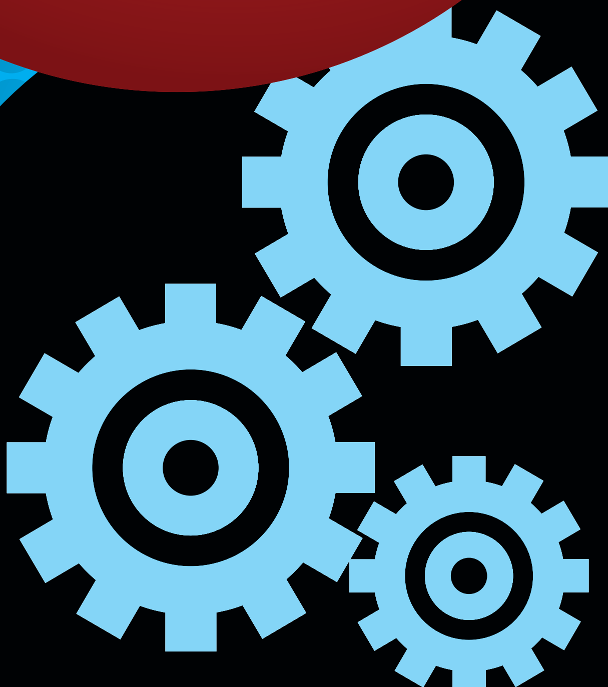
EA

From the Institute of Economic Affairs

Issue 9 £3.75

ASSESSING TRUMP'S IMPACT



THOUGHT CONTROL

Can behavioural economics justify government intervention?

PLUS: ART LAFFER, AUSTERITY and more in our TAX SPECIAL

WELCOME

This past year has seen a **tide of tumultuous events** which surprised many...the Brexit vote, the US presidential result – and Leicester City winning the Premiership (though that now seems a distant memory!).

All this has created a **climate of risk and uncertainty**. Pollsters have been wrong-footed, politicians shaken to the core and economic forecasters have hardly covered themselves in glory.

And that uncertainty is mirrored in several of the articles in this edition of **EA** – we reflect on the **global economic** and **political implications** of **Donald Trump's presidency (p58)**; contemplate **Cuba after Castro (p52)** and ponder the **price of protectionism (p53)**. And, in our cover story, we ask **whether behavioural economics should be used to justify government intervention (p26)**.

But some things do remain more predictable, if not exactly reassuring. As long ago as 1789, Benjamin Franklin, one of the founding fathers of America, said: "...in this world **nothing can said to be certain, except death and taxes**".

And whilst we don't want to dwell on the former, we do concentrate on the latter.

Starting on **page 4**, we feature a series of articles **exploring the links between taxation, government spending and economic growth** – including calls for **radical tax reforms** and an enlightening – and entertaining – interview with **Art Laffer**, the man behind the famous **Laffer curve**.

But one thing is absolutely certain. At 64 pages, this is the **biggest-ever issue** of **EA** – and I trust you'll find it **packed with informative, enlightening and thought-provoking material**.

Philip Booth
Editor
March 2017

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This edition of **EA** magazine was made possible, in part, through the support of a grant from the John Templeton Foundation.
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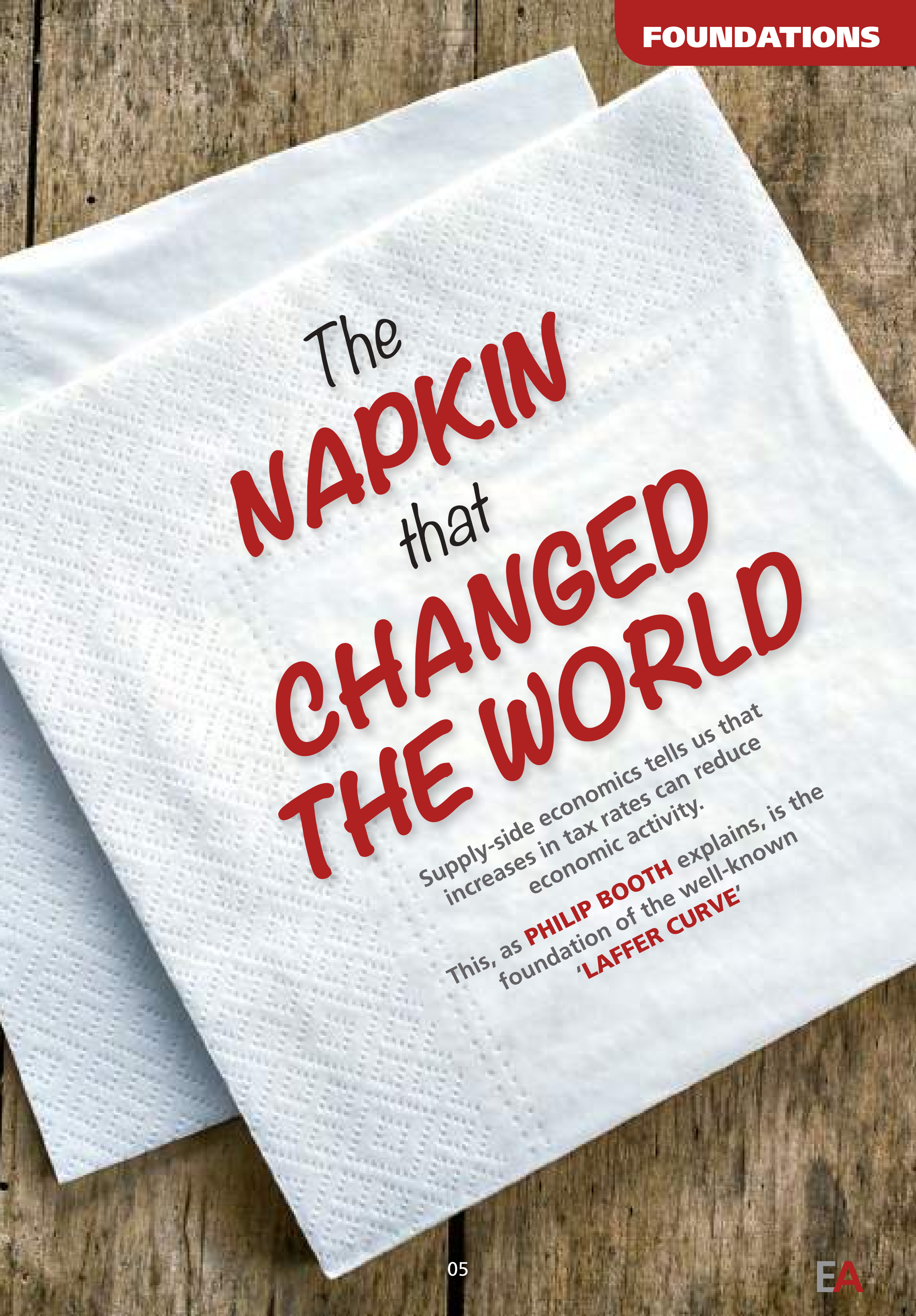
THE TAX ISSUE

Examining the UK's complex taxation system – and its impact on the economy

The TAX ISSUE

Across the next 20 pages, we examine the impact of taxation and government spending on economic growth – and put forward radical calls for reform of the UK tax system. Read on...



The NAPKIN that CHANGED THE WORLD

Supply-side economics tells us that increases in tax rates can reduce economic activity.

This, as PHILIP BOOTH explains, is the foundation of the well-known 'LAFFER CURVE'

Introductory economics often includes the idea of 'supply-side' reforms and the 'Laffer curve'.

Interest in these ideas increased in the 1980s (much earlier in the US) because the emphasis on Keynesian income-expenditure models of the economy seemed not to explain the malaise of the 1970s.

Supply-side reforms are normally thought of as economic policies that increase the supply capacity of the economy – or, in the jargon of A-level economics, they move the aggregate supply curve to the right.

This might include welfare reforms that increase incentives to work, the liberalisation of regulations that reduces barriers to employment or changes to the tax system. This article focuses on the tax system.

The Laffer curve

Supply-side effects in the tax system are often illustrated using the Laffer curve.

The Laffer curve shows the relationship between tax rates and tax revenues. Underlying the curve is a trade-off that might occur between government spending, taxation and economic growth.

