is a real risk, such policies may include substantially increased public investment and better training for young people and retraining for displaced workers, as well as measures to reduce barriers to private investment in spheres such as energy production, where substantial job creation is possible.

Books that represent the last word on a topic are important. Books that represent one of the first words are even more important.

By focusing attention on what has happened to a fortunate few among us, and by opening up for debate issues around the long-run functioning of our market system, *Capital in the Twenty-First Century* has made a profoundly important contribution.

Lawrence H. Summers
Charles W. Eliot
University Professor
President Emeritus at
Harvard University

Editor's note:
imagine that the only capital in an economy was a road network owned by a very rich person. Adding more roads to the network will reduce the rate of return (diminishing returns) but Piketty argues that this will be outweighed by the extra total return the owner will get because there are more roads. His percentage rate of return per mile of road falls, but there are more miles. However, Summers is arguing that we also have to take into account the fact that the road network will depreciate and that, if we do, the evidence suggests that the total return to the road owner will fall.

This article is abridged from an article that first appeared in issue number 33 of the journal Democracy. The abridgement has been published with kind permission.

Capital in the Twenty-First Century by Thomas Piketty; Translated by Arthur Goldhammer • Belknap/Harvard University Press • 2014 • 696 pages • $39.95

SWISS ROLE

What the euro zone could learn from Switzerland

The EU has tried to impose fiscal discipline on euro zone members. However, this won't work – unless it's very clear that euro zone members getting into trouble won't be bailed out. The example of Switzerland demonstrates this, says CHARLES BEAT BLANKART

Tax competition among Swiss cantons and municipalities puts downward pressure on taxation.

But cantonal and municipal governments will not allow themselves to be steered towards a low-tax policy at any price.

Cantons will not incur debt to reduce taxes. Why is that? Why are Swiss cantons prudent while in other countries governments accumulate large debts?

Often the budgetary responsibility is attributed to "debt brakes" (or fiscal rules) that limit the annual and total indebtedness of central and many local governments.

But debt brakes have been adopted also by the European Union for its member states in the Stability and Growth Pact of 1997 and in the subsequent Fiscal Compact. Compliance is, however, far from complete in the EU.

Tables 1 and 2 summarise the fiscal performance of Swiss cantons and the Swiss federation and compare it with that of the larger euro member states.

In Switzerland, the annual deficits of federal, state and local governments were low, leading to a declining debt burden between 2002 and 2012 (Table 1).

In the euro average, debt has increased from 2002 to 2014 from 68.0 per cent of GDP to 95.9 per cent (see Table 2).

Debt breaks plus bailout in the euro zone

Why are debt brakes disregarded in the European Union and observed in Switzerland?

Overspending is a general problem of democracies as they have a tendency to spend too much and to postpone taxation into the future via government debt.

Before the euro, EU member states had very different public debt accounts. Some had balanced budgets, low public debts, were reliable borrowers, were unlikely to devalue their currencies and therefore had low interest rates.

However, others had large deficits, depended heavily on public borrowing, depreciating currencies and were less reliable borrowers facing higher interest rates.

Though the latter governments were unreliable as borrowers they did not tend to renege on debt – they tended to relax monetary policy and allow their exchange rate to fall.

The situation of these two groups of countries concerning interest rates is illustrated on the left hand side of Figure 1. Countries with good records such as Germany had low interest rates. Countries with lower ratings such as Greece had higher interest rates.

From the beginning of 1999, a number of EU member states irrevocably fixed their exchange rates and declared the euro as their common currency. Any exchange rate risk seemed to be eliminated and few expected a member state to default on its debt. Therefore all government bonds had low interest rates which were very close together, see the middle part of Figure 1.

As, however, the banking crisis appeared in the United States and spilled over to Europe, European investors began to ask: who is responsible if one of the large banks in the EU falls into bankruptcy?

The ecofin ministers wanted to calm the markets and decided on 5th October 2008 that each member state was responsible for its own banks.

Investors then correctly concluded that southern euro countries such as Greece, Italy, Spain, Portugal and, perhaps, France might be unable to carry the debt of their distressed banks in addition to their own government debt. Interest rates in these countries rose as can be seen on the right hand side of Figure 1.

After a series of meetings and initiatives, the ECB found a way of, in effect, guaranteeing the debts of the heavily indebted euro zone countries.

The joint bailout fund of the euro nations was too small to calm the market. However, eventually, the President of the ECB, Mario Draghi, proposed the "Outright Monetary Transaction Programme" in 2012 which effectively guaranteed a full bailout to each government in fiscal distress regardless of whether it complied with the debt rules. This calmed the government bond market.

As a consequence interest rates of the heavily indebted countries fell (see the far right of figure 1).

The conclusion for individual euro members was clear: why should they comply with the debt rules brakes when a bailout would be available from the deep pocket of the ECB spending, in effect, taxpayers' money?

Switzerland – the land of "no bailout"

The situation of Switzerland is different. While the ECB and some euro governments are large and have deep pockets to bailout smaller indebted members, Switzerland is a small country.

The Swiss National Bank (which is Switzerland's Central Bank) cannot afford to act as a lender of last resort. It cannot afford to finance credibly a programme to bailout distressed federal and cantonal governments: it would lose its credibility.

IT IS NOT POSSIBLE TO SUBSTITUTE THE NO-BAILOUT POSITION BY A BETTER SET OF BUDGET CONSTRAINTS AND FISCAL RULES SUCH AS THE FISCAL COMPACT... BOTH ARE NECESSARY

The external value of the Swiss Franc would decline on international markets and international investors would stop buying Swiss federal and cantonal bonds or want higher interest rates. The Federal and cantonal governments in Switzerland cannot count on the Swiss central bank bailing them out.

The no-bailout principle in Switzerland has the character of what can be called a "dynamically developing credence capital good". This means that the belief that the policy will be followed grows through its application over time, and debases itself when it is disregarded.

Each application of the no-bailout rule strengthens the expectation that it will continue to be applied in the future.

Therefore it is important that the no-bailout principle is continuously applied. Once a bailout takes place it takes time for the markets to believe that it will not happen again and borrowing costs rise.

When the cantons of Bern, Solothurn, Geneva, Waadt, Appenzell Ausserrhoden and Glarus ran into severe financial difficulties due to the losses of their cantonal banks in the 1990s, they were left to their own devices.

The question of whether the federal government would provide a financial injection was not even raised.

Instead, both the federal and cantonal governments acted on the assumption of the no bailout principle, according to which each

FISCAL DISCIPLINE IS NOT POSSIBLE WITHOUT A STRONG NO-BAILOUT CONSTITUTIONAL PROVISION

canton is responsible for its own finances.

If a financially distressed cantonal government approaches the federal government with a petition for a bailout, the federal government would simply reply: "We have both to survive as borrowers on the international credit market. We both enjoy fiscal autonomy, you as a cantonal, and I as a federal borrower. We are free to choose, but we are responsible for our choices. If I fail as federal government, nobody will come to rescue me. If I bail you out, my creditworthiness is undermined and I would have to pay interest at higher rates."

Fiscal autonomy buttresses the no bailout regime. The cantons know that they take their own decisions and are responsible for the consequences.

The key to fiscal responsibility in Switzerland does not rest with balanced budget rules as such, but with a credible no-bailout position. The causality runs the other way. The fact that cantons will not be bailed out encourages them to have fiscal rules to stop the build-up of debt. This sends a signal to capital markets and allows them to borrow on more favourable terms.

Debt brakes have no value for their own. They are only helpful if they are linked to a credible no bailout position. In the euro area the no-bailout clause of the Lisbon Treaty has gone. Therefore debt brakes cannot be credible and they contribute little to budget stability.

It is not possible to substitute the no-bailout position by a better set of budget constraints and fiscal rules such as the Fiscal Compact. Both are necessary.

The problem that euro zone faces now is that once expectations of "no-bailout" have disappeared it is difficult to convince markets that the principle will be followed again.

Credit markets in systems with bailouts do not differentiate between good and bad borrowers.

As such, the good borrowers, such as Germany, will suffer because of the weakening of the no-bailout position. Investors have no incentive to discover which jurisdiction is more and which is less reliable.

Governments also have little interest in building up a good reputation. Disinterest on both sides of the market drove interest rates towards convergence at a low level as represented on the right hand side of Figure 1.

No-bailout in practice

The significance of the no-bailout principle can hardly be illustrated more clearly than with the example of the bankruptcy of Leukerbad in 1998, a 1,400-inhabitant municipality in the Wallis canton.

After a series of expensive investment projects mainly in the tourism industry, for which it ran up high debts, Leukerbad's municipal council declared that it had run out of money: it could no longer service its debt.

Just as cantons in Switzerland cannot count on federal support, local government cannot count on bailouts by cantons. Otherwise the Wallis canton would have had an incentive and an obligation to keep an eye on Leukerbad.

Instead, it is the role of creditors – not higher levels of government to exert due diligence and monitor the loans.

Given the unusually large volume of the debt (346 million Swiss francs) and the layered nature of the credit relationships (eight to ten creditors), the control problem turned into a public-good problem.

None of the creditors wanted to bear alone the costs of monitoring, so each creditor left the task to the next. Leukerbad's financial situation deteriorated and led in 1998 to its insolvency.

What should the creditors do in such a situation? They could not break up the municipality as in a private bankruptcy procedure: only a few assets could be sold. Thus, they tried to have the Wallis canton assume the debt. The cantonal government, however, rejected any responsibility.

The federal court in Lausanne, which was called upon to hear the matter, upheld the position of the Wallis canton and dismissed the case filed by Credit Suisse First Boston and other creditors. The no bailout principle was applied unambiguously.

With this ruling, the court sent a clear signal. It is the responsibility of the creditors to perform due diligence regarding their prospective borrowers' actual creditworthiness.

But how could the creditors access information regarding the borrower? This gap has been filled by the establishment of private rating agencies which developed as a consequence of the Leukerbad judgement.

The agencies assess the creditworthiness of municipalities on the basis of the state of their finances and possible bailout or no-bailout expectations as inferred from the constitution of the cantons.

Ratings are also prepared regularly to give information on the cantons' fiscal state. This reduces the information asymmetry between creditors and borrowers, which in turn contributes – and this is the key aspect – to overcoming the previous market failure and improving the efficiency of the credit market.

The cantons have an incentive to improve their ratings so that they can borrow at lower interest rates and, indeed, this has happened. Out of 26 cantons, seven have an AAA rating and fifteen an AA rating.

If the court had forced the Wallis canton to assume the Leukerbad debt, the ability of the market to allocate capital efficiently would have been eroded, and the incentive to balance budgets would have been eliminated.

Lessons for the euro zone

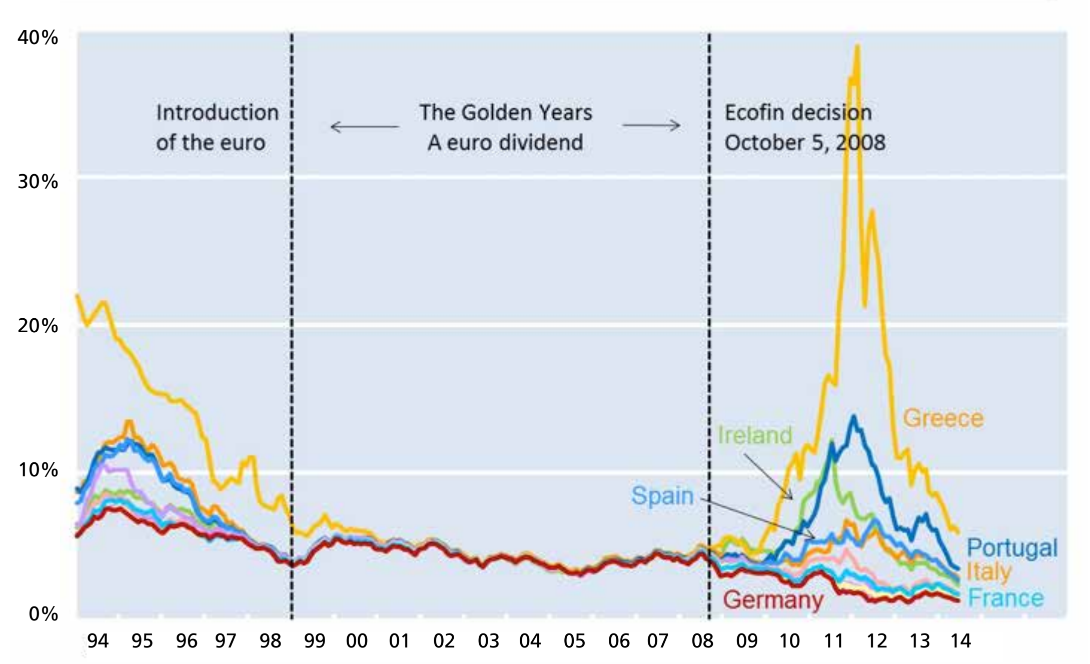
The lessons for the euro zone are clear. Fiscal discipline is not possible without a strong no-bailout constitutional provision which is observed and upheld.

Creditors must know that when they lend to particular EU governments they bear the risk which is determined by the creditworthiness of that government.

It is from this starting point that fiscal discipline will follow. There is no point directly imposing fiscal discipline from above through limits on debt and borrowing. Apart from the resentment this creates, it has not been and will not be effective in promoting sound fiscal policies•

Charles Beat Blankart
Professor
Humboldt University, Berlin
Permanent guest professor
University of Lucerne
charles@blankart.net

Figure 1: Ten years' government bond interest rates in euro member states.



Source: Ifo Institute for Economic Research, Thomas Reuters Datastream and author's own additions

Table 1: Deficits and surpluses in Switzerland according to the Maastricht definition

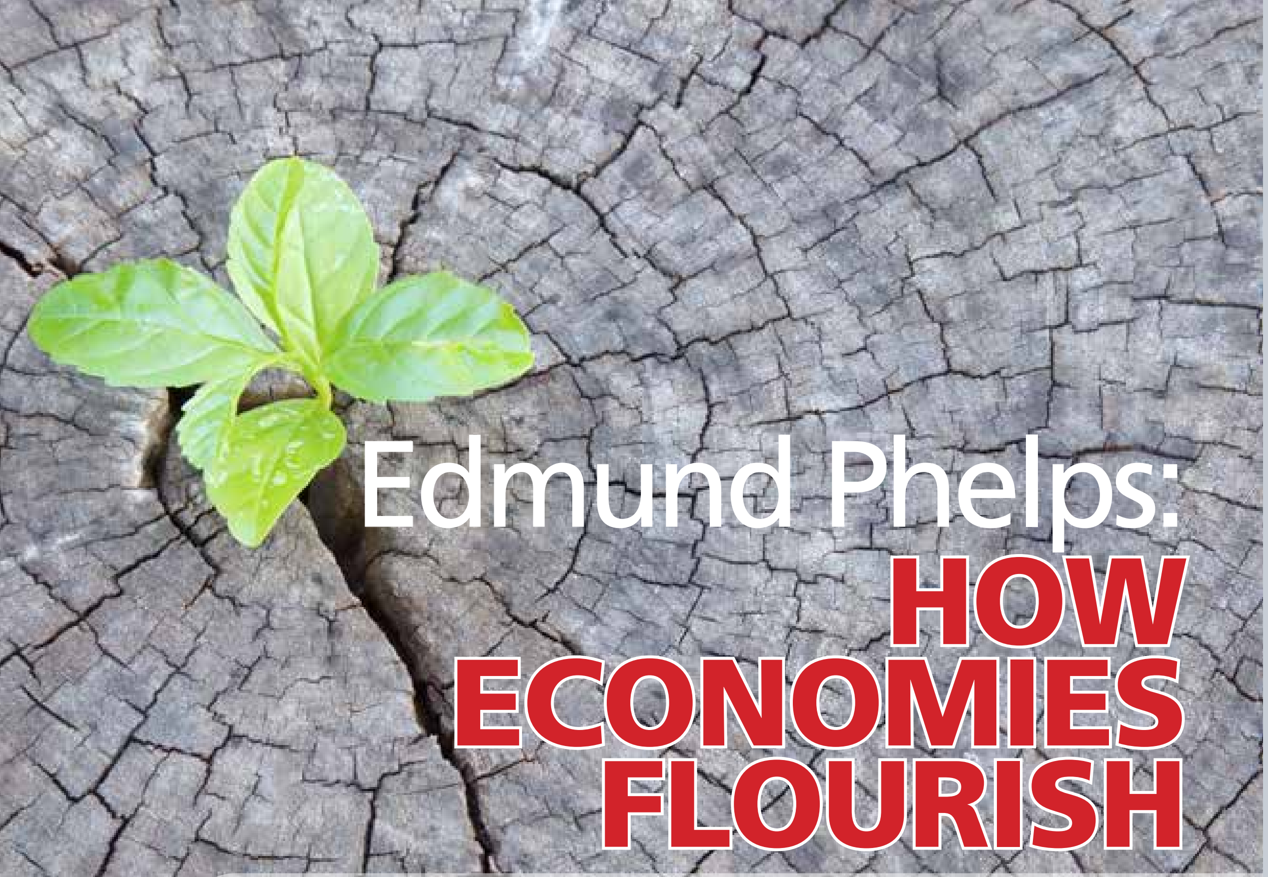
	2002	2007	2012
Debt (% of GDP)	52.9	41.8	36.4
Deficits and surpluses (% of GDP)			
Total government	-0.1	1.3	0.0
Federal government	-0.7	-0.5	0.1
Cantons	0.2	0.4	-0.1
Local government	0.5	1.0	0.5
Social security	0.5	1.0	0.5

Table 1: Deficits and surpluses in Switzerland according to the Maastricht definition
Source: OECD Economic Outlook November 2013

Table 2: Deficits and surpluses in the EU according to the Maastricht definition in larger euro countries

	Government Debt		Annual Financial Balances	
Year	2002	2014	2002	2014
France	59.0	96.7	-3.3	-3.7
Germany	60.6	76.1	-3.8	+0.2
Greece	101.7	181.3	-4.8	-2.2
Ireland	31.8	118.5	-0.3	-5.0
Italy	105.4	133.2	0.5	-2.8
Netherlands	50.5	77.0	-2.1	-3.0
Portugal	56.8	127.4	-3.4	-4.6
Spain	52.6	98.0	-0.3	-6.1
Euro area	68.0	95.9	..	..

Table 2: Deficits and surpluses in the EU according to Maastricht definition in larger euro countries
Source: OECD Economic Outlook November 2013



Edmund Phelps: HOW ECONOMIES FLOURISH

EDMUND PHELPS is one of the great economists of the mid-to-late twentieth century and author of the widely acclaimed *Mass Flourishing* (Princeton University Press 2013). Here, the Nobel Prize winning economist discusses unemployment, economic dynamism and Europe's long term economic outlook with the IEA's Editorial and Programme Director, PHILIP BOOTH

Much of your early work was in relation to the Phillips curve and unemployment. Indeed, it was for this work that you won the Nobel Prize. What was your key insight about the trade-off between inflation and unemployment?

The key insight was this. If, for example, a firm was trying to keep its wage competitive in order not to have to hire replacements who it would need to retrain, it would be constantly raising its wage in order to keep pace with what it thought to be the rate of growth of wages in its industry. That would mean that there would be no unbreakable link between "wage inflation" and unemployment.

If the firm expected there to be inflation, it would increase its wages and any effect of inflation on reducing unemployment would only be temporary as the cost of hiring new workers would increase.

Unemployment is therefore mainly determined by other factors and cannot be "traded off" against inflation.

I also integrated the idea of "efficiency wages" into macro-economic theory. Firms might increase wages in order to improve motivation and reduce labour turnover. The higher wages would generate an excess of supply of labour – and could lead to higher productivity in particular circumstances.

If there is no trade-off between inflation and unemployment, what are the main determinants of unemployment in the long run?

Some important determinants are the propensity of employees to quit, their propensity to shirk, and the size of the area over which unemployed workers are spread.

In the EU, or in any economic union, there are also the influences coming from neighbouring countries. Basically, unemployment is determined by how well the labour market is functioning.

Many countries in continental Europe have had chronically high unemployment for some time, what should they do to try to reduce unemployment?

In 1973 I argued the importance of keeping the inflation rate up. In 1997 I argued that governments could – and should – pay subsidies to employers based on the number of low-wage workers in their work force. But these things may not resolve long-term structural problems.

In my 2014 book there is the suggestion that an economy of high dynamism has a tendency on that account to have high employment through a couple of mechanisms. In general, brilliant economies don't have a lot of unemployed labour lying around.

BRILLIANT ECONOMIES DON'T HAVE A LOT OF UNEMPLOYED LABOUR LYING AROUND

Your new book, Mass Flourishing, looks at the sources of economic dynamism and progress. Currently the UK is experiencing what is often termed a "productivity crisis" so this is perhaps especially relevant to us. What have you discovered during the course of your work about the causes of the vitality of the US economy in the twentieth century?

As in any country, Britain's "progress" – the rise in the mean levels of productivity, wages and wealth – depends heavily on new and better products and production methods in the rest of the world.

Mass Flourishing takes a different course and has a series of themes. I prefer to focus on individual prosperity and flourishing – and their inclusiveness. I think of "prospering" as acquiring *material* gains through one's efforts and insights: obtaining better terms for one's work and reaping profits from well-judged investments. I think of "flourishing" as acquiring *non-material* gains through living imaginatively, creatively and adventurously: enjoying the fascination of venturing into the unknown; the thrill of discovery; and the satisfactions of personal growth.

For most people, flourishing requires being engaged in innovative activity. The breadth and depth of prospering and flourishing in Britain will depend largely on its own dynamism: the desire of the British people to attempt innovation, their capabilities at innovating and the latitude that society gives to innovative activity.

My impression is that the UK lost quite a lot of its dynamism between the 1930s and the 1950s. It is imperative to get it back. The world's scientists won't help much. A recovery in US innovation from the weakness that developed in the late 1960s would help, but it cannot be counted on.

THE BREADTH AND DEPTH OF PROSPERING AND FLOURISHING IN BRITAIN WILL DEPEND LARGELY ON ITS OWN DYNAMISM

You have expressed concern about the reduced dynamism of the US economy since the 1960s. What are the causes of this and how can they be addressed?

Another theme in my book is the cultural roots of the desire to innovate and the cultural roots of society's resistance to innovation.

We all know about the harm to innovating brought by rent-seeking, vested interests, social protection, etc. etc. but ultimately these social attitudes and practices can be traced back to the struggle between modernism and corporatism.

In the 19th century modernism was on the rise and corporatism was receding, but since the middle part of the 20th century the tide has turned and now corporatist values are riding high.

I think innovation has been pretty weak on the whole in most of the West since the late 1960s and I think the cause is a resurgence of some core elements of corporatism that prohibit aspiring innovators from introducing new products and methods and that inhibit people from attempting to become innovators.

How would you compare the long-term economic outlook of Europe on the one hand with China and other more recently developed economies in Asia on the other hand?

It could go either way. Imaginably, Europe will reform itself, root and branch, and that will usher in a new epoch of indigenous innovation such as Britain started up in 1815 and Germany and France around the 1870s. To some observers it seems that Europe simply does not want to embrace dynamism.

TO SOME OBSERVERS IT SEEMS EUROPE SIMPLY DOES NOT WANT TO EMBRACE DYNAMISM

In contrast, an increasing number of Chinese do want to acquire dynamism throughout the land. China's premier has read my book and grasped its vision of mass flourishing. He has said: "imagine how powerful it would be if 800 or 900 million Chinese workers were to be engaged in creative, innovative and entrepreneurial activity!" There have been expressions of interest in transforming Greece to a nation of dynamism. In Helsinki a movement has adopted the name "Mass Flourishing Finland". It would be great if next we see "Mass Flourishing Britain".

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

LICENCE to THRILL

"Triple play" and "quad play" are two new phrases in financial markets. They may herald a busy round of merger and acquisition activity in the global media industry over the next few years.

All being well, the banking system and the investment community can put the agonising of the Great Financial Crisis behind them and start to think about the future. They can do something useful, by translating ever-changing technology into profitable business opportunities.

Too many people have forgotten the New Era euphoria of the late 1990s, when the fusion of technological innovations in telephony and computers created the Internet and a host of Internet-related ventures.

The stock markets of the world buzzed with "TMT", as analysts salivated over the possibilities created by the coming together of telecoms, media and technology.

Many economists even thought that the new technologies would facilitate a higher rate of productivity growth.

In practice, New Era thinking has turned out to be over-optimistic and unjustified, and productivity growth over the last decade has been disappointing in most advanced countries.

Even so telecoms, media and technology are being joined up in exciting ways, and public policy needs to respond.

In the old days before mobile telephony and the Internet, telephone utilities (often state-owned) provided phone services over fixed lines; broadcasting organisations (also often state-owned, such as the BBC) put out live broadcasts over television and radio; and film companies recorded films which could be viewed in cinemas. Consumers paid separately for these services.

Nowadays advances in technology have enabled people to enjoy the same set of images and sounds over televisions, computers and mobile phones.

A media business is engaged in "triple pay" if it tries to persuade customers to take from it television, broadband and fixed-line telephony, and to pay for all three of these on one bill.

The notion of payment for television by subscription began in Britain only in the late 1980s, and it took BSkyB (now Sky) over a decade to become entrenched in the national media scene.

In November 2013 BT plc, which 35 years earlier had been the telephone arm of the Post Office, announced that it was buying up the television rights to 350 football matches so that it could compete in the market for subscription television. BSkyB had already started to market itself as a provider of telephone and broadband services. Both Sky and BT are therefore now competitors for triple-play customers.

"Quad play" is an extension of "triple play", involving the addition of mobile telephony.

Again, 35 years ago the idea of seeing moving real-time images on a portable device (such as a tablet or mobile phone) was science fiction.

It would have been inconceivable for phone utilities, broadcasting organisations and film companies to form conglomerates with the intention of marketing such images and charging for them.

But the science fiction of the 1970s is the everyday reality of the 2010s. Free-market capitalism is endlessly versatile and innovative. The corporate world has transformed the technological possibilities into marketable products and is re-organising commercial structures to deliver the best return to shareholders.

There are no national markets

Also revolutionary is the inevitability of globalised markets for media output. Top sports events involve teams from many countries, while dozens of countries share English as the language of business, politics and high culture.