Some government spending can increase economic growth. At the very least, defence, law and order and a well-functioning legal system are necessary for a thriving business economy.

However, at some point the ability of the government to find spending projects that will enhance growth will be exhausted. Furthermore, the effect on growth of the taxes necessary to finance spending is likely to increase with the level of tax.

So, at quite moderate levels, increases in government spending and taxation will reduce economic growth.

Eventually, the impact of additional taxes on growth may be so large that the fall in growth caused by raising taxes further will actually lead to a drop in tax revenues.

In other words, attempts to raise taxes further will actually reduce tax revenue and consequently lead to a reduction in the resources available for government spending.

The higher marginal rates of tax will generate no net revenue because of the shrinkage of the tax base caused by the extra taxes. We call this point the top of the Laffer curve.

Indeed, this shrinkage of the tax base can be caused by a number of factors and not just by lower economic growth. Other factors can include higher levels of illegal tax evasion; higher levels of legal tax avoidance; and lower levels of inward investmen.

The original Laffer curve arose from a discussion between Art Laffer and US government officials Dick Cheney and Donald Rumsfeld. Laffer sketched the curve on a napkin as shown in Figure 1.

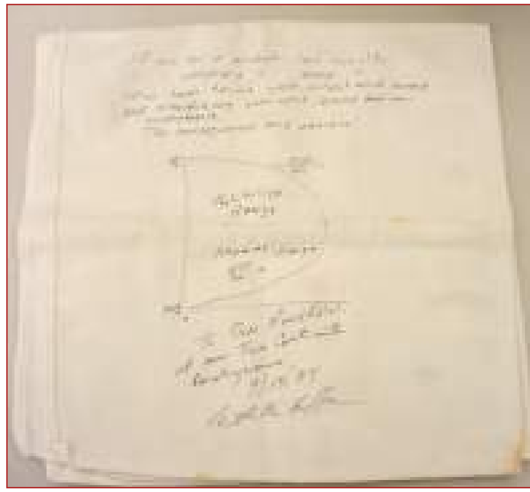
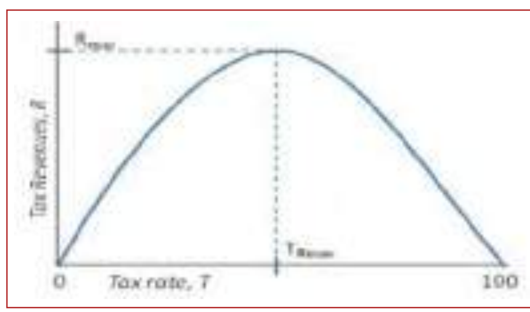


Figure 1 – The 'original' Laffer curve

An easier version to understand (with the tax rate on the horizontal axis and tax revenues on the vertical axis) is shown in Figure 2.

Figure 2



Estimating the top of the Laffer curve is complex and there is no clear consensus about where it lies. The Laffer curve is often used in discussions about what the average tax rate should be in the economy (that is the percentage of national income that is taken in taxation). However, it probably makes more sense to apply it to individual taxes.

The impact of different tax rises on revenues

In the UK, we have dozens of different taxes some of which are better designed than others and which are all charged at different rates. Whether an overall rise in taxation increases tax revenues will depend on which tax is raised.

For example, if VAT were increased slightly, it is highly likely that there would be an increase in revenue. It is a tax that is difficult to avoid and evade and it is spread across a broad base of taxpayers.

However, if the government were to try to raise the same amount of revenue by increasing inheritance tax or the top rate of income tax, it might fail to do so.

Firstly, such tax rates are already high. Secondly, the people affected are likely to change their behaviour (work less, invest less,

THERE ARE HISTORICAL EXAMPLES OF SIGNIFICANT INCREASES IN TAX REVENUES WHEN HIGH MARGINAL TAX RATES HAVE BEEN REDUCED

find avoidance mechanisms and so on).

In economic jargon, the people affected have a higher elasticity of supply – so their behavioural changes are more likely to undermine the government's efforts to raise more taxes.

In Figure 2, we can think of VAT (at current rates) as being a tax that is likely to be on the left-hand side of the Laffer curve, but the top rate of income tax and inheritance tax as being closer to the top of the Laffer curve (either on the right hand side or left hand side).

Indeed, when the UK government reduced the 50 per cent top income tax rate to 45 per cent in 2013-14, it conducted a serious analysis of the impact on tax revenue that might result from individuals changing their behaviour as a result of the change.

Their analysis suggested that, if there were no change to behaviour, the Treasury would lose around £3.5 billion as a result of reducing the top tax rate.

However, the Treasury found that this fall in revenue was more or less entirely cancelled because people would work more, there would be more investment in education and training and less tax avoidance and evasion.

In other words, we can say that the old 50 per cent tax rate[1] was more or less at the top of the Laffer curve – a reduction in the rate made no difference to revenue. Indeed, there are historical examples of significant increases in tax revenues when high marginal tax rates have been reduced.

Should governments aim for the top of the Laffer curve?

The 'top' of the Laffer curve is often described as the optimal level of taxation and government spending. It is not.

The top of the Laffer curve is the level of taxation that will maximise government spending. Any further attempt to increase tax rates beyond this level will be self-defeating – the government would be shooting itself in the foot because higher tax rates would lead to lower revenues.

The 'optimal' level of government spending and taxation is the point at which economic welfare is maximised. This cannot be accurately estimated, not least because it is impossible to calculate welfare at the national level.

However, there are certain things that the government might need to provide to ensure the right background for economic growth

Then, beyond this, there may be other things that we want the government to do (provide income transfers to the poorest, mental health services and so on) that might be insufficiently provided in the private sector and that will raise welfare further.

This takes us into an entirely different area of debate. However, the important point is

THERE MIGHT WELL BE MANY INDIVIDUAL TAXES WHERE REDUCTIONS IN RATES ACTUALLY YIELD INCREASES IN REVENUES

that politicians might well try to maximise the tax take from the country, whereas welfare is likely to be maximised at a much lower level of taxation and government spending.

Even so, there might well be many individual taxes where reductions in rates actually yield increases in revenues•

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[1] It should be noted that a 50 per cent income taxpayer (now 45 per cent) paid a much higher rate of total tax. The 50 per cent just referred to income tax. There are then other taxes such as consumption taxes which lead the total tax at the margin on higher rate taxpayers to be much higher.

BONFIRE of the INANITIES

Britain's tax system is not fit for purpose. We should think again about the principles that should underlie it and introduce radical reform. And such reform could actually benefit the poor more than the rich, says RORY MEAKIN

Most of us believe that some tax is required to fund government spending and some taxes are better than others.

Given this starting point, how might economists weigh up whether a tax system is a 'good' system or a 'bad' system?

In this article we look at the principles which underlie a good tax system, what taxes emerge from those principles (and which existing taxes would not), and what implications the implementation of such a system would have across income groups.

Principles

The principles on which a tax system should be based were laid out by Adam Smith in 1776 and have largely stood the test of time.

They are: certainty, proportionality, convenience and efficiency. In summary, taxes should be known in advance, levied in proportion to ability to pay, payable in a convenient manner and inexpensive to administer.

These principles are sound, but further insight has been gained subsequently by economists including N. Gregory Mankiw and Sir James Mirrlees. Using their ideas, we can propose reformulating Smith's lessons as follows:

1. Taxes should be as transparent as possible, a core component of which is certainty.

2. Taxes should be as neutral as possible, thus applying the same tax at the same rate to different activities wherever possible.

3. Marginal tax rates should be as low as possible, except for taxes designed to ensure people pay for 'externalities' caused by their behaviour.

Simplifying the UK tax system

How would applying these principles change the UK's current tax system?

Firstly, it would be radically simplified to maximise transparency and neutrality. So there would only be a single income tax, at a single rate, on all income types, however received.

Corporation tax, national insurance and capital gains tax are all, fundamentally, variations of income tax and should all be abolished.

Distributed profits (such as dividends) should be taxed like any other income. National insurance is effectively a duplicate income tax and has no useful distinct function. And capital gains often arise from investors anticipating increases in the income an asset will produce and that will be taxed in the future - therefore capital gains tax is normally a double tax and should also be abolished.