There is a prospect of combined supply of mobile, fixed-line, broadband and television not just within countries by suppliers defined by national markets, but across national frontiers by media giants intent on capturing a big slice of the global market.

TELECOMS, MEDIA AND TECHNOLOGY ARE BEING JOINED UP IN EXCITING WAYS – AND PUBLIC POLICY NEEDS TO RESPOND

Google has cleverly positioned itself as the world's top search engine, with ample cash flows from internet advertising to fund its ambitions across all the media and telephone markets.

Indeed, Google's dominance as a search engine terrifies all its rivals. Its revenues this year may well exceed $70 billion, ahead of the much longer-established Walt Disney Company ($50 billion), Time Warner ($30 billion), CBS Corporation ($15 billion) and Viacom (also about $15 billion). All these businesses are American.

On this side of the Atlantic Sky tends to be seen as "British", but it is in fact almost 40 per cent owned by 21st Century Fox, which is headquartered in New York and has annual revenues in its own right of over $30 billion.

Yes, the UK is present in this space, with both BT and Vodafone as significant potential participants in the triple-play and quad-play markets. But for the time being their income is predominantly from phone bills rather than media and television. (BT has revenues of about $30 billion and Vodafone of over $60 billion.)

All these companies are working out corporate strategies for the next few decades, when media output of all kinds (both recorded and live) will be conveyed over fixed-line phone and cable networks, over broadcasting masts of the traditional type and over mobile phones, and when the marketplace will become increasingly global.

Vast sums of money will change hands, as subsidiaries are bought and sold, mergers are agreed, bids are announced and resisted, and so on.

Some concerns will specialise on content and others on technological platforms, and every outfit will have its own distinctive geography (of market share, the location of production, the siting of legal and administrative headquarters). No one knows the eventual outcome.

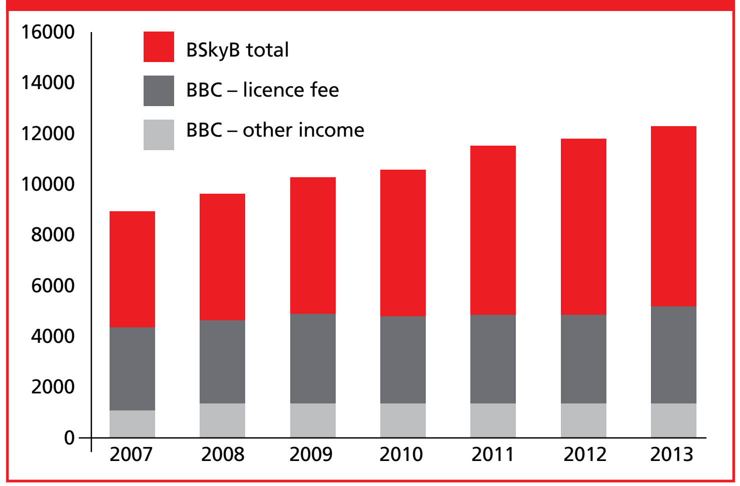
Anyone trying to forecast, over the next 10 or 20 years, the revenues of Google, Walt Disney, 21st Century Fox, BT and so on would be mad. The only certainty is the rough and tumble of the international market-place.

The BBC should enter the international league

What about the BBC? Surely, the

IS THE BBC ALREADY AN UNDERDOG?

Bars show total revenue received by the BBC and BSkyB, annually since 2007 in £m.



Tim Congdon is also author of **Privatise the BBC**, published as an ebook by Standpoint: *http://www.amazon.co.uk/Privatise-BBC-Tim-Congdon-ebook/dp/B00OXSRX3C*

BBC has the best brand of any British broadcasting organisation.

It likes to think of itself as still enjoying immense goodwill and prestige not just in Britain, but in a global context.

According to Anthony Scadding, head of public affairs at the BBC, a Populus survey of 14 countries in October 2013 rated "BBC One highest on quality out of 66 major TV channels", while BBC Two was in third place.

Fine, but the truth is that it is being marginalised and increasingly forgotten on the global media scene.

The BBC's problem is that it is state-owned and depends on a special kind of tax, the licence fee, for over 70 per cent of its revenues of about £5 billion ($8 billion).

It does nowadays have market-based revenues, largely from its international arm, BBC Worldwide, of about $2 billion.

However, the BBC is a midget in a world setting and, as the chart shows, it no longer dominates Britain: its revenues are smaller than the revenues of Sky.

Furthermore, the BBC's licence fee commitments limit its expansion outside old-style broadcasting.

Its current Director-General, Tony Hall, has said that he wants the BBC iPlayer to be "the best in the world", but for obvious reasons the BBC cannot seek revenues from fixed-line or mobile telephony.

The BBC therefore cannot position itself for a "triple play" or "quad play" market presence. More generally, while it is in public ownership, it can never have the resources and commercial freedom to compete against the global media conglomerates that are now emerging.

A new government after May 2015 must decide what to do about the BBC's licence fee in the next Royal Charter, due for review in 2016.

Powerful arguments have been assembled for ending the licence fee altogether.

A safe forecast is that the licence fee will fall in real terms, just as the global media conglomerates are establishing strong positions in the new competitive landscape.

The right long-run answer is both to end the licence fee and to privatise the BBC, so that its top management can maximise the value of the brand in a rapidly changing world•

PROJECTED REVENUES 2015

GOOGLE	$70 BILLION
WALT DISNEY	$50 BILLION
TIME WARNER	$30 BILLION
CBS CORPORATION	$15 BILLION
VIACOM	$15 BILLION
BBC	$8 BILLION

Tim Congdon
International Monetary Research
timcongdon@btinternet.com

Why BRITAIN should leave the EU

Supporters of a free economy have different views on whether the UK should leave or remain in the European Union. In this article, PATRICK MINFORD explains why he believes Britain should leave

The impact of the euro crisis on the UK

The euro zone crisis is likely to continue for a number of years. The European Central Bank will act as a backstop until agreement is reached on a new institutional structure that reassures northern Europe that its transfers to southern Europe will have a good chance of being repaid.

The UK's exclusion from the euro has meant that it is neither vulnerable to the panic that has engulfed southern European sovereign bonds nor will it directly make large transfers to the crisis-stricken south.

The institutional framework now being developed implies a high degree of monitoring and intervention by creditor countries of debtor countries within the euro zone. There will be controls on bank behaviour, targets for governments and, possibly, new financial taxes.

While in principle this will take place within the euro zone, there will be pressure to extend the regime to all EU countries on the grounds that other EU members could 'undercut' euro zone arrangements.

The UK will be seen as an offshore competitor against banks, businesses and governments in the euro zone that are burdened with these controls and regulations.

Such competition, it will be argued, is unfair within the Single Market. It may well be quite easy for the measures that currently apply only to the euro zone to be extended to the UK through the qualified majority voting system.

This tendency for the euro to strengthen the drive towards excessive regulation as a way of bolstering the single currency was something widely foreseen at the start of the euro project.

But the crisis is likely to make this tendency much stronger. And the City of London, towards which the prevalent attitude on mainland Europe is one of extreme hostility, is likely to suffer.

This all strengthens the argument for the UK to leave the EU. The economic case was already quite strong, but the risks of remaining within the EU are now that much greater. So, what are the costs of EU membership as far as the UK is concerned?

Category of Cost	Cost (% of GDP)
Net UK contribution	0.4
Costs of the Common Agricultural Policy	0.3
EU protection of manufacturing	2.5–3
Regulation	6–25
Bail-out transfers	2–9
Total costs of EU membership	11.2-37.7

Table 1: A survey of costs from EU membership[1]

THE ECONOMIC COSTS TO THE UK OF EU MEMBERSHIP ARE SUBSTANTIAL…THEY TOTAL A MINIMUM OF 11 PER CENT OF GDP

Costs of EU membership

Even without any change in the status quo, the economic costs to the UK of EU membership are substantial.

Table 1 summarises the estimates made in 2005. They total a minimum of 11 per cent of GDP. Later work confirms that these estimates are still of the right order of magnitude. The costs arise from various sources.

Firstly, there are the obvious costs of our budgetary contribution and the possible cost of future bail outs (which could arise as a result of the ongoing euro crisis or relate to the huge cost of future EU pensions).

Secondly, there are the costs of enforced EU protectionism via a variety of trade measures which force up costs.

Thirdly, there are the costs of regulation to UK industry. These costs include measures that raise the price of energy, regulation on the City and regulation of the labour market (through trades union powers, hiring and firing restrictions, and a variety of extra worker rights).

These measures raise the cost of doing business in the UK and reduce employment. With the ongoing euro crisis these costs threaten to get ever heavier.

At Cardiff University, we estimated these costs in three main ways. For the costs of protectionism we used what economists call a "computable general equilibrium model" of the UK, the EU, the US and the Rest of the World. This allows the second- and third-round effects of protectionist measures to be estimated.

Protectionism raises the costs of consumption, it can raise the costs of production, and it leads to a misallocation of economic resources.

Such a model allows all those costs to be taken into account as well as any offsetting benefits.

The regulatory costs are estimated using the Liverpool Model of the UK economy which can measure how costs of regulation affect employment and output.

The bail-out costs are computed by looking at potential scenarios for fiscal crises (both due to the euro and due to the growing costs of pensions and other costs of ageing populations) across the EU on the assumption that a bail out would in practice occur if members got into difficulties.

The wide range of estimates in the last two categories reflects huge uncertainty about how regulation

[1] These estimates use work done over a number of years under the auspices of the Julian Hodge Institute of Applied Macroeconomics in Cardiff University Business School.

will develop and how fiscal problems will be dealt with.

An aspect which we do not examine is the effect of EU policies on UK growth. Here research is ongoing but it seems likely that these policies also reduce the UK growth rate by reducing the dynamism of the economy rather than just creating "one-off" costs.

But what about the costs of leaving?

A popular argument is that there are benefits of EU membership such as from foreign direct investment (FDI).

However this argument is largely fallacious. FDI does not bring a direct benefit. It is an input into production and the foreign funders providing the capital benefit from the returns.

It is true that FDI brings indirect benefits because of technological spill-overs from foreign firms which raise productivity.

But the UK economy's productivity is likely to be maximised when comparative advantage is allowed its fullest rein: i.e., outside the EU, under free trade. Indeed, if free trade leads to industries operating more efficiently, then less FDI will be required.

Some argue that exclusion from the EU's Common Tariff would be damaging. But tariffs lead to costs. The removal of the common tariff would mean cheaper goods for consumers and cheaper inputs for manufacturers. And our production would be governed by our comparative advantage. In fact, we would gain around 3 per cent of national income from the removal of the common tariff.

It is also said that we would no longer influence EU regulations if we left. This is true. But we do not influence the regulations of any country to which we export. And, in reality, we have negligible influence on EU regulation as just one of 28 members.

If we left the EU, producers of goods and services would not have to adhere to inappropriate regulations on the 90 per cent of output that is not exported to the EU.

Of course, if we left the EU, political and economic co-operation will continue in areas of mutual interest as it does with all our allies.

Transitional issues

There are a number of problems of transition from our current full membership to total departure from the EU.

These must not be allowed to blur the basic point: Britain's

BRITAIN'S INTERESTS LIE IN LEAVING THE EU BECAUSE OF THE LARGE BALANCE OF COSTS OVER BENEFITS OF OUR MEMBERSHIP

interests lie in leaving the EU because of the large balance of costs over benefits of our membership.

Transitional issues basically relate to the adjustment for industries and groups currently enjoying gains from the protection given by EU arrangements.

These industries and groups are likely to be vocal in their opposition to leaving the EU; they will get added impetus from the CBI and TheCityUK, two big business organisations. This opposition will be reminiscent of the opposition from essentially the same groups to the UK's decision not to join the euro.

These groups will have to adjust using their own resources and strategies. For example, it is likely that the euro zone and the EU will attempt to restrict certain euro financial transactions from taking place outside the EU after we leave.

This means that City institutions that were previously successful in this market will need to find alternative markets. The general efficiency of City services is such that it dominates the world market in a wide range of financial transactions. The City will therefore find little difficulty in attracting other worldwide business.

Another industry that is likely to suffer from EU departure is volume car production. In this industry, factories in parts and assembly have been located all around the EU under the assumption of a continued customs union.

When the UK leaves the EU cars from non-EU countries would be free to enter the UK at world prices in as large a quantity as consumers desire. Hence UK car prices would drop to world prices.

UK producers of volume cars will not get protected prices in the EU markets, while EU producers will continue to do so.