Inheritances can be viewed as a transfer of income from one person to another. However, the income that is transferred has already been subject to income tax and should not be taxed again.

Transaction taxes such as stamp duty on shares and property depress values, gum up markets and lead to assets and houses not being held by those who value them most. They should be abolished, along with business rates, which arbitrarily push business into unnecessarily cramped use of property.

So-called 'Pigouvian taxes', whereby we try to tax activities that lead to social costs that are higher than private costs or 'externalities', generally fail to stand up to the scrutiny – certainly if we consider those taxes which actually exist in the UK system such as taxes on alcohol and tobacco.

Even in the context of socialised healthcare financing, the costs incurred by others associated with alcohol and tobacco are too weakly correlated to individual consumption to be useful.

As a result, the relevant duties effectively operate as arbitrary and distortive 'sin taxes', reducing welfare and falling disproportionately on the poor. They should be abolished entirely.

Because wealth is normally so mobile, wealth taxes are particularly damaging. They should be avoided. An exception is a tax on the value of land which is attributable solely to its location – a location value land tax.

A property's location value is the amount it would be worth if the land were found in a state of wilderness but the state of all other properties remained as they were.

Taxing this value alone ought not to disincentivise landowners from improving land by clearing it or building structures and it has long been promoted by economists.

A good tax system should therefore introduce such a tax in a phased manner, to account for the unfairness imposed on those who have previously bought land in good faith. This should replace a range of other taxes including council tax.[1]

There should also be some further reforms to property taxes. These are discussed in part three of *Tax, Government Spending and Economic Growth*, published by the Institute of Economic Affairs.

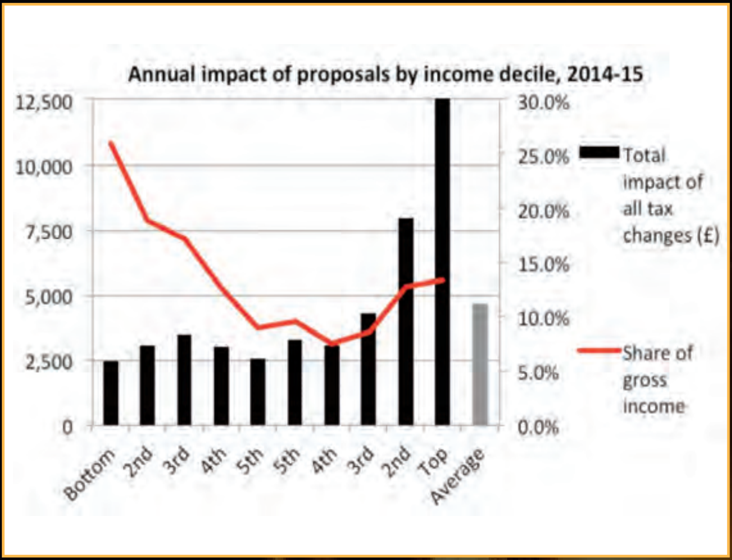
Various other fiddly, opaque or distortionary taxes should also be abolished, such as air passenger duty, the television licence and the climate change levy.

Some taxes to be reformed

Consumption should be taxed with a broad consumption tax, probably a value added tax (VAT), as at present. VAT should apply universally to all consumption with no exemptions or reduced rates, unlike currently where there are wide-ranging exemptions.

Although it has been suggested that existing Pigouvian taxes should be removed, there is one area where they could be retained but at a lower level – that is in the case of externalities caused by carbon emissions and other pollutants.

Here, a single carbon tax would be the best way to ensure emitters cover the costs to others of their emissions. In addition, limited local fuel duties could be used



to cover the cost to others of congestion, the impact on the local environment of car use and the cost of road building and maintenance.

Current fuel duty rates are set at least twice as high as a reasonable estimate of the level necessary to deal with the externalities caused by cars (including reasonable estimates for the social cost of carbon emissions) and the rate should fall accordingly.

Vehicle excise duty performs no useful function in most cases and should be restricted to particularly heavy vehicles which damage roads disproportionately compared with their fuel usage.

Impact of a reformed tax system

Reform of tax systems is often avoided on the ground that it creates winners and losers and the losers scream more loudly than the winners.

Of course, if the overall tax burden is reduced, the discussion then becomes one of who wins the most – in other words, what are the distributional consequences of the change?

It is often assumed that any reduction in taxes must disproportionately benefit the better off. However, a change of the kind proposed has been modelled and this is found not to be the case.

It was assumed that there would be a 15 per cent single income tax above a personal allowance of £10,000; a 12.5 per cent VAT, including on both residential rental property and the rental value of owner-occupied property, and a location value tax aimed at capturing 75 per cent of the location value of land.

The impact on households would be largely progressive due to the substantial cuts in highly regressive sin taxes and the reform of property tax.

The biggest winners would be households in the bottom three income deciles, gaining tax cuts worth 26, 19 and 17 per cent of gross household income, continuing to fall to 7 per cent at the fourth richest decile.

The richest two deciles would enjoy tax cuts worth 13 per cent of gross income. This is illustrated in the figure where the line shows the proportionate increase in income from introducing such a system (right hand scale) and the bars show the total amount of additional income that will be received from a proposed change in the tax system (left hand scale).

Conclusion

Tax need not be nearly as complex and incoherent as the UK system currently is.

There are some sound economic principles that have, in recent years, been forgotten by politicians. Also, the poor pay more taxes than they think and a reduction in the tax burden in the context of a reformed system may well help the poor more than the rich•

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FOR MORE:

You can download the IEA's *Taxation, Government Spending and Economic Growth* for free at

www.iea.org.uk/publications/taxation-government-spending-and-economic-growth/

[1] There should also be some further reforms to property taxes as discussed in Part 3 of *Taxation, Government Spending and Economic Growth*, published by the Institute of Economic Affairs

Just how AUSTERE is AUSTERITY?

Despite the rhetoric of the past few years, cuts in overall government spending have been small. However, the government has made specific political choices to protect or increase spending in some areas whilst reducing it in others. But, says RYAN BOURNE, this shouldn't be confused with general 'austerity'

The prominent economic debate in the 2010-2015 Parliament was how far and how fast the then Coalition government should seek to reduce the budget deficit. The 2015 election likewise featured discussion of how to 'finish the job' on fiscal consolidation.

Yet many misconceptions exist about how far the UK government has, and plans to, reduce government spending to achieve that objective.

For most of the past six years, a perusal of almost any newspaper would have found reference to 'savage', 'deep' or 'dangerous' cuts to government expenditure. Are these claims justified?

We can combine evidence from the last Parliament with the Conservative government's forward plans for spending to ask: just how austere will so-called austerity be between 2010 and 2020?

The coalition's overall record on spending 2010/11-2014/15

In fact, overall government spending in cash terms rose from £714 billion in 2010/11 to £746.7 billion in 2014/15.

Given that nominal GDP growth was faster than this over the same time period, overall spending as a proportion of GDP did, of course, fall. At the beginning of the Parliament spending was 45.3 per cent of national income and, at the end of the parliament, it was 40.8 per cent[1].

But what really matters is how far that spending goes in terms of its purchasing power, i.e. what has happened to real spending. Inflation was relatively high across this same period. But even adjusting for this, the figures above represent *a cut in real spending of just 2.1 per cent* over four years.

In other words, during the four years of the last Parliament for which the Coalition controlled the budget, *just over 2p was cut for every £1 the government had spent back in 2010/11.* To put it another way, real spending was cut by just 0.5 per cent per annum.

You could argue that in order to see the impact of government spending cuts on actual public service delivery, it is better to look at real spending per capita.

After all, the population has also risen during that period. Adjusting in this way shows a decline of just under 5 per cent (see Table 1). More significant, yes, but certainly not 'savage'.

Changed composition of spending 2010/11-2014/15

Why then do we hear so much about spending as if it has been cut to the bone? There are two main reasons.

The first is that, even though real spending has only been cut slightly, this is still highly unusual in Britain's post-war history – in the past, the state has only tended to grow. The public sector has become used to ever higher spending, and real cuts therefore provide a shock.

Secondly, these headline figures mask large changes in the composition of spending since 2010, arising from both political promises and demographic trends which affect spending.

The coalition government pledged to maintain spending in real terms on the NHS, to increase spending significantly on international development aid and to institute increases in the state pension as a result of its 'triple-lock' (at the same time as the pensioner population is rising). Some schools spending was also protected. Debt interest payments rose as we ran large deficits.

Ring-fencing or even increasing spending in these areas means that spending elsewhere has to be cut much more deeply to meet a given target.

This can be shown clearly by looking at the functions of government and how spending on these different areas changed (Figure 1).

Measured in this way, spending on international services (including foreign aid) rose by 26 per cent above inflation, health spending by 4.7 per cent, and the social protection budget (welfare in its broadest sense) by 6.0 per cent.

Other functions of government saw significant real-terms cuts. These included

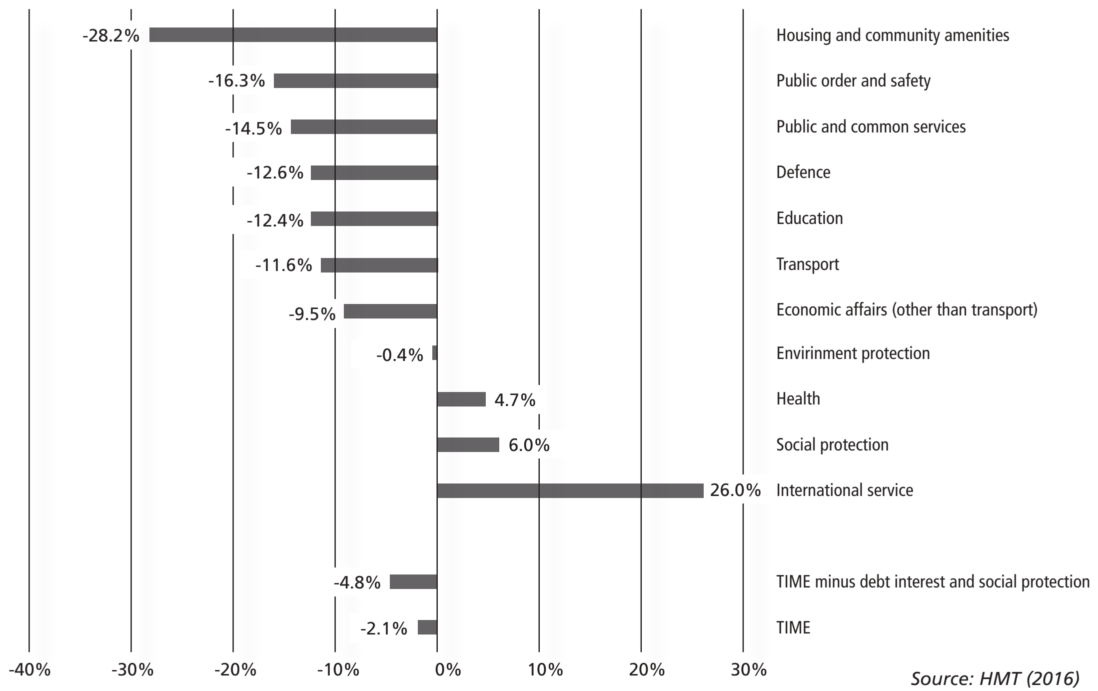
Table 1: Real spending per capita (2015/16 prices), 2010/11 to 2014/15

	2010/11	2011/12	2012/13	2013/14	2014/15
Real spending (£billion)	£764	£755	£744	£747	£755
Change in real spending since 2010/11		-1.2%	-2.5%	-2.2%	-2.1%
Real spending per capita	£12,168	£11,923	£11,682	£11,654	£11,569
Change in real spending per capita since 2010/11		-2.0%	-4.0%	-4.2%	-4.9%

Source: OBR (2016), ONS (2016).

[1] These figures use GDP calculated at market prices. Some would argue that GDP at factor cost is more appropriate. Using this measure, both figures would be about five percentage points higher.

Figure 1: Real changes in government spending by function 2010/11 to 2014/15



Source: HMT (2016)

housing and community amenities (28.2 per cent in real terms), public order and safety (16.3 per cent in real terms) and, perhaps more surprisingly, education (12.4 per cent cut in real terms).

In short, there was modest spending restraint in the last Parliament, but this masks the fact that political choices were made to increase spending in some areas, maintain it in others and make deeper cuts elsewhere. However, these were genuine choices about priorities – the cuts overall do not reflect 'deep austerity'.

The Conservative government's plans to 2019/20

The Conservatives have pledged to restrain government spending growth further to complete the job of deficit reduction.

This commitment is now somewhat in doubt given the Chancellor's promise to 'reset' fiscal policy in the fall out from the Brexit referendum, but, in the medium term, the government will have to engage in more spending restraint to meet its declared aim of getting the debt-to-GDP ratio back on a downward path.

Examining the last Budget, the figures are clear that over the course of this Parliament the Conservatives had planned not just to increase overall spending in nominal terms but also deliver a slight increase in spending in real terms (up 0.9 per cent between 2014/15 and 2019/20).

Once again, the flat-lining of spending overall masks some big changes in its composition.

Spending on areas such as social protection will rise, not least due to a combination of an ageing population and the continuation of the guaranteed increases to state pensions.

The government has also promised more resources for the NHS, is protecting defence and aid spending and has pledged to maintain other pensioner benefits. This all necessitates cuts in the remaining functions.

The reckoning up

Assuming that the plans outlined in the last budget are delivered, what will be the overall shape of spending changes after a decade of 'austerity'?

Overall government

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spending will rise in nominal terms from £714.0 billion in 2010/11 to £810.4 billion in 2019/20.

In real terms this will reflect a cut in overall expenditure of just 1.3 per cent in total over a ten-year period (see Figure 2). Given population growth over that period, real spending per head will have fallen further than this – in total by 7.4 per cent.

But within these totals, real spending by departments will have fallen by 13 per cent, whilst annual managed expenditure, which includes debt interest payments and the state pension, will have risen by 11.3 per cent.

In other words, the small overall cut to expenditure masks large changes to spending on particular activities. Of course, all of these forward-looking projections of spending are subject to change. But evidence from the last Parliament suggests that, by-and-large, decisions in the spending review tend to stick.

Conclusion

What then can we conclude about the severity of austerity given current plans? There are five key conclusions from this analysis:

1. Overall spending will have only been cut very modestly over the period 2010 to 2020.
2. Holding spending down in this way should lead to a significant fall in the spending-to-GDP ratio if real national income growth is robust.
3. This level of spending as a proportion of GDP is still high by long-term historic standards: approximately the same proportion of GDP at market prices as it was in 2000 and five percentage points higher than in 1960.
4. The overall spending totals mask a significant increase in spending in some areas, not least social protection spending, whilst departmental expenditure will have been cut significantly.
5. Even within departmental spending, significant ring-fencing of certain budgets (such as health, some schools spending and aid) means some departments will see very deep cuts overall whilst others have been insulated from restraint for a decade•