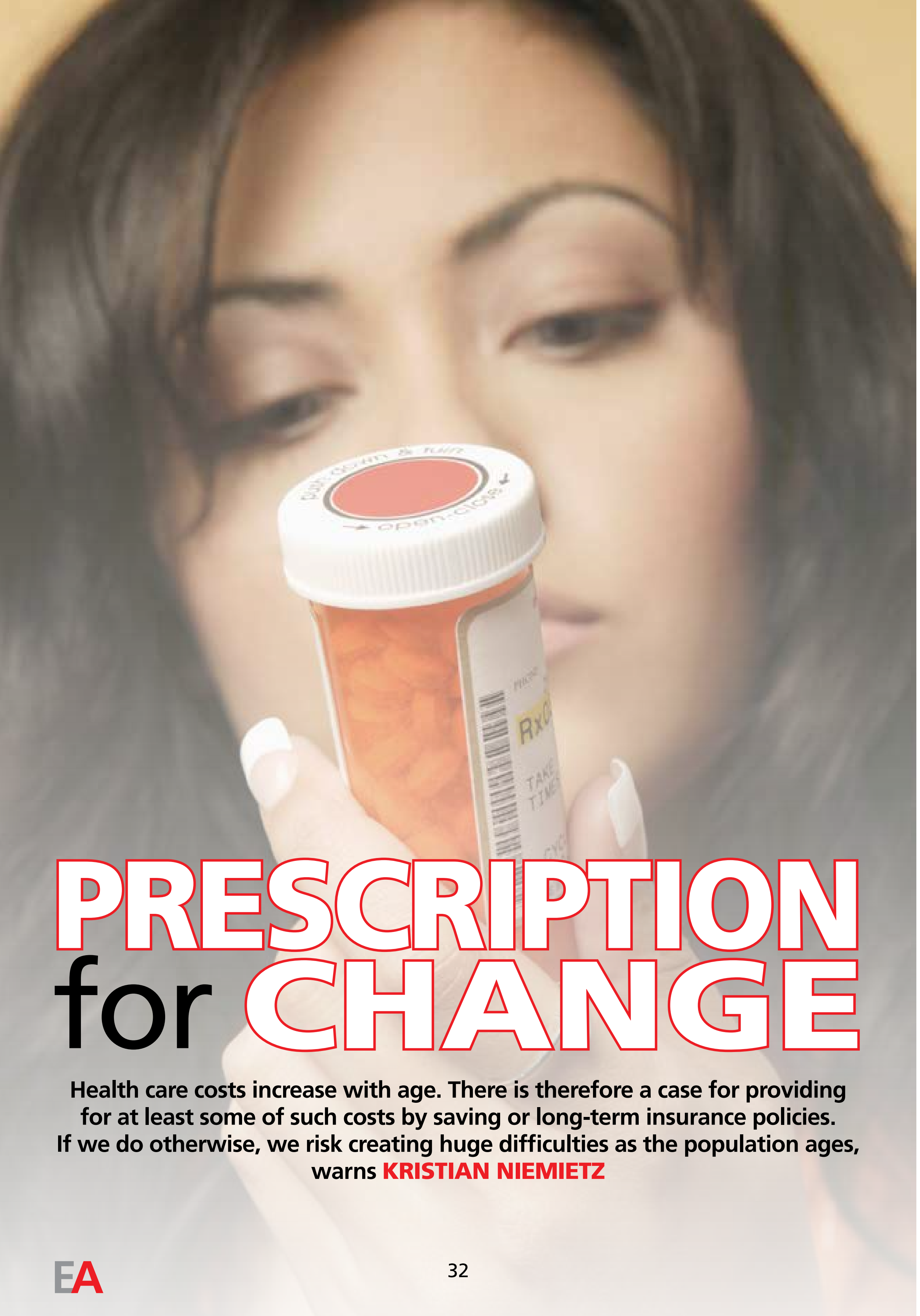
In the long run this must lead to a contraction of UK-based capacity up to the point that the remaining industry can survive at world prices. The industry will lobby intensely for some transitional compensation. Probably the easiest way to provide compensation is through transitional trade arrangements. This is also the most likely route for other sensitive industries affected.

Conclusion

The institutional evolution triggered by the euro crisis threatens to make the economic costs of EU membership higher than ever, in a highly visible way. The case for leaving the EU has become overwhelming.

Patrick Minford
Professor of Applied Economics
Cardiff Business School
MinfordP@cardiff.ac.uk

The key reference is '**Should Britain leave the EU? An economic analysis of a troubled relationship**', by Patrick Minford, Vidya Mahambare and Eric Nowell, published by Edward Elgar in association with the Institute of Economic Affairs, 2005. The work has been updated in various other publications.



PRESCRIPTION for CHANGE

Health care costs increase with age. There is therefore a case for providing for at least some of such costs by saving or long-term insurance policies. If we do otherwise, we risk creating huge difficulties as the population ages, warns KRISTIAN NIEMIETZ

Individual healthcare costs are generally unpredictable. We cannot know whether we will need healthcare treatment next year, what kind of treatment that would be, and what its price is.

It is therefore sensible to hedge against health expenditure shocks through some kind of risk-pooling mechanism, whether that role is performed by private insurers (as in the US), social insurers (as in most of continental Europe) or a tax-funded system (as in Canada and the UK).

But while healthcare expenses may not be predictable on a year-to-year basis, their general trajectory over an individual's lifetime is predictable enough.

The details differ over time and across countries but a breakdown of healthcare expenditure by age can be described in the following way. Healthcare costs are at their lowest during the first four to five decades of life, and rise only gently during that period; at some point after that, though, they begin to rise exponentially.

In the UK, per capita health expenditure for people in their mid-to-late 70s is about five times as high as for people aged 20-49 years.

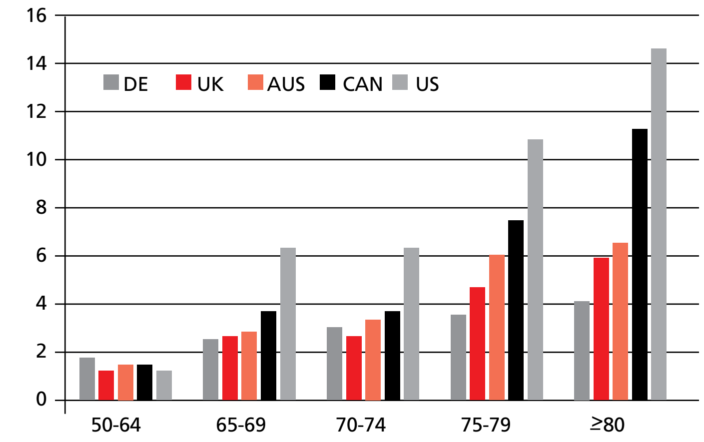
There is, of course, huge variation within cohorts, but the trend is broad-based, and at least for some aspects of healthcare consumption, it is almost a universal trend.

For example, Stabile and Greenblatt (2010) show that by the age of 70, 85 per cent of men and 95 per cent of women in Canada are taking at least one prescription drug.

Health insurance is therefore not like fire insurance or theft insurance, where a sudden outlay could be necessary at any time in your life. For those sorts of risks, it is very sensible to take out annual insurance policies and the premiums do not vary very much with people's ages.

Healthcare costs are heavily and systematically biased towards the later years of life, and it would therefore seem sensible to "prefund" them: to build up a pot of savings in younger years, and use it up in old-age.

Healthcare expenditure per capita by age group, as a multiple of those aged 20-49



based on data from Hagist & Kotlikoff (2005)

A pension fund works in this way and, though it is less obvious, so does life insurance.

In the case of life insurance, people take out policies for several decades and pay the same premium. There is a surplus of premiums over claims in the early years and the insurance company invests this for the years when there is an excess of claims over premiums.

HEALTHCARE COSTS ARE AT THEIR LOWEST DURING THE FIRST FOUR TO FIVE DECADES OF LIFE… AFTER THAT THEY BEGIN TO RISE EXPONENTIALLY

In the absence of pre-funding, each generation's old-age healthcare bill will be picked up by the subsequent generation, a financing arrangement which is only stable as long as a relatively large number of working-age people support a relatively small number of elderly people.

Alternatively, people have to pay higher and higher insurance premiums as they get older. Such arrangements also create incentives for medical over-consumption.

If costs are mainly met by the government – and even in the US, healthcare spending for the old is paid for through a government scheme – the main beneficiaries of healthcare spending will have more political power as the electorate ages and political parties pander to the 'grey vote'. Of course, the cost of those decisions is split among all taxpayers.

So there are good economic reasons for prefunding healthcare spending. And yet, perhaps surprisingly, there are virtually no examples of prefunded healthcare anywhere in the world.

There are a number of examples of prefunded pension schemes, but, despite the similarities, this approach is almost never applied to healthcare. There are, however, two examples of partially prefunded healthcare which are worth a closer look: Medical Savings Accounts (MSAs) in Singapore, and Private Health Insurance (PHI) in Germany.

In Singapore, all employees (and the self-employed) are required to build up savings for healthcare expenses via MSAs, with monthly contribution rates between 7 per cent and 9.5 per cent of salary.

Contributors are expected to accumulate at least £21,000 in their accounts by the age of 55 (but no more than £24,000). Those funds are the personal property of their account holders, but spending is ring-fenced: MSAs can only be used to purchase medical goods and services, and then only for officially approved ones, and subject to withdrawal limits. MSAs are coupled with catastrophic health insurance for high-cost treatments. This setup is not unique to Singapore, but

The IEA would like to thank the Templeton Foundation for its support of the IEA's work in the field of healthcare funding through the project: Encouraging Independence and Enterprise for a Healthy Old Age.

Singapore's 'Medisave' system is the only one of its kind that covers virtually the whole population.

When Medisave was created in 1984, the intention was not to prefund healthcare spending, but to limit demand, and encourage personal responsibility (Haseltine, 2013; von Eiff et al, 2002). But even if it was not the original purpose of the approach, MSAs automatically led to a degree of prefunding, as people built up a pot of savings during their working life and use it up in retirement.

Still, it would be an exaggeration to describe Singapore's health system as 'prefunded'. Out-of-pocket payments account for over half of healthcare spending in Singapore, but Medisave itself only accounts for a relatively small part.

However, Singapore has exceptionally high general savings rates so we could think of healthcare

IN SINGAPORE, PEOPLE ARE REQUIRED TO BUILD UP SAVINGS FOR HEALTHCARE

spending being prefunded from saving in a more general sense even if not from earmarked savings through Medisave.

PHI in Germany comes close to full pre-funding, but then, only about one tenth of the population are privately insured, with the remainder being covered by the pay-as-you-go financed social insurance system.

Private insurance premiums for younger people reflect expected current healthcare costs, based on individual health risks, plus a mark-up for expected increases in healthcare costs later in life.

Those mark-ups are invested in low-risk assets, and they are later used up to smooth premiums over a policy holder's lifetime. Taken together, the old-age reserves held by PHI providers amount to 170bn, and annual additions account for about 5 per cent of the country's net savings rate (Schönfelder & Wild, 2013, pp. 28-29).

This system does not work perfectly: PHI premiums are not supposed to increase with age at all, but, in practice, they do, as insurers have persistently under-estimated medical inflation.

But, at least, this private pre-funded system is not vulnerable to demographic changes. It already offers a higher standard of medical care than the state system, and this gap is likely to widen in the future, when the private system will be able to fall back on its old-age reserves while the state system has a smaller and smaller tax base as the population ages.

In the Singaporean Medisave system, it is individual patients who prefund their future healthcare spending through their MSAs. In the German PHI subsystem, insurance companies perform that function on behalf of their clients. Either way, the result is a financial footing that is much more solid than in pay-as-you-go systems.

In order to see why prefunded healthcare is as rare as it is, it is instructive to look at two examples of countries with large private insurance industries, which should, in principle, be well placed for prefunding: the US and France.

In the US, the vast majority of the working-age population (and their dependants) are privately insured. Upon retirement, however, people switch to the public insurer Medicare, which is run on a pay-as-you-go basis.

For private insurers, this removes the need to build up funds when patients are young to pay for more expensive treatments as patients age. In other words, the need for a long-term insurance market with the building up of savings has been crowded out by the special government system for older people.

In France, private supplementary insurance is almost universal, but insurers do not accumulate old-age reserves. Their premiums therefore tend to go up with people's age, and become increasingly difficult to afford for the elderly.

The government's response to this problem is to subsidise the elderly's premiums, thus effectively extending the pay-as-you-go mechanism into

the private subsystem.

So, in the end, both the US and France end up with pay-as-you-go financed healthcare systems. The government, in one form or another, takes over the healthcare costs of the elderly.

In both countries, it would be far more sensible to have a system in which private insurers build up old-age reserves, and smooth premiums over a client's lifetime.

In principle, prefunding could be introduced into virtually any healthcare system, even into a system like the British NHS with the government building up the funds.

In practice, however, prefunded healthcare is still as rare as hen's teeth and it is only likely to work by harnessing private sector insurance and savings vehicles. Changing this requires a complete rethinking of healthcare financing•

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

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

Is the UNITED STATES still a LAND OF OPPORTUNITY?

There is a general perception in both the US and the UK that inter-generational mobility is declining.

In other words, there is a general perception that, if you are born poor, you are more likely to die poor than a person in a similar position was a generation ago.

This paper examines the evidence for the US. In fact, the paper does not find that inter-generational mobility has fallen.

Interestingly, though, the paper found that inter-generational mobility is especially low in particular areas (the rust belt area where there are dying industries and the south east).

Indeed, the regional differences in mobility dwarf any changes over time. This is especially interesting. We would not expect a society of complete mobility (for example, where 25 per cent of those in the upper-earnings quartile found their children in the lower earnings quartile and vice-versa) because of, amongst other things, inherited characteristics.