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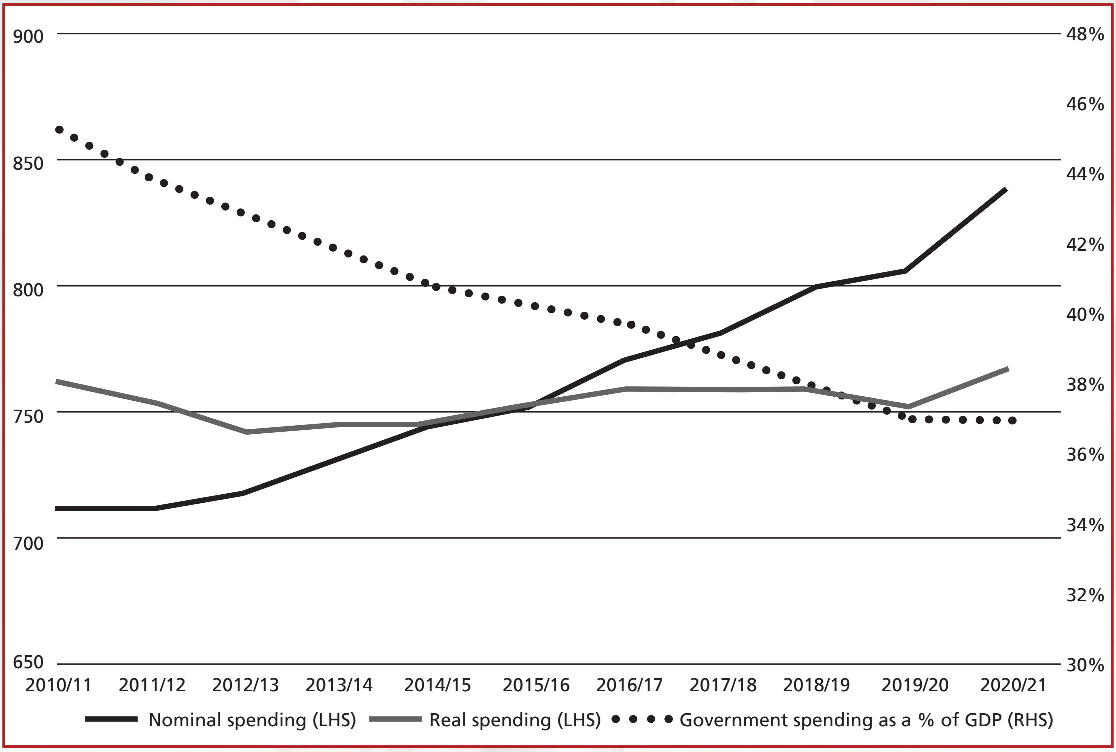
Figure 2: Nominal and real expenditure (£ billion; real expenditure in 2015/16 prices) and spending as a proportion of GDP



Source: OBR (2016).

Does LOWERING TAX RATES cause ECONOMIC GROWTH?

It's often argued that higher taxation reduces economic growth. In fact, the theory is ambiguous. So what does the evidence say? LUCY MINFORD explains

Can government policy generate economic growth?

By growth we mean more resources to put to any use society might choose, net of harmful bi-products such as pollution. Defined this way, growth is good and so the question is important.

Aggregate growth is the rate of change of total output. Technological progress is the key to sustainable growth per head of population.

This cannot be achieved by simply increasing other inputs such as labour and capital: adding people boosts population at the same time as output and adding capital leads to diminishing returns if the population is limited.

Therefore growth theories now tend to focus on understanding how technology evolves, and the role that government policy plays in that process.

Exciting new theories of so-called 'endogenous growth' have proliferated. But the more different theories we have – often prescribing very different policy solutions – the more we want an answer to the question: "does that theory actually explain how this economy works?"

In other words, we wish to test theories convincingly using data, so we can have confidence that we are choosing the right policy. This article focuses on the role of tax policy in growth, in particular on the empirical evidence.

Why might the level of taxation affect growth?

Theoretical reasons to suspect a negative impact of tax rates on growth centre on incentive effects.

Higher rates may lower incentives to supply labour and invest in new capital, since the worker or investor retains less of the proceeds. This means less output growth due to lower labour and capital input growth.

For a profit-motivated innovator, higher tax rates lower expected take-home profits and so discourage innovation, reducing growth via lower increases in productivity.

Higher taxes on earnings deter managers from spending extra time and effort employing inputs efficiently and imitating industry leaders, so the gap widens between the technological frontier (defined by leaders) and the average productivity in the economy.

There are some theories, however, that predict a positive relationship between taxation and growth.

This is especially so if tax revenues are spent by governments in ways that enhance productivity. Subsidies to research and development (R&D), the provision of education, or transport networks and broadband might be examples here.

What does the evidence say?

Given that theories can point in different directions, these are questions that we should seek to settle empirically.

Various studies have been done in recent decades that attempt to shed light on this subject. They tend to use what are known as 'panel regressions'. This involves the statistical analysis of data on growth rates, tax policy, and various 'control variables' for a number of countries over time.

The control variables capture other factors affecting growth, allowing us to ask the question: "holding those factors constant, what is the effect on growth of changing tax policy?"

This work seems to suggest that, as a "rule of thumb", a 10 percentage point fall in the average tax rate (the ratio of tax revenues to GDP) is associated with a roughly 1 percentage point increase in the growth rate. Results of this magnitude seem to recur in different investigations.

The problem with this sort of approach is that it can only uncover an association between two variables.

As is well known, that does not mean that changes in one variable cause changes in the other. Higher growth may allow a country to reduce its tax burden whilst its government provides the same level of services and transfers – so the causality might work in the other direction.

Or there may be third factors that affect both taxation and economic growth such as the rule of law. A country's governance. Improvements in the rule of law, for example, may lead to higher economic growth and people paying a greater share of the taxes they owe (less tax evasion), thus allowing tax rates and tax receipts as a percentage of national income to fall.

Such factors can be difficult to measure. It is difficult to untangle everything that is going on using this style of model.

New work on tax and economic growth

Economic modelling has become complex in recent decades. However, a promising route for modelling tax and growth has been developed that can be easily explained, without referring to the underlying maths.

It is possible to build and test a model of the economy in which lower taxes work in a well-defined way to raise productivity. The idea is that high tax (and also regulation) form barriers to entrepreneurship.

Why emphasise entrepreneurship as a channel by which tax and regulation affect growth?

Many theories of growth focus on "innovation" and, when they are tested, innovation is equated to formal R&D. This is dominated in the data by large firms and so excludes the effect of start-ups and smaller firms. However, small and new businesses are often the engine of growth and the aim is to capture their contribution.

Here, tax is treated as one part of the broader phenomenon of "barriers to entrepreneurship". Labour market regulation is another.

Such regulation is intended to protect worker rights, a social objective which is not about promoting economic growth. However, if such regulations introduce frictions

SOME THEORIES PREDICT A POSITIVE RELATIONSHIP BETWEEN TAXATION AND GROWTH – ESPECIALLY IF TAX REVENUES ARE SPENT BY GOVERNMENTS IN WAYS THAT ENHANCE PRODUCTIVITY

THE UK WAS AN EARLY STARTER AMONG OECD COUNTRIES IN THE DEREGULATION OF LABOUR MARKETS, WHICH HAS BEEN LINKED TO THE REVERSAL OF ITS RELATIVE ECONOMIC DECLINE

in labour markets which have an impact on growth, we would like to know.

The UK was an early starter among OECD countries in the deregulation of labour markets, which has been linked to the reversal of its relative economic decline within Europe since the 1970s, and the extent to which we should regulate labour markets is an important debate within the EU and also within the current government.

Although labour market regulation could improve investment in skills and productivity, it is also possible that less workforce flexibility causes firms to resist new technologies.

When the labour market is not functioning well, it is difficult for workers to find the firms where they will be best (most productively) employed, given their skillset.

Regulations tend to hit small firms hardest because they are a fixed cost and so a higher proportion of revenues. As such, they act as a barrier to entry, reducing competition.

The testing of the model is designed to work out whether these barriers to entrepreneurship really did reduce growth. There is more detail about the testing in the box.

In the model, barriers to entrepreneurship are measured by an index constructed from top marginal income tax rates and a labour market regulation indicator.

This labour market indicator reflects the extent of collective bargaining and union power as well as the costs imposed by government on hiring staff. The study's goal is to see whether movements in tax and regulation caused long-lasting changes in productivity growth. The results show that they do.

This study finds that a 10 per cent fall in the tax and regulation index relative to the trend in the index generates growth over a 30-year period, leaving output 24 per cent higher at the end of the period than it would have been be with policy unchanged. This is equivalent to a higher average annual growth rate over that period of 0.8 percentage points.

As it happens, this result – though not directly comparable – is similar in magnitude to the earlier research work on tax and growth•

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Testing the model to find whether tax and regulation affects economic growth

So, to reiterate, I have tested the role of these policies in UK growth using a method which allows an interpretation of the results in terms of cause and effect. How is this done?

The first step is to develop a model of the UK economy in which productivity is driven by entrepreneurship, which in turn is discouraged by tax and regulation.

The next step is to simulate this model many times. It is subjected to different random shocks. We observe the behaviour the model produces if these random shocks (including changes in policy barriers to entrepreneurship) follow different patterns. The simulations can be thought of as different "parallel histories" of the period.

When you take two different models of this type and repeatedly simulate them like this, the average economic behaviour produced by each is actually very different.