However, if mobility varies within countries, it may help us isolate and understand better the factors that cause it•

RAJ CHETTY
NATHANIEL HENDREN
PATRICK KLINE
EMMANUEL SAEZ
NICHOLAS TURNER
American Economic Review
2014, 104(5)
http://eml.berkeley.edu/~saez/chettyetalAERPP2014.pdf

INTERGENERATIONAL TRANSMISSION of WELFARE DEPENDENCY

There is very limited empirical evidence about whether welfare dependency transmits through the generations.

Even if the children of welfare recipients are more likely to receive welfare, this might simply be because of educational disadvantages of various forms.

This paper looks at two groups in Norway who are divided only by whether they receive welfare for disability – theie other characteristics are the same.

The groups were separated according to whether their appeals were heard by lenient judges: the individual characteristics of the claimants were not correlated with whether their case was heard by the more lenient judge.

The findings suggest that, if a child's parent is on welfare, there is a considerable increase in the probability that the child will also be on welfare. That probability increased over time.

Detailed analysis suggests that this is not to do with reduced stigma when parents are on welfare or differences in the investments made by parents in their children between the two groups.

It is concluded that the tendency of welfare dependency to pass down the generations may arise from children learning about the programme from their parent's experience and thus being more likely to use it•

GORDON DAHL, ANDREAS KOSTOL and MAGNE MOGSTAD
NBER Paper 19237
http://cep.lse.ac.uk/seminarpapers/18-06-13-GD.pd

INCENTIVES, SELECTION & TEACHER PERFORMANCE

Teacher readers of this magazine may be interested in the results of NBER research on incentives and teacher performance.

There is very little differentiation of teachers' pay by performance, though elements of performance-related pay have been introduced in the UK.

This paper examines the introduction of performance pay in the District of Columbia in the US. It looked at teachers of very similar ability but who marginally fell one side or the other of the cut-off point for disciplinary action to be taken or incentives provided.

In fact, performance pay did improve the performance of those teachers who became eligible for it. Incentives did work.

Furthermore, amongst those teachers whose performance in one year led them to be eligible for dismissal the following year, there was increased voluntary attrition of poor teachers and an improvement amongst those who remained.

Overall, it would seem that incentives worked within the group of teachers who had the possibility of higher pay or who faced the possibility of dismissal•

THOMAS DEE and JAMES WYCKOFF
NBER Working Paper 19529
https://cepa.stanford.edu/sites/default/files/w19529.pdf

campus

Our student programme is kindly supported by **METRO BANK**

TOM IS GOLD-WORTHY!

Congratulations to Tom Goldsworthy, from Denstone College in Staffordshire, who was chosen as winner of our Annual Essay Competition.
He won the Dorian Fisher Memorial Prize for his essay on "Why has the proportion of the world's population defined as being in 'extreme poverty' declined and can we expect this to continue?"
Congratulations also to runners up **Liam Haslam**, of John Leggott College, **Calum Davy** of Colchester Royal Grammar School, and **Dimitry Karavaikin** of St Paul's School.
The awards ceremony took place at the Mary Sumner House in Westminster for prize winners and those placed in the top 10. Details of our 2015 competition will be published soon at ***www.iea.org.uk/essaycompetition***

Laurels for Laura

18 year old Laura Chitty was chosen from an exceptional crop of interns as the Best IEA Intern of the autumn.

Laura's impressive report on the impact of micro financing on women in Bangladesh, and her equally accomplished presentation of her findings to the IEA staff won her the accolade.

Expanding on her work at the IEA, Laura is now in Bangladesh working with a microfinance company. When she returns to the UK, Laura will be telling us exactly how micro financing works to reduce poverty. Good luck with the rest of your trip Laura!

A TASTE OF FREEDOM 1

Applications are now open for this year's Freedom Week, to be in held in Cambridge on 13-18 July.

If you're interested in attending this free annual, one-week seminar, designed to teach undergraduate students about classical liberalism and free market economics, you can apply via the website: ***www.freedom-week.org***

A TASTE OF FREEDOM 2

The IEA has launched a new series of monthly events exclusively aimed at under-30s, from sixth formers to young professionals, titled Future Freedom.

Events so far have included film screenings, book launches and panel discussions.

To keep up with our latest events you can like our Facebook page, or visit our website ***www.iea.org.uk/events***

CONFERENCE CALL

Over the last two terms we have had 20 one-day conferences at sixth forms from Edinburgh to Portsmouth.

Sir Anthony Seldon, Headmaster of Wellington College, said of our conference:

"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!"

We are already planning our schedule for Autumn and Spring of the 2015-2016 academic year.

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

INTERN INTAKE

Would you like to become an intern at the IEA this summer? Our programme consists of lectures, seminars, debates, discussions, and of course beer and pizza nights!

During your time with us you will produce an individual research project and be mentored by one of the senior research staff here at the IEA.

We also have intern opportunities all year round, for sixth form students right up to recent graduates, so if you are interested in joining or just want to find out some more information, email ***Grant Tucker: gtucker@iea.org.uk***

THINK about it...

On Saturday 11th and Sunday 12th July the IEA will be bringing together some of the biggest names in economics for a special two day conference called Think.

The conference – to be held at the Royal Geographical Society in London – will include sessions on our changing education system, innovation and capitalism, helping the poor, and much more.

For more information – and to secure yourself a ticket – go to **www.iea.org.uk/think**

SPEAK? EASY!

The IEA has an impressive roster of speakers who visit schools, universities and other institutions around the world.

In the last few months our speakers have addressed thousands at organisations from Oxford University to the European Parliament.

If you need a speaker for a talk or debate at your organisation email ***gtucker@iea.org.uk***

TIME TO GIVE ADMEN A BREAK

Some say advertising is manipulative and harmful to consumers. But is this true? **CHRISTOPHER J. COYNE** and **RACHEL L. COYNE** investigate…

Advertisements pervade our daily lives – and businesses invest a significant amount of resources in attempting to attract customers.

Consider Figure 1 which shows the advertising spending per person across ten countries.

Given the prevalence of advertisements, it makes sense to step back and ask what role they play.

Do advertisements lead consumers to spend their money frivolously, or do they communicate important information? As this question indicates, there are two different schools of thought regarding the role that advertising plays.

Advertising as manipulation

The first school of thought views advertisements as either manipulative or wasteful.

The idea that the central purpose of advertising is to manipulate consumer preferences was popularised in Vance Packard's 1957 book, *The Hidden Persuaders*.

Packard argued that advertisers attempt to "channel our unthinking habits, our purchasing decisions, and our thought processes by the use of insights gleaned from psychiatry and the social sciences."

A year later, in 1958, economist John Kenneth Galbraith published his book, *The Affluent Society*, in which he argued that corporate advertising created a "dependence effect" whereby the "direct link between production and wants is provided by the institutions of modern advertising and salesmanship."

From this perspective the producer controls the consumer in markets by manipulating their preferences and "creating desires" for products they would not otherwise want.

More recently, Fritjof Capra and Hazel Henderson (2009) argue: "Since human needs are finite, but human greed is not, economic growth can usually be maintained through the artificial creation of needs through advertising. The goods that are produced and sold in this way are often unneeded, and therefore are essentially waste."

The common theme of the manipulative view of advertising is that it is a harmful practice that adds no value to the lives of private citizens. In stark contrast, it makes consumers worse off because it manipulates them into wasting their money on things they do not want or need.

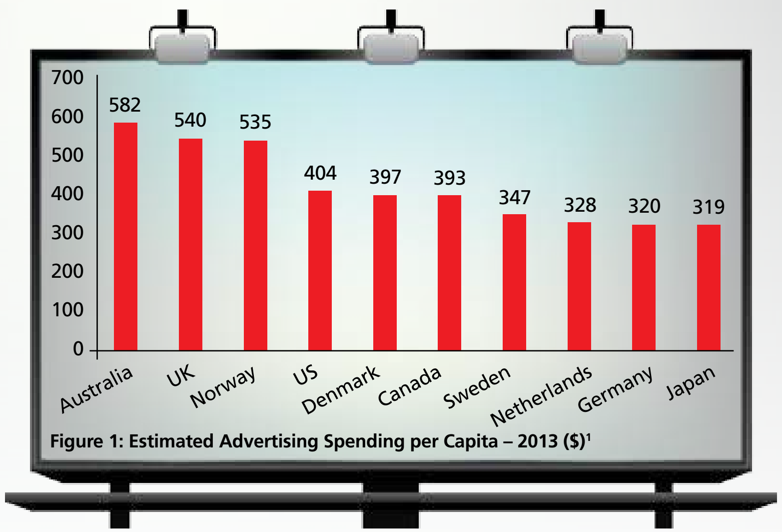


Figure 1: Estimated Advertising Spending per Capita – 2013 ($)[1]

Advertising as information

An alternative school of thought views advertising as providing information that allows consumers to make informed decisions.

This view emphasises consumer sovereignty, meaning that it is the wishes of the private consumer which are the ultimate determinant of market outcomes.

Producers must constantly compete for consumers and one way of doing this is to inform consumers about their product or service.

By providing this information, producers are attempting to accomplish two things. They are alerting consumers to the existence of their good or service. Secondly, they are attempting to engage in product differentiation which entails convincing consumers that their product or service is different from, and superior to, those offered by others.

From this perspective, advertising is a value-added activity that exists precisely because consumers control market outcomes through their purchasing decisions.

In contrast to the manipulative view of advertising, the informational view contends that producers have no ability to control the decisions of consumers.

Advertising exists precisely because producers feel constant pressure from competitors and realise that the only way to maintain, or gain, market share is to inform consumers of the beneficial aspects of their product or service.

Which school is right?

Given the two competing views on advertising, how are we to determine which is more accurate? A recent IEA publication, *Advertising in a Free Society*, reviews the available evidence (Harris and Seldon, 2014). There are a number of key insights in the book.

There is little evidence that producers can manipulate consumer preferences so that they purchase their product. Most businesses spend relatively little on advertising. This would be an odd strategy if producers really could profit simply by shaping consumer preferences at will through advertising.

If this truly were the case, businesses would spend much more on advertising to manipulate consumers to buy more of their product and at higher prices.

Also, the available empirical evidence fails to find support that consumers can be manipulated through advertising.

As David Stewart and Michael Kamins write in the 2006 publication *Handbook of Marketing*: "both the empirical evidence and logical deduction offer compelling evidence that marketing communication does not create demand; it is a response to demand."

In other words, the existing evidence indicates that consumers purchase goods and services because they choose to buy them, not because they are tricked or manipulated into doing so.

In addition, there is no evidence that advertising leads to monopoly power. Proponents of the manipulative view of advertising often contend that, by creating brand loyalty, advertising creates artificially high barriers to entry.

According to this logic, it is difficult, if not impossible, for smaller or newer firms to compete with those that are already established and well-known to consumers.

The result, critics contend, is that established firms can act like a monopolist (artificially raising prices and restricting output) due to the weakened competition. There are three responses to this line of reasoning.

The first is that while advertising can be seen as a means of establishing a brand, it can also be seen as a means of communicating information about alternative

[1] Includes advertising through digital, directories, magazines, newspapers, outdoor, radio, and television.
Source: eMarketer through Statista, *http://www.statista.com/chart/1492/ad-spend-per-capita/*

products and services. That is, advertising is a means of facilitating competition by providing information to consumers about new choices available to them.

Further, with improved technologies, such as social media, it has become easier and cheaper for smaller and newly founded businesses to reach consumers around the globe with new products and services, thus increasing competition.

Secondly, there are numerous instances of firms with well-establish brand names and reputations losing significant market share or going bankrupt.

Consider, for instance, the case of Eastman Kodak. Founded in the late 1880s, this US-based company dominated the market for photographic film for much of the 20th century. The company also invested in advertising and brand building.

However, starting in the early 2000s, Kodak began to lose market share because of innovations in digital photography. In 2012, the company filed for bankruptcy. Consumers had spoken, and no amount of advertising or marketing could save the company despite its once dominant market share.

Furthermore, the empirical evidence indicates that advertising is likely to reduce prices which is fundamentally at odds with the predictions of monopoly and market power and manipulation theories.

The reason for the fall in prices is that advertising expands the extent of the market for producers, resulting in lower costs due to greater economies of scale – though it can also increase competition as there are more companies competing in a more widely-defined market.

The informational role played by advertising is at the centre of this process because it allows consumers to become more aware of what producers have to offer.

Of course, understanding the informational role played by advertising in no way suggests that consumers are perfect and perfectly informed – far from it.

All consumers make mistakes, regret making certain purchases and engage in impulse buying at some point or another.

These imperfections are not the result of manipulative advertising, but rather they are a result of being human and living in a society where free choice is valued.

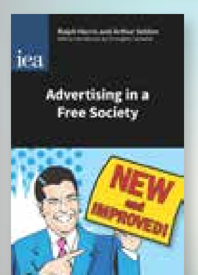
Human flourishing involves allowing individuals to discover what makes them happy even if others disagree with their decisions.

As this discovery process evolves, each individual is aided by having more information as compared with less.

In this regard, advertising can be seen as playing a key role in improving our well-being, even if one person's choices are at odds with the preferences of others●

Christopher J. Coyne
F.A. Harper Professor
of Economics
George Mason University
ccoyne3@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



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Harris R. and Seldon A. (2014), Advertising in a Free Society, (with an Introduction by Christopher Snowdon), Hobart Paper 176, Institute of Economic Affairs, London, UK

Available for free download at: www.iea.org.uk/publications/research/advertising-in-a-free-society

AFRICAN DAWN

Can the continent become a success story?