A model in which growth causes policy changes will produce very different results from a model which specifies the opposite, for example. Therefore this process allows us to test the hypothesis that these policy 'barriers' to entrepreneurship (tax and regulation) actually cause changes in growth.

A so-called 'indirect inference' test finds the probability that the actual history could have been produced by this particular model. If that probability is below a certain level, the model is rejected.

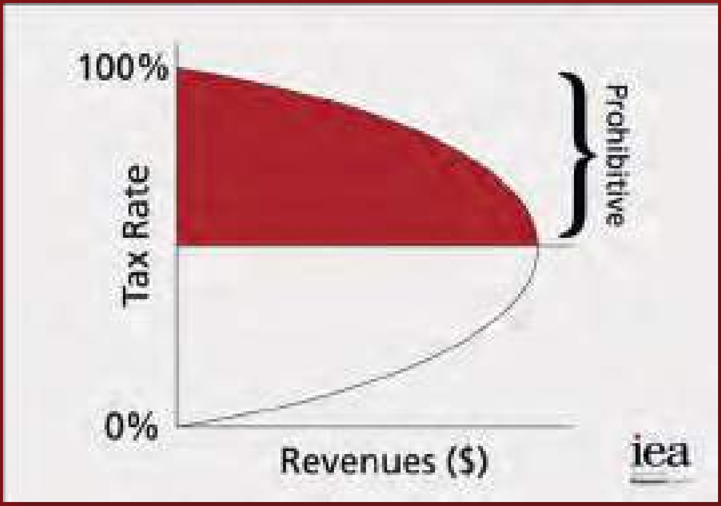
The test tends to reject false models very firmly, so we can be confident in a model that passes.

STRAIGHT TALKING on the LAFFER CURVE

PHILIP BOOTH interviews one of the world's best-known economists, ART LAFFER, about the Laffer curve, tax and more

What can you tell us about the origin of the so-called "Laffer curve"?
The so-called Laffer curve, as I have described it, is a diagram relating tax rates to tax revenues, or in some instances to government budgets. Just for the record, it was Jude Wanniski in his article "Taxes, Revenues and the Laffer curve" who gave the curve my name. But even before then, the curve had a long, long pedigree.

Given the basic economic proposition that imposing or increasing a tax reduces the economic product available to be taxed, it is a simple logical extension to derive what is now called the Laffer curve.



In fact, even the idea that tax rates could be sufficiently high, so that an increase might actually result in lower tax revenues, has been described many times. With need-based welfare programmes, the curve is even more obvious because lower tax rates lead to more growth and thus, less need-based welfare.

The oldest explicit reference to the "wrong" side of the Laffer curve I have seen is from Ibn Khaldun in the Muqaddimah, written in 1377 AD: "It should be known that at the beginning of the dynasty, taxation yields a large revenue from small assessments. At the end of the dynasty, taxation yields a small revenue from large assessments."

Apart from the obvious point that tax rates do have a negative impact on the tax base, there is the question as to whether the concept of the Laffer curve is relevant in public policy.

Up until the late 1970s, the Laffer curve was virtually unheard of and had been under-used in my opinion to the grave detriment of countries' economies the world over. Tax rates are way too high, and, as a result, prosperity has suffered.

The Laffer curve is as obvious as any economic concept can be, yet, in a debate at Oxford, I was told that slides in the very first lecture of Oxford's undergraduate economics course describe the Laffer curve as "the economics of wishful thinking".

In addition, I was told that, in a 2012 survey of the top 40 US economists at Princeton, Yale, MIT and Harvard, "Not a single one agreed with the curve!"

What does the Laffer curve tell us about governments that already levy high levels of taxes trying raise more revenue by increasing tax rates further?

The Laffer curve, of course, is a pedagogical device that illustrates a stylised relationship between tax rates and total tax revenues. At a tax rate of over 100 per cent, who would work? Tax revenues would be zero at both 100 per cent tax rates and at zero tax rates.

In between zero and 100 per cent tax rates, tax revenues would be positive, rising at first, from the zero tax rate, then hitting their maximum somewhere in the middle, and falling once again to zero revenues at some very high tax rate.

The power of the Laffer curve is its simplicity and practicality. Even a politician can understand it. But, when it comes to applying the curve, most politicians and academics would prefer to be precisely wrong than approximately correct. Too often they conflate tax rates and tax revenues, which are never the same.

to receive an after-tax return. Therefore it is the after-tax return that motivates people, not the tax rate per se.

At a 10 per cent tax rate, the after-tax return is 90 per cent of total pay. Double that tax rate and the after-tax return drops to 80 per cent. That drop from 90 to 80 represents an 11 per cent cut in incentives (10/90).

However, if the tax rate is 45 per cent to begin with, the after-tax return is 55 per cent of total pay. Double the tax rate to 90 per cent and the after-tax return drops to 10 per cent. This represents over an 80 per cent decline in after-tax returns.

THE POWER OF THE LAFFER CURVE IS ITS SIMPLICITY AND PRACTICALITY… EVEN A POLITICIAN CAN UNDERSTAND IT

Although we rarely know the exact relationship between tax rates and tax revenues, we do know that the increase in revenues is always less than the increase in tax rates and that an increase in tax rates may even result in less revenue.

Politicians and economists alike are disappointed by tax revenues that they expected to flow following a tax hike and are pleasantly surprised by the tax revenues that arise following a tax cut. And the higher tax rates are to start with, the greater will be the effect of any change in the tax rates and the more likely it is that revenues will actually fall if tax rates increase.

This is the stuff of first-year undergraduate economics. People don't work or save to pay taxes. They work and save

The point here is simply that the higher tax rates are, the greater will be the reduction in incentives for any given increase in the tax rate and the less will be the increase in revenues if there is any increase in revenues at all.

Can you give us an example of a government that cut taxes and raised revenue?

Former British Prime Minister Gordon Brown increased the UK's highest tax rate from 40 per cent to 50 per cent, and tax revenues went down - as did the British economy and the Labour government. And then George Osborne cut the highest tax rate to 45p and revenues went up.

US Presidents Harding and Coolidge cut the highest tax rate – from 77 per cent in 1919 to 25 per cent in 1925 – and tax revenues from the rich soared. The story was repeated when President Kennedy cut the highest tax rate from 91 per cent to 70 per cent and repeated yet again when President Reagan dropped the highest tax rate from 70 per cent to 28 per cent. I could go on and on, but I think you get the picture.

In the US, there is effective tax competition between states. How does this help discipline state governments?

The US is special in that each of our 50 states controls its own tax structure, and any barriers to the free movement of people and goods between these states are unconstitutional.

Over any ten-year period for the past 50 years, the nine states with no state income tax have grown faster according to virtually every metric as compared with the nine states with the highest tax rates. The states with no state income tax even had faster growth in state and local tax revenues than the states with the highest income tax rate.

Eleven states since 1960 have introduced an income tax, and each and every one of those states has declined in population, employment, gross state product, and yes, in state and local tax revenues relative to the rest of the nation.

In your experience, if you want the rich to pay more tax, how do you achieve that?

Because of the vast array of resources available to the rich and their special ability to alter their own circumstances, it is the case that, as often as not, reducing their tax rates increases tax revenues, increases employment, increases output and makes for a far happier society.

The rich, at lower tax rates, eschew the use of lawyers, accountants, deferred income specialists and political favour-grabbers and actually pay the taxes they should pay.

What we have found is that when treated civilly, rich people for the most part are willing to pay what they owe. Rich people, like everyone else, take offence at being demonised, and move their tax domiciles, shelter their income, hire lawyers and accountants and pay off crooked politicians.

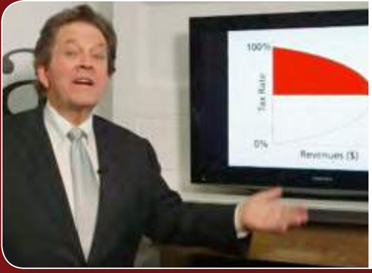
TAX RATES ARE WAY TOO HIGH…AS A RESULT PROSPERITY HAS SUFFERED

Just read what Andy Sewer wrote of the Rolling Stones in *Fortune* magazine, 30 Sept. 2002:

The Stones are famously tax-averse. I broach the subject with Keith in Camp X-Ray, as he calls his backstage lair. There is incense in the air and Ronnie Wood drifts in and out – it is, in other words, a perfect venue for such a discussion. "The whole business thing is predicated a lot on the tax laws," says Keith, Marlboro in one hand, vodka and juice in the other. "It's why we rehearse in Canada and not in the US. A lot of our astute moves have been basically keeping up with tax laws, where to go, where not to put it. Whether to sit on it or not. We left England because we'd be paying 98 cents on the dollar. We left, and they lost out. No taxes at all."