Things are improving in Africa. But much deeper reforms are needed to guarantee the continent's lasting growth: **MARIAN L. TUPY** and **DALIBOR ROHAC**

Sub-Saharan Africa (hereafter Africa) has seen a marked improvement in economic performance in recent history.

In part, this is related to the global rise in commodity prices but also to domestic reforms, such as more prudent fiscal and monetary policies, privatisation of state-owned enterprises, and improvements in the business environment.

To sustain and accelerate the growth of African economies, deeper structural and institutional reforms are needed, as well as further progress in removing existing barriers to trade and investment on the continent.

The West can help too – by abandoning its agricultural protectionism, including the wasteful programmes of support of domestic agricultural production, which hurts agricultural sectors in developing economies.

The state of Africa

Between 2000 and 2008, real gross domestic product in Africa rose at an average annual rate of 4.9 per cent – twice as fast as in the 1990s.

Even in the aftermath of the financial crisis, African growth quickly rebounded to rates approaching 5 per cent.

As a result, between 1990 and 2010, the share of Africans living on $1.25 per day or less fell from 56 percent to 48 percent, while the continent's population almost doubled in size.

AFRICA REMAINS ONE OF THE LEAST INTEGRATED REGIONS IN THE GLOBAL ECONOMY… ITS PRIVATE SECTOR IS HOBBLED BY SOME OF THE MOST RESTRICTIVE BUSINESS REGULATIONS IN THE WORLD

If current trends continue, Africa's poverty rate will fall to 24 per cent by 2030.[1] Between 1990 and 2013, the per-capita calorie intake in Africa increased from 2,150 kcal to 2,430 kcal.[2]

The proportion of the population of African countries with access to clean drinking water has increased – from 48 percent to 64 percent in 12 years up to 2012.[1]

Many African countries have also seen dramatic falls in infant and child mortality. Since 2005, Senegal, Rwanda, Uganda, Ghana and Kenya, have seen child mortality decline by an annual rate exceeding 6 percent.[3] Still, these improvements have not been sufficient to overcome the enormous gap in income that has long existed between Africa and other parts of the world (see Figure 1).

What is holding Africa back?

Economic freedom is a prerequisite for economic growth and development. Notwithstanding the recent institutional improvements, Africa remains the least economically free region in the world.

All the main surveys suggest that many African countries lack functioning legal systems that protect private property.

Africa also remains one of the least integrated regions in the global economy and its private sector is hobbled by some of the most restrictive business regulations in the world.

The extent of trade protectionism in Africa, for example, is large. While between 1988 and 2010, the average applied tariff in high-income OECD countries fell from 9.5 per cent to 2.8 per cent, Africa saw a reduction from 26.6 per cent to 11 per cent. That is not a negligible decrease but it leaves the continent with unnecessarily high tariff protection, hindering trade.

According to the United Nations Economic Commission for Africa, Africa's total merchandise exports constituted only 3.3 per cent of the world's exports – less than in the 1970s.

Tariffs facing African exporters trading with other African countries are often higher than those facing African exporters selling goods to other parts of the world.

For 13 African countries, bilateral tariff costs for agricultural products are higher vis-à-vis their regional trading partners in Africa than they are with the rest of the world.

For manufactured goods, tariff costs within Africa are higher than with the rest of the world in the case of 25 African countries.

In addition to tariffs, a plethora of non-tariff barriers to trade exists in African countries, ranging from poor infrastructure, sanitary and phytosanitary rules, to corruption.

A recent study by the Rwandan Ministry of Trade and Industry reveals that, in order to reach the port in Mombasa, Kenya, a little over 1,000 miles from Kigali, a lorry driver must stop at 26 different road blocks and navigate eightweigh bridges.

At eleven of the roadblocks and at seven of the weigh bridges, officials request bribes, totalling an average of $846. The journey takes more than 121 hours.

And, as a World Bank economist noted in 2012: "in southern Africa, a truck serving supermarkets across a border may need to carry up to 1,600 documents as a result of permits and licenses and other requirements."[4]

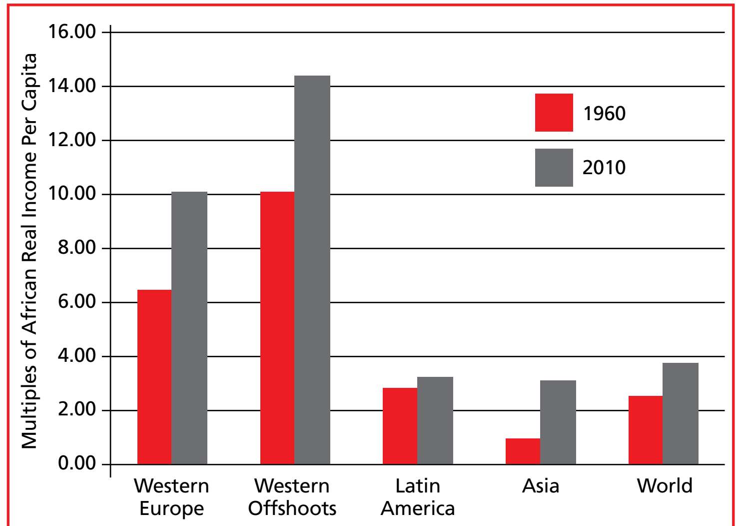


Figure 1: Real income of the Rest of the World relative to Africa (1960-2010)

Source: Bolt and Zanden (2013)

TO REACH THE PORT IN MOMBASA, KENYA, A LORRY DRIVER MUST STOP AT 26 DIFFERENT ROAD BLOCKS AND NAVIGATE EIGHT WEIGH BRIDGES

The way ahead

Besides strengthening the rule of law and governance, cutting red tape, and improving their business environments, African countries need to open to trade and investment.

Unfortunately, regional free-trade initiatives, such as the African Free Trade Zone, have not yet resulted in a significant reduction of trade barriers within Africa.

For most African countries, unilateral trade liberalisation can be a feasible and appealing alternative to protracted trade negotiations.

Developed nations can help too, particularly by eliminating the existing barriers to trade. These include tariffs, particularly on agricultural goods, which make it difficult for African economies to fully exploit their comparative advantage.

The structure of the tariff protection in the US and EU is a significant part of the problem. Once a given quota of imports is reached, tariffs can be very steep – in some cases up to 350 per cent.[5]

Furthermore, agricultural subsidies in rich countries cause surplus production which lowers world prices thus undermining the livelihood of farmers in poor countries.[6]

However, the West cannot solve the root cause of poverty in Africa. It is up to African governments to embrace the reforms that have made other regions of the world prosper•

Marian L. Tupy and Dalibor Rohac
Center for Global Liberty and Prosperity
The Cato Institute
mtupy@cato.org • drohac@cato.org

[1] Chandy, Ledlie, Penciakova (2013). [2] Food and Agriculture Organization of the United Nations (2014). [3] Demombynes and Reinikka (2012). [4] Brenton (2012). [5] Asmah and Routman (2011). [6] According to Thomas Beierle of Resources for the Future, overproduction in the developed world depresses world commodity prices by 12 per cent. Developed countries are also responsible for 80 per cent of the global price distortions in agricultural commodities. See Beierle (2002, p. 9).

HELPING HAND?

Does foreign aid work? The empirical evidence suggests most foreign aid is ineffective. Furthermore, aid tends to increase inequality within countries rather than helping the poor, says CHRISTIAN BJØRNSKOV

Despite widespread growth and unprecedented prosperity, almost a billion people live in absolute poverty. An entire industry has developed with the sole purpose of helping these people.

Yet, many commentators and politicians claim that still not enough is done. The United Nations has, for example, a stated goal that all rich countries ought to provide at least 0.7 per cent of their national income as foreign aid to poor countries.

In fact, richer countries have provided foreign aid to poor countries all over the world since the 1940s. Scandinavia is the region that has given the most relative to its size, although the United Kingdom was one of the pioneers of aid.

The very first foreign aid was provided to British overseas colonies in 1929 as a result of the Colonial Development Act, and the UK has recently reached the official UN goal. In 2013, the coalition government spent £11.4 billion on foreign aid, of which almost 40 per cent was given to African countries.

The rich countries in total spent more than £80 billion in 2013, one third of which went to Africa, which has, together with Asia, received almost £1 trillion in foreign aid since 1950.

If aid did what official agencies and politicians claim it does, one would perhaps expect Africa and Asia to both be economically thriving and fairly rich by now.

A patchy growth record

Yet, although some countries in Asia and Africa have done well in recent years – Ghana and Vietnam are often mentioned as models to copy – others are substantially poorer today than they once were.

Despite progress in the last decade, Zambian citizens today have only about 80 per cent of the purchasing power they had in the late 1960s. In countries such as the Comoros and the Democratic Republic of Congo, real incomes have been falling for decades.

While the typical African country has received about 5 per cent of their national income as foreign aid, Zambia on average has received double that level. Indeed, in several countries aid has financed almost half of all public consumption.

This raises the question of whether it is foreign aid that promotes development where it happens, or is it something else?

In fact, most independent research suggests that foreign aid has no positive consequences in the long run and that it may come with unintended and unwanted side effects.

Economic planning and economic development

In the aftermath of World War II, hopes ran high that the many European colonies, which were becoming independent in those years, would develop rapidly.

Official statistics coming out of the Soviet Union not only suggested that rapid economic development was possible, but also seemed to imply that communist command economies outperformed the free world.

Many believed that development could best be achieved by commanding massive investments in government-run industrialisation and that the more gradual and unplanned way that had led to Europe growing rich was too slow.

What the Soviet model and the growth theory of the day suggested as necessary were capital investments well in excess of those which could be financed by the relatively limited domestic savings in poor countries.

In addition, the Marshall aid received by Western Europe after the war provided an example of how substantial aid from richer countries could seemingly speed up modern development and sustain new democracies.

It was forgotten that the Marshall aid was intended to help European reconstruction after the massive destruction of World War II. In other words, its aim was to re-establish what had already been working before the war in a reasonably good institutional environment. The intentions of modern foreign aid are fundamentally different from those of the Marshall aid: it is mostly supposed to help poor countries develop and construct what had never been there. During the 1960s, many social scientists also started to realise that the theoretical foundations of aid were wrong and that the Soviet example was most likely a fiction. The British-Hungarian economist Peter Bauer famously described aid as transfers from poor people in rich countries to rich people in poor countries.

ZAMBIAN CITIZENS TODAY HAVE ONLY ABOUT 80 PER CENT OF THE PURCHASING POWER THEY HAD IN THE LATE 1960S

Clutching at straws

Despite the debunking of the original case for foreign aid, in the mind of the public and in political discourse, aid came to be seen as entirely indispensable for the development of poor countries until studies in the late 1980s began to shed more light on the subject.

Paul Mosley famously summarised the first findings as describing a micro-macro paradox: while about half of all aid projects work, aid does not seem to help entire countries.

Hristos Doucouliagos and Martin Paldam, who have surveyed the entire literature on the effects of foreign aid that has been published since 1970, conclude that most analyses show no effects from aid.

Although a number of researchers find that aid is associated with faster growth, other people working with similar data and methods tend to find no effects. The studies that find positive effects tend to be conducted by researchers with close ties to or funding from donor organisations.

Applying more advanced methods and distinguishing between democracies and dictatorships make no real difference to the results. Doucouliagos and Paldam conclude that, overall, aid is entirely ineffective in creating growth but they also note that their findings do not imply that all aid is ineffective.

Some of the most recent work indeed tries to ascertain whether particular types of aid work. Doing so first requires some way of dividing aid into different categories. This proves to be difficult.

Michael Clemens and colleagues for example argue on theoretical grounds that some types of aid work in a way that makes its effects visible within five to ten years. They find evidence that this ‘early-impact aid’ generates growth whereas other types of aid do not affect growth in any visible way.

What works, and what does not work?

In recent work I look at different categories of aid. The vast majority of foreign aid disbursed since 1970 can be divided into four groups: aid given with the aim of furthering economic development; aid with the purpose of furthering social development; reconstruction aid disbursed after wars and major natural disasters; and a residual category that includes small amounts of aid for other purposes.

EXAMINATION OF THE EVIDENCE SUGGESTS THAT ONLY RECONSTRUCTION AID IS EFFECTIVE

As Figure 1 shows, the shape of foreign aid has changed over the years. In the early years, most aid was given for economic development in line with the idea that rapid industrialisation was the key to development.

In more recent years, a growing share of aid has been given for social purposes such as education, healthcare and environmental protection.

Economic aid now accounts for less than a third of all aid. In addition, about 15 per cent of all aid has been for reconstruction after wars, major civil unrest or natural disasters.

Examination of the evidence suggests that only reconstruction aid is effective. When a developing country has suffered a war, civil war or natural disaster, inflows of reconstruction aid help get countries quickly back on their feet.

Interestingly, this type of aid is similar to Marshall aid which is also thought to have been helpful to post-war Europe. The remaining 85 per cent of aid flows in the other categories seem to provide no benefits.