Will the next US President cut taxes? *(This interview was conducted a couple of weeks before the election).*

My answer is, "no…not if the President's name is Hillary."•



FOR MORE:

See Art Laffer's brief – and humorous – explanation of the Laffer curve at:

www.iea.org.uk/films/laffer-curve-explained/

CUCKOO IN THE NEST

There's been a huge growth in government spending in the last 150 years. DAVID B. SMITH asks: Are governments now spending beyond the point at which welfare is maximised? Or are we beyond the point at which enough can be raised in taxation to finance spending?

Arguably, the most important political-economy development of the past one-and-a-half centuries has been the hugely increased role of the state in mature, developed economies.

Today's government spending ratios are typically some four-and-a-quarter times the ratios observed in the late 19th century.

Together with demographic developments, state intervention determines the 'deep parameters' of the economy, which are often assumed fixed in theoretical analyses and in macroeconomic forecasting models.

Like an inexorable glacier, however, these long-term factors eventually swamp the shorter-term influences that dominate politics, finance and much theoretical economic analysis.

The international experience

The OECD regularly publishes annual figures for the general government spending burden (and government receipts) in its *Economic Outlook* reports.

This and other information, can be used to obtain data on the share of government spending in national income from the late 19th century onwards. Data for a selection of countries are shown in Table 1.

As can be seen, the typical industrialised state was spending just over one tenth of national output around 1870, between a fifth and a quarter in the inter-war period, something under 30

Difficulties in measuring the government spending and tax burdens

It might be thought that measuring the proportion of national income spent by the government over time is a simple exercise.

Conceptually, all that is required is agreed measures of national output and government spending that are: 1) consistently defined over time, and 2) measured compatibly, if international comparisons are being made.

In practice, however, there are several different measures of national output, while government spending can also be measured in many ways, depending on whether semi-autonomous bodies - such as public corporations, for example - are included. In addition, international statisticians regularly re-work their figures on different conceptual bases.

For example, the specific measure of GDP used to represent 'national output' can make a difference of up to 5.5 percentage points to the calculated UK government spending ratio.

As a result of changes in the way things are measured, perhaps surprisingly, even historical estimates of the share of government spending in the economy frequently change.

Similar qualifications apply to the international data. In OECD estimates, the present estimates of national government spending burdens, say, twenty years ago may differ by up to *plus or minus 5* percentage points from the figures published at the time.

Is there a 'best buy'?

In general, best practice is to use the OECD's statistics for international comparisons and the UK Office for National Statistics (ONS) measure of government expenditure compiled by sub-sector and economic category for Britain.

The major difference between the two data sets is that the OECD divides general government expenditure by market-price GDP when calculating its spending ratios, while the British figures use the factor-cost measure.

The factor-cost measure correctly excludes taxes and subsidies from the definition of national income and so is arguably better.

The ratio of UK general government expenditure to GDP in 2015-16 was 39.8 per cent using market-price GDP and 45.3 per cent using the factor-cost measure. This latter figure is probably the best estimate of the share of government spending in UK GDP.

per cent in 1960, and some 45 per cent to 46 per cent in 2015.

The typical spending burden today is 4.2 times what it was in 1870 and twice the level prevailing when Keynes's *General Theory* appeared in 1936.

The British experience – 1870 to 2015

Britain's experience has been broadly similar. The ratio of UK general government expenditure to factor-cost GDP was generally between 10 per cent and 15 per cent from 1870 and 1913.

The spending ratio peaked at 51.1 per cent in 1917, during World War I, before dropping to 22.9 per cent in 1920 as wartime expenditures were cut back.

Subsequently, the spending ratio spent much of the inter-war period fluctuating between 27.5 per cent and 33.7 per cent, before hitting a record 75.6 per cent in 1944, when World War II was at its highpoint.

Spending reached a post-war trough of 36.5 per cent in 1955, during the 1950s Churchill administration.

After that, the spending ratio started a steady upwards climb: firstly, under the paternalist Conservative Harold Macmillan, and subsequently during the 1964-1970 Labour administration.

The latter saw the spending ratio peak at 45.5 per cent in 1969 when the UK had to be bailed out by the International Monetary Fund (IMF).

The government spending ratio fell to 40.5 per cent in 1973, but then rose rapidly in the mid-1970s. The spending ratio peaked at 44.4 per cent in 1976, at the end of which the UK again had to borrow from the IMF.

In 1979, Lady Thatcher inherited a spending ratio of 41.6 per cent. However, this rose to 47 per cent during the recession of 1981 before falling to 39 per cent by 1990, when she left office.

The ratio stood at approximately that level when New Labour took office in 1997. Interestingly, this figure declined to 38.5 per cent in 2000, during Gordon Brown's flirtation with 'prudence', but then the purse strings were relaxed and it had already risen to 42.9 per cent in 2007, ahead of the global financial crash.

The subsequent recession, and the costs of the bank bail

Table 1: Ratios of general government expenditure to GDP at market prices (%) – selected countries

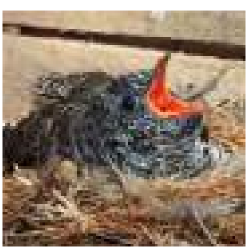
	1870	1913	1920	1937	1960	1980	2000	2010	2015
Australia	18.3	16.5	19.3	14.8	21.2	34.1	34.6	36.6	35.6
France	12.6	17.0	27.6	29.0	34.6	46.1	51.1	56.4	57.0
Germany	10.0	14.8	25.0	34.1	32.4	47.9	44.7	47.4	44.0
UK	9.4	12.7	26.2	30.0	32.2	44.7	37.8	48.8	43.2
USA	7.3	7.5	12.1	19.4	30.0	35.3	33.9	43.2	37.8

Sources: Tanzi & Schuknecht (2000),OECD Economic Outlook (June 2016, Annex Table 29), and OECD data bank.

outs, meant that the spending ratio had climbed to over 50 per cent in 2010, before falling to just over 45 per cent in 2015.

So, in fact, the current government is spending around the same as a percentage of national income as before the sterling crises that provoked the 1969 and 1976 IMF loans.

Why should we worry about the government spending ratio?



THE CURRENT GOVERNMENT IS SPENDING AROUND THE SAME AS A PERCENTAGE OF NATIONAL INCOME AS BEFORE THE STERLING CRISES THAT PROVOKED THE 1969 AND 1976 IMF LOANS

Many politicians and economists seem unaware of how far the UK and other industrialised economies are highly socialised by historic standards.

This is particularly true of UK regions, such as Northern Ireland and Wales, which, it could be argued, have smaller private sectors than the Soviet Union's former Eastern European satellites under Communism.

The measurement issues are crucial because policy recommendations to increase public spending, that might have been helpful when government spending was roughly half its present level in the 1930s, might prove highly de-stabilising starting from the current higher base.

Given the effects of government spending and taxation on growth and welfare, it is reasonable to ask whether there are "growth maximising" or "welfare maximising" levels of government expenditure. There is a third important statistic, which is the maximum sustainable share of taxation in GDP.

Measurement issues make it difficult to identify the growth, welfare and revenue maximising levels of government spending with precision. Nevertheless, certain rules of thumb have emerged from work in this area:

- The growth maximising share of government spending in GDP appears to be between 18.5 per cent and 23.5 per cent of market-price GDP, using current (October 2016) British definitions. Ratios in this sort of range are typical of the fast growing South-East Asian 'Tiger' economies, countries such as Japan and Korea in their high growth phases, and even Australia, Canada and Spain in the 1950s.