In previous studies, it seems as if it is this inconsequential 85 per cent of aid flows that have dominated the results and overshadowed the 15 per cent of aid that had some benefit.

Does aid help the poor most?

We could, of course, ask whether it is only growth that matters. Might it be possible that foreign aid helps the poor whilst not affecting growth?

For example, it might change the distribution of incomes in poor countries? However, a new study by Dirk Herzer and Peter Nunnenkamp finds no evidence of such a positive effect.

Instead, when comparing 21 countries across a long period of time, they find that countries receiving more aid develop a more uneven distribution of income, consistent with Bauer’s claim that aid mainly helps rich people in poor countries.

While more work on poverty reduction is evidently necessary, what little research has been done suggests that aid funding may tend to end up in the hands of the wrong people or at least sets in train forces that benefit richer people more than poorer people.

The depressing conclusion of more than 40 years of research is therefore that although some types of aid work under some types of conditions, it does not do what it was intended to do: help poor countries grow faster and lift people out of poverty.

At best, our financial aid to poor countries can help them overcome disasters in the same way as US aid helped Europe find its footing again after World War II.

Christian Bjørnskov
Professor of Economics
Aarhus University
chbj@econ.au.dk

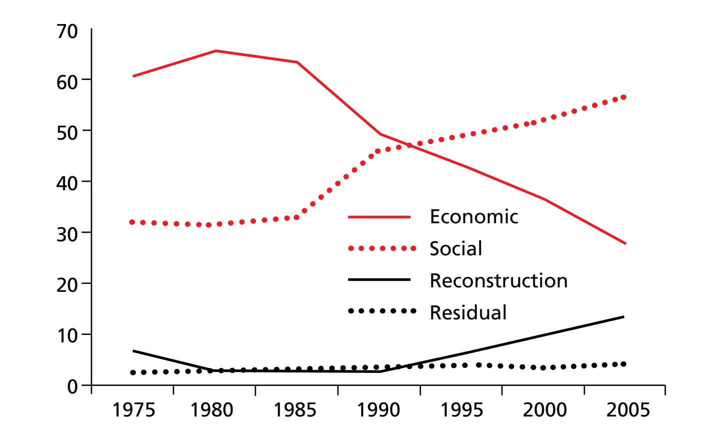


Figure 1: Shares in total foreign aid of different types of aid 1975-2005

FASCISM VERSUS CAPITALISM

The shadow of economic fascism

LLEWELLYN H. ROCKWELL ***THE MISES INSTITUTE 2013***

About 30 years ago I wrote a book with the edifying title of "95 Per Cent is Crap: a Plain Man's Guide to British Politics". It was recommended by F. A. Hayek. Many years later I wrote a follow-up text.

It is not surprising that Ludwig von Mises was my staple diet from then on. However, despite this, only recently have I read a few books which cover the contrast between fascism and capitalism.

Several of these books provide wonderful insights for those interested in economics and politics.

An important first question when dealing with this subject is to define what actually is fascism? And how does it compare with capitalism?

Most people would probably be stumped by this question, simply because they do not understand fascism at all.

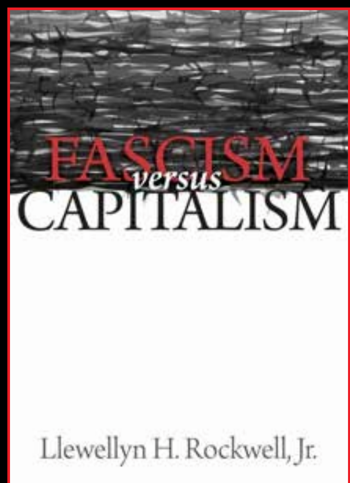
The book *Fascism versus Capitalism*, by Llewellyn H Rockwell, is a goldmine, as he sets out the eight marks of fascist policy, building upon what was originally set out by John T Flynn, the American journalist, who wrote *As We Go Marching*, published in 1944.

Flynn immediately turned to the incredible collaboration between right and left. The collaboration between people of the extreme right and left arose because both urged for more regulation in precisely the same statist direction.

Hence, it was argued, the economic system must be controlled by cartelised producing groups.

The part that best sums up the essential message of the book is Rockwell's recovery of and commentary on Flynn's list of eight key points taken to be the hallmarks of fascism.

These points are listed below with comments on the contemporary US situation added where appropriate:



- Government is totalitarian, acknowledging no restraint on its powers. On this point, Rockwell argues "all of us today are but one step away from Guantanamo"
- Government is a de facto dictatorship based on the leadership principle. The executive state in the US is such a state with all directions flowing from the White House down. The role of the courts is to a large extent to enforce the will of the executive
- Government administers a capitalist system with an immense bureaucracy. The planned economy is the heart, lungs, and veins of the planning state
- Many producers are organised into cartels in the form of syndicates. In the US giant banks, pharmaceuticals, insurers and car companies have all worked closely with (and often within) the state apparatus
- Economic planning is based on the principle of national economic self-sufficiency. This requires a big state to support expansionism. This is often at the core of US energy and agriculture policy
- Government sustains economic life through spending and borrowing
- Militarism is a mainstay of government spending
- Military spending has imperialist aims

The technical distinction between fascism, in which enterprises are nominally in the private sector but are state-directed and communism, in which "enterprises" are clearly state-owned, can be illustrated by remembering the US's National Industrial Recovery Act (NIRA).

This was passed in 1933 – as it happens when Mussolini was at the peak of his powers and international reputation. Under the NIRA, the President gained very significant powers over the economy. This set the stage for massive state-corporate regulation.

In a sense this was nothing less than economic fascism, primarily promoted by American businessmen in tandem with the government.

If we think carefully, I suggest that this is not a million miles away from the UK's situation today.

The distasteful and racist overtones are not there but there are many areas where strategic economic policy and control of sectors such as education are beginning to look somewhat like the economic side of fascism.

Terry Arthur
IEA Fellow
terry@tgarthur.co.uk

THE OPEN SOCIETY AND ITS ENEMIES

A powerful defence of liberalism

KARL R. POPPER ***ROUTLEDGE & KEGAN PAUL, 1945***

Karl Popper was born in Vienna in 1902. He died as Sir Karl Popper in 1994, a proud British subject. His works were mainly focused on the philosophy of knowledge and science.

He became highly influential – perhaps more so amongst scientists than professional philosophers. Nevertheless, his brief incursions into political thought – *The Open Society and Its Enemies*, in 1945, and *The Poverty of Historicism*, in 1957 – bestowed upon him worldwide fame.

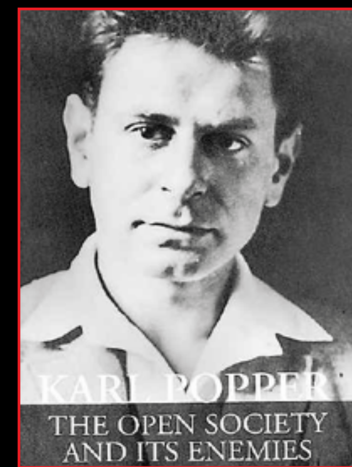
Popper wrote *The Open Society and Its Enemies* between 1938 and 1943 during his voluntary exile from Austria. He could not immediately find a publisher, however, and it was Ernst Gombrich and F. A. Hayek, in London, who managed to get the book published by Routledge & Kegan Paul, in 1945.

Karl Popper presented this book as a defence of liberal democracies. According to Popper, the twentieth-century conflict in which liberal democracies were opposed to Nazi and Communist regimes was similar to the conflict between the Athenian democracy and Spartan tyranny.

In chapter 10 of *The Open Society*, Popper wrote a powerful and moving defence of the ideal of the open society, referring to its origins and to the commercial, seafaring, democratic and individualistic civilisation of the fifth-century BC Athenian enlightenment.

In the book, Karl Popper launched a fiery attack on three great philosophers considered by him as the main enemies of the open society: Plato, Hegel and Marx.

He attributed to them, in different degrees, the promotion of poisonous ideas that have been responsible for the attacks on the open society: historicism,



collectivism, ethical positivism and utopianism.

These views share the same animosity against the principles of liberty and personal responsibility that Popper defined as the core of the open society.

Being a committed defender of liberal democracy, Popper was also a forceful critic of the so-called principle of "popular sovereignty".

Democracy, he argued, is not about "who should rule" but about much more fundamental questions: how to avoid tyranny and how to allow change without bloodshed.

Western democracies are the result of a long process of limiting power. The rule of law and constitutional government have been crucial elements of this process.

As in the *Federalist Papers* or in Edmund Burke's views of accountable government, Popper's theory of representative government defines it as one of the instruments to limit power, and not as a source of absolute power to be transferred from one, or from the few, to all.

There is a clear analogy here with Popper's theory of knowledge, where the sources of knowledge do not retain ultimate authority: the emphasis is given to the tension between rival proposals in the attempt of mutual refutation between conjectures.

For this reason, Popper also argued that the most adequate electoral system for this vision of democracy is a majority system based on uninominal circles, as opposed to proportional systems of representation based on party lists.

The former is the prevalent system among the English-speaking peoples, whom Popper thought were a sort of bulwark of freedom in the modern world.

In 1961, Karl Popper decided to include an addendum to the 1945 edition of *The Open Society*, entitled *Facts, standards, and truth: a further criticism of relativism*.

In this essay, Popper presents his theory of "fallibilistic absolutism": a view that combines the defence of the existence of an objective and absolute standard of truth with recognition of the fallibility of the criteria to identify the truth.

This can be similarly applied to the moral realm, although Popper recognised that the concepts of "good" or "justice" are obviously more complex than the concept of "truth".

However, he argued, we can also learn from our mistakes in the realm of moral standards, and we can also seek more demanding moral standards.

He believed that this was a fundamental characteristic of liberalism which involves searching for ever better standards, especially in the field of politics and of legislation.

João Carlos Espada
Director, Institute for Political Studies
The Catholic University of Portugal

RENT CONTROLS

A red herring in the cost of living debate

One cannot possibly begin to address the high cost of living in the UK without examining the state of the housing market.

Average rent levels across the country for those in the private rented sector are equivalent to 41.1 per cent of weekly gross household income. The problem is particularly acute in London.

In this context, it is understandable that policymakers are concerned about the plight of renters.

Unfortunately, rather than seeking to address the underlying reason for high rents – namely, planning controls – many are advocating a return to some form of rent control.

We can be thankful, however, that very few suggest returning to the sort of disastrous 'first generation' rent controls which were common through the 20th century.

Setting rents below market rates reduces the quantity of private rented accommodation available.

In Britain, for example, the private rented sector collapsed from nine-tenths of the housing stock at the start of the 20th century to just one-tenth during the time rent controls were imposed.

There were also substantial observed costs in terms of lowering the quality of accommodation available, the misallocation of property and reduced labour mobility.

Interest groups and politicians now advocate what are known as 'tenancy rent controls'.

This might involve a system where there would be complete freedom of rent setting between tenancies, but within tenancies rents would be benchmarked so that increases were linked to average increases within a locality, some measure of inflation, or both, during a three-year fixed contract. This, it is said, would help families, given the current high cost of living.

IT IS UNCLEAR THAT 'TENANCY RENT CONTROLS' CAN HELP REDUCE THE COST OF RENTING

These regulations would clearly not be as damaging as first generation controls. But it is unclear that 'tenancy rent controls' can help reduce the cost of renting.

Since rents would be able to adjust between tenancies, this sort of rent control can do nothing to improve affordability in anything other than the very short term.

Indeed, landlords may 'front-load' rents to compensate them for lower rents later in the contract.

And the existence of the controls themselves is likely to increase overall market rents by increasing regulatory uncertainty and reducing the ability of landlords to use turnover to manage risk – thus raising the returns landlords will want from property.

Advocates of these sorts of controls like to point to the fact that something similar operates in Germany, where the market is regarded as tenant friendly.

But Germany has a much more sensible planning regime which allows substantial development of new dwellings. As a result, house prices there have actually fallen over the past 30 years.

Rent controls are a good example of how we continue to debate policies which treat the symptoms of problems rather than addressing the problems themselves.

Ryan Bourne
Head of Public Policy
IEA
rbourne@iea.org.uk

Full version at:
www.iea.org.uk/blog/rent-controls-%E2%80%93-a-red-herring-in-the-cost-of-living-debate

MAKING THE WORLD A BETTER PLACE

It is easy to pick up a newspaper, watch television or look on a blog and assume the end is nigh - foreign affairs crises, demographic time bombs, debt icebergs and so on. Are things getting worse, has capitalism failed?

Happily, they are not and it hasn't. Thanks to capitalism, free trade and globalisation we live in the most prosperous, healthy, safe, equal and free period in human existence.

Across the globe we are seeing remarkable falls in worldwide poverty, hunger, disease, inequality and (despite current humanitarian disasters) deaths from war and natural disaster.

Over the past 50 years, the fall in poverty has improved the lives of hundreds of millions of people.

More than 500 million Chinese have been lifted from poverty since Deng Xiaoping's enactment of the Four Modernisations starting in 1978.

Today the GDP of Mozambique is 60 per cent larger than it was in 2008. India, Vietnam, Peru and Rwanda have all experienced the benefits of reforms to their economies even though there is still very much to do.

Freer trade has enabled more consumers to afford better food (for example, the level of meat consumption in China has doubled since 1991) as well as afford items

IT IS WORTH STOPPING AND APPRECIATING HOW FAR WE HAVE COME

that would have been considered luxuries only decades ago.

In human health we have seen an almost unbelievable improvement over the past fifty years.

We have eradicated smallpox, cases of polio have been cut to the low hundreds (down from 350,000 in 1988), the incidence of tuberculosis has been halved (since 1990) and cases of measles have fallen 71 per cent. Infant mortality has fallen dramatically as well. There are more than 7,200 fewer infant deaths every single day than in 2000.

The reason for pessimism lies not in this incredible improvement in living standards, but in governments around the world retreating from free markets and free trade.

Trade barriers often hurt the world's most vulnerable – protecting comparatively wealthy westerners at the expense of poor farmers from Asia and Africa.

For many people, life is still 'nasty, brutish and short', and there is still much to do.

Government debt and the growth of the state risk undoing the gains from the development of market economies. Increasingly illiberal legislation affects our ability to interact and trade with others.

But in the great march of human civilisation, from slavery to freedom; from castes to social mobility; from dictators and kings to presidents and parliaments, it is sometimes worth stopping and appreciating how far we have come – especially in the last three decades.

Sam Collins
Director
Age Endeavour Fellowship
scollins@iea.org.uk

Full version at: www.iea.org.uk/blog/cheer-capitalism-and-free-trade-have-made-the-world-better

UK ENERGY POLICY

WHEN THE LEFT HAND DOESN'T KNOW WHAT THE FAR LEFT HAND IS DOING...

It has long been one of my personal gripes that the UK spends a large amount of money on energy market interventions to reduce carbon emissions whilst simultaneously providing domestic consumers with an effective (approximately) 15 per cent subsidy by exempting energy from the full rate of VAT.

It is a bit like a group of cabinet ministers trying to push a boulder uphill whilst the prime minister has quietly sent another group of ministers to the top of the boulder to push the other way.

A new report from the European Commission[1] shines a bright light on the problem of energy market interventions: their total cost across all member states is estimated at over €120 billion.

Just under 40 per cent of these interventions by cost are in the form of subsidies for renewables. Of course, green groups normally support renewable subsidies because they increase demand for renewables compared with carbon-intensive energy production. However, this approach is mistaken.

Renewables do not have a 'negative social cost' (or positive social benefit) that would justify a subsidy. At best, they have a zero social benefit or cost.

The neutral position is not to tax or subsidise them any more than any other product or service.

Some would argue that renewables have lower social costs than carbon-intensive energy forms, but that is an argument for taxing

THE TOTAL VALUE OF OUR GOVERNMENT'S SUPPORT FOR ENERGY CONSUMPTION IS OVER £13 BILLION

carbon intensive energy forms and not for subsidising renewables.

But, of course, governments being governments are inclined towards sub-optimal policies. Governments subsidise the consumption of those forms of energy that they believe will lead to the greatest 'market' failure of all time (man-made climate change).

And the interventions in the UK market are greater than the interventions in any other market in the EU other than Germany. The total value of our government's support for energy consumption is over £13 billion.

Most of the UK interventions (about 60 per cent) come in the form of support for energy demand. This is made up largely of the exemption of domestic energy consumption from VAT.

Basically, this exemption boosts demand for various forms of fuel, the consumption of which, it is widely believed, leads to huge social costs. As a result, we then believe we have to boost the demand for less damaging forms of energy through other subsidies.

Why are we subsidising through tax exemptions the use of something of which we are trying to reduce consumption? Does the left hand of government know what the far left hand is doing?

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

[1] Subsidies and Costs of EU Energy, http://ec.europa.eu/energy/studies/doc/20141013_subsidies_costs_eu_energy.pdf

Full version at: www.iea.org.uk/blog/uk-energy-policy-when-the-left-hand-doesn%E2%80%99t-know-what-the-far-left-hand-is-doing


SOUNDBITE
Soundbite
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DRUG PRICING: A primer

In November, Tufts University published its latest analysis of drug research and claimed that it costs roughly $2.5 billion to make a new drug.

The average time a drug takes from discovery to laboratory testing and clinical trials, is more than a decade, and the vast majority of targeted chemicals never make it to the market.

The Tufts analysis allows for the costs of the failures as well as the successes. The figure was roundly attacked by health and anti-capitalist activists as being far too high, and in Washington DC the debate raged for days.

Drugs are not unique goods, but they are unusual, and the way they are produced and the costs of that production mean that there are always disagreements about how to price drugs.

The pricing of pharmaceutical drugs is not a simple function of supply and demand: production is highly regulated, which affects costs greatly; and ensuring access to some drugs is widely perceived as a moral issue.

Prices need to be higher in industrialised countries in order for pharmaceutical companies to recoup the costs of production, as well as to provide an incentive for further innovation.

The costs of research and development must be shared across the myriad drug markets, with the richer paying significantly more than the poor, and those in the middle contributing more than the poorest

The goal of distinguishing between markets when setting prices is ultimately to reconcile patents – which are necessary for innovation – with the affordability and accessibility of these drugs in poor countries.

In technical language, in order to recoup research costs, companies need to charge more in countries in which demand is more price inelastic and charge less in other countries. The various markets, however, need to be kept apart or the strategy will not work.

While it costs hundreds of millions of pounds to produce the first pill of a new drug, the marginal cost of producing additional pills is very low.

Therefore, a traditional pricing system that charges consumers the marginal cost of the drug would not take into account the high research and development costs that the firm incurred.

A system of competition regulation (or other government action under pressure from activists) that imposed pricing at marginal cost would simply mean that there would be no research and the supply of drugs would dry up. These problems are best dealt with when producers can charge different prices to different people.

Simply put, those who are able and willing to pay more (normally the wealthier) are charged a higher price, while those who can or will only pay less (normally the poorer) are charged a lower price.

If this strategy is successful, and those receiving the lower prices cannot resell to those willing to pay more, then the company will get higher profits than it would by setting a single price – and more poor people will receive drugs.

Studies show that this form of differential pricing leads to a more socially efficient outcome.

In the context of the pharmaceutical market, differential pricing allows pharmaceutical companies to produce more drugs than would be possible in a single-price system, thus giving patients in developing countries greater access to life-saving drugs.

Profits incentivise and finance more research and development. The pricing model ensures that middle- to high-income countries bear most of the research and development costs, while affording low-income countries greater access than otherwise would be the case to the safe, effective drugs they need.

However, such differential pricing of drugs has numerous opponents. Americans often believe they pay too much; and many health activists are still annoyed that the poor pay more than the marginal cost of production for HIV/AIDS medicines. But, both in theory and practice, differential pricing is both equitable and efficient.

Roger Bate
American Enterprise Institute
rbate@aei.org

STRETCHING the BUDGET: Should the state support the arts?

Those who wish to cut government arts funding are often branded "philistines". But there is a difference between appreciating the arts and believing that the state should support the arts.

Economic arguments in favour of state funding often revolve round "public good" or "externality" effects. In other words, it may be difficult to exclude those who do not contribute to the arts from the benefits they provide; or there may be social benefits from the arts leading them to be under-provided. But, did the arts thrive before 1946 when state funding took off?

In fact, England's rich cultural tradition developed free of government funding and it often had a commercial edge, suggesting that the arts can thrive in a market economy.

In the 16th century we had commercially successful and popular English theatre, including Shakespeare. Although Shakespeare had the patronage of the monarch, this was much more like the royal warrant that a shop might receive rather than financial support. Shakespeare was commercial.

Indeed, it is interesting to note that, even today, whilst the Royal Shakespeare Company is 50 per cent funded by the state, the Globe theatre stages Shakespeare plays with no subsidy.

In 17th century Britain, the public concert developed and 18th century London was a hothouse of composers. The Hallé Orchestra, the Royal Albert Hall, Gilbert and Sullivan, and the Fitzwilliam are all great cultural creations from the era of subsidy-free culture. Elsewhere, Chopin, Bach and the Dutch masters all paid their own way.

There can be a thriving commercial arts scene without state funding. The economic arguments at best can be used to justify the position that certain types of arts might be "under-provided". But we should also consider that state provision of the arts might lead to problems.

Firstly, with state finance, we will often get the arts that the government wants and not the arts that the people want. This is especially problematic as culture is an important part of civil society which can be used for communicating all sorts of moral and political messages.

Secondly, arts funding can be captured by other interests – such as those leading big, high-profile projects centred on London or the administrators of the funding bodies.

Much arts funding goes through the Arts Council. It has slimmed down its operation under much pressure from recent budget cuts but, until recently, the Arts Council spent about as much on administration as it did on arts in three of the nine main regions of England put together. 50 per cent of all funding went to London and the regions got the crumbs.

Furthermore, even after much resisted staff cuts, the Arts Council will have nearly one employee for every £1m given out in grants; in 2008 it had 50 press and communications staff – effectively all paid advocates of state funding.

State funding also crowds out private funding, which is pitifully low in the UK compared with the US.

The removal of user charges from museums not only removed an important source of revenue, but also has the effect of making museums less interested in their visitors and more interested in the bureaucracy that funds them. Few other European countries have totally removed admission charges from museums for good reason.

State funding can also raise costs. Performers are highly "inelastic" in their supply, just like footballers. When Sky TV pumps more money into football, footballers are paid more. The same happens to artists when the government pumps money into the arts: it can be the cost and not the supply that increases.

What might be the best solution? If there is to be state support for the arts at all, it is probably best provided at local level. This is less likely to lead to a monoculture in the arts and ensures greater variation in what is provided.

Secondly, perhaps the lottery is a reasonable source of funding. This is voluntary: those who buy a ticket are choosing to support the arts.

But, our history shows that arts and culture can develop independently of the state.

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

SUCCESS and the CITY

Last year I co-ordinated a report for the World Economic Forum on the competitiveness of cities. We compiled case studies of cities around the world – cities with different endowments and at different stages of development

Urbanisation is the "megatrend" that is most relevant to city competitiveness. Never before has the world urbanised at such speed and scale as it is doing today.

As of 2010, for the first time in history, over half the world's population lives in cities. But they already account for over 80 per cent of global GDP. According to the UN, globally, an extra 2.5 billion people will urbanise by 2050.

For the foreseeable future, rapid urbanisation will be an almost-exclusively non-Western affair: 94 per cent of those who will move to cities in the next few decades will come from the developing world.

What makes cities successful?

Institutions are vital to a successful city – that is, the decision-making framework of the city. Leadership and vision – a clear, far-sighted view of where cities should head, and a single-minded practical will to ensure they get there are also important: Lee Kuan Yew in Singapore, Sheikh Mohammed in Dubai, Sergio Fajardo in Medellin, Colombia and S.R. Rao in Surat, India, are stellar examples.

Hong Kong and Singapore highlight the importance of building up sound economic institutions through successive phases of development. But Monterrey in Mexico and Cebu in the Philippines point to fragile institutions that can endanger existing gains as well as future competitiveness.

Cities should also look out for windows of opportunity – often during a political or economic crisis – to push through a critical mass of decisive reforms. This is what happened when Singapore was ejected from Malaysia in 1965.

There should also be a sound regulatory framework. Getting the basics right – stable and prudent fiscal policies, including low and simple taxation; a flexible labour market; openness to trade and foreign investment; simple and transparent business regulation – is vital. Cities should develop their own policies on trade, foreign investment, tourism and attracting talent, and go global as far as they can. Hong Kong, Singapore, Dubai, Hyderabad and Ahmedabad in India, and Ningbo in China are great examples.

AN EXTRA 2.5 BILLION PEOPLE WILL URBANISE BY 2050

Thought also needs to be given to the city's core physical infrastructure. Cities need a mix of planning (in terms of "rules of the road") and organic growth, which are complements, not substitutes.

Manhattan is a great example with its street grid and room for organic expansion over the past two centuries. Brasilia, Chandigarh in India, and many Chinese cities today are counter-examples of over-planning.

Urban density, including "building tall" in city centres, is preferable to urban sprawl. Hong Kong and Singapore are great examples of urban density, as is Chicago in recent years.

Education, health care, digital infrastructure, the arts and culture all need innovative market approaches to boost cities' human capital and quality of life. Not least, an "open society" – tolerance, freedom of expression and cosmopolitanism – is the city's seedbed of ideas, entrepreneurship, innovation and growth – as the most successful cities in the West have shown.

The renowned urbanist Jane Jacobs said that successful cities are those that are flexible and adapt quickly to changing conditions. The alternative, like Detroit, is to get stuck in mono-industrial, mono-cultural decline.

Economic freedom is the prerequisite. Cities will have different priorities depending on their endowments, levels of development and other initial conditions. But "getting the basics right" and expanding economic freedom should be the common denominator for all cities.

The best thing going for cities is that reforms at the municipal level are usually more feasible than at the national level.

That is the premise behind Paul Romer's idea of "charter cities" – start-up cities that import rules based on the freedom of individual choice and movement.

Urbanisation trends enlarge these possibilities. Cities should grasp these new opportunities and put reforms on a fast track.•

Razeen Sally
Director, European Centre for International Political Economy
Razeen.sally@ecipe.org

Institute of
Economic Affairs

IEA, 2 Lord North Street, Westminster, London SW1P 3LB
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