- Using the definitions of the time, Tanzi and Schuknecht (2000) and Tanzi (2008) claimed that the welfare maximising share of government spending in GDP was at most 30 per cent to 35 per cent of market-price GDP. This conclusion reflected

[i] Tanzi and Schuknecht (2000) and Tanzi (2011) are especially useful sources.
[ii] David B. Smith is an economic forecaster, former chairman of the Shadow Monetary Policy Committee and author of *Living with Leviathan: Public Spending Taxes and Economic Performance*, Institute of Economic Affairs, London.

their detailed examination of the effects of state spending on measures of human wellbeing. This corresponds to a range of 26.5 per cent to 32.5 per cent on present ONS definitions.

- The upper limit on taxable capacity in Britain seems to be around 33 per cent of market-price GDP. After allowing for other government revenues, and a small budget deficit of some 2 per cent of GDP, this suggests that spending only becomes sustainable when it falls into the 37 per cent to 38 per cent range. A similar rule of thumb also seems to apply to the OECD in aggregate.

Conclusion

Making a success of Brexit requires improving the micro-economic flexibility of the UK economy as resources have to be shifted from supplying continental markets to the wider world outside.

Such supply-side flexibility is unlikely to be achievable while the government is absorbing over 45 per cent of factor-cost GDP and the private sector is hamstrung by an excessive regulatory burden, much of which could be removed if we exited the European Union's single market.

A 1950s Churchill-style 'bonfire of controls', together with bold tax simplification and reform, should be overriding aims of the new administration•

David B. Smith[ii]
Beacon Economic Forecasting
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It's often argued that behavioral economics demonstrates the need for more government intervention – but **CHRISTOPHER J. COYNE** and **RACHEL L. COYNE** beg to differ…

THOUGHT CONTROL

PUDDLE PUZZLE:
Why do New York's cabbies drive fewer hours on rainy days? Find out on **p28**

Behavioural economics informs a lot of economic policy discussions. But whilst its insights may be interesting and important, do they really tell us anything about the appropriate role of government in economic life?

In 2010, the UK government established the Behavioural Insights Team (BIT) or 'Nudge Unit'.

It was to use 'behavioural science to encourage people to make better choices for themselves and society'. The US government has recently launched a similar body. A central part of the work of these units is grounded in behavioural economics.

Behavioural economics focuses on differences between observed human behaviour and the models used in mainstream economic analysis.

WHEN HUMAN BEHAVIOUR DEVIATES FROM THE PREDICTIONS OF ECONOMIC MODELS, IT IS INCORRECT TO ASSUME IT IS A HUMAN FAILURE THAT NEEDS CORRECTING THROUGH REGULATION

Many conclude that the deviations between predicted and actual behaviour provide a justification for expansions in government regulation. However, there is reason to be sceptical of this conclusion.

Ideal models versus reality

Behavioural economics identifies situations where people do not act according to the rational decision-making model that economists have tended to use. These deviations are seen as 'failures'.

For example, it is suggested that people systematically save too little, make diet decisions at odds with their long term health and misjudge risks. These failures, it is commonly argued, require correction by policymakers.

However, the models that economists use are tools designed to help us understand the world. They should not be mistaken for accurate representations of all aspects of reality.

Consider a paper map of the world spread out on the floor. Standing on the map, one could easily step from the United States to the United Kingdom and back again in a matter of seconds. But this does not mean that, in reality, one can physically travel between the US and UK at that speed. No one would view this as a 'failure' on my part, or of the map.

Instead, people understand maps as incomplete representations of the world. They accurately portray geography, but not the scale of the actual world.

This same insight should be applied to economic models and their relevance for understanding economic behaviour.

When actual human behaviour deviates from the predictions of economic models, it is incorrect to simply assume that it is a human failure that

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[1] Colin Camerer, Linda Babcock, George Loewenstein, and Richard Thaler. (1997). "Labor Supply of New York City Cabdrivers: One Day at a Time" *The Quarterly Journal of Economics* 112(2): 407-441

[2] Drew Fudenberg. (2006) "Advancing Beyond 'Advances in Behavioral Economics'" *Journal of Economic Literature* 44: 694-711.

needs correcting through regulation.

For example, a well-known paper in behavioural economics found that New York City taxi drivers worked fewer hours on rainy days.[1]

The authors concluded that the cab drivers have a daily income target, and once they meet that target, they stop driving. Since more people demand cabs on rainy days, drivers tend to meet their targets faster and, hence, drive fewer hours.

Many consider this behaviour 'irrational' because taxi drivers could, in principle, earn more income by driving more hours during rainy days, earn more overall income in a shorter amount of time (and have some more time off on sunny days).

However, this reasoning, and the model on which it is based, assumes that maximising overall income is the main goal of taxi drivers. In doing so it neglects a range of other possibilities.

For example, perhaps taxi drivers are more fearful of getting into an accident in bad weather and, thus, seek to limit their time on the road during inclement weather conditions. Or perhaps they value spending time with family or friends on a daily basis and are willing to trade off additional income to do so.

There are numerous other possibilities to explain this seemingly irrational behaviour such as the possibility that people are more likely to want to use taxis for shorter trips when it is raining and taxi drivers find these less lucrative.

The more general point is that it is too simplistic to assume that people are irrational because they fail to satisfy the predictions of an idealised, simplistic model.

Models are never able to fully explain the behaviour of economic actors. What appears irrational to outsiders may, in fact, be perfectly rational to the person taking the decisions.

MODELS ARE NEVER ABLE TO FULLY EXPLAIN THE BEHAVIOUR OF ECONOMIC ACTORS

For instance, some individuals may live happier lives eating doughnuts and smoking cigarettes rather than running marathons and consuming kale – having a long life expectation might not be a major part of their utility function.

Behavioural economics does not account for these differences in the subjective values of individuals, which are specific to their lifestyles and personal preferences. It purports to have better models of behaviour but, in reality, the discipline often misses the subtleties of real life.

Regulators are people with behavioural biases too

Despite the need for scepticism about the assumptions underlying behavioural economics, it cannot be denied that some of the observations it makes about human behaviour have some merit.

And it might therefore be possible to improve our understanding of people's behaviour by including some of the traits that are highlighted in behavioural economics in our models.

Such a model may produce a better economic 'map'. However, the assumption underlying the work of the various government bodies that have been set up seems to be that, because we do not always make rational choices, those choices can be improved by regulation. But, can they be improved in practice?

Arguments for increased government regulation to address behavioural anomalies assume that policymakers are immune from those same behavioural traits.

But, policymakers are also error-prone human beings. If ordinary citizens suffer from the inability to self-regulate or to accurately judge risks, so do regulators. For example, regulators may systematically over-estimate their ability to improve on market outcomes.

Embracing this symmetry of behavioural assumptions has important implications. Just because economic actors are imperfect human beings does not, by default, suggest that government should be empowered to make appropriate corrections.

It is possible that if behaviour is directed by policymakers informed by behaviourial economics, it might generate worse outcomes. As economist Drew Fudenberg writes:

"*Even if we believe people do make systematic errors in evaluating how various choices will influence the appropriately defined measure of their welfare, we might not trust that the government or policy analysts would make better evaluations. For this reason, it is consistent to believe both that people make mistakes and that government policy should (with a few exceptions) be based on the assumption that*

BEHAVIOURAL ECONOMICS… OFTEN MISSES THE SUBTLETIES OF REAL LIFE

people's actions and ex-ante predictions are the best guide to what is in their own interests."[2]

Appreciating that people acting in the market and regulators come from the same human stock and are prone to errors should lead us to consider what is the best institutional framework in which people should take decisions.

Should markets be broadly free? Or should governments nudge and cajole us to prevent us succumbing to behavioural biases?

Comparative institutional analysis

Comparative institutional analysis begins by recognising that human imperfections are pervasive and affect all people.

Rather than emphasising these limitations as failures, as is common in many discussions of behavioural economics, focus is instead placed on how different institutional arrangements allow people to best deal with their fallibilities.

For example, markets have several features that allow people to correct their mistakes and deal with their cognitive limitations – prices, profits and losses guide people's behaviours leading them to correct their mistakes over time.

The institutions of the market tend to filter out inefficient behaviours, including those that are inefficient due to behavioural biases. They provide feedback regarding our errors and an incentive to act on that feedback.

Political institutions lack these desirable properties and tend to be fragile in the face of human imperfection.

For instance, there is no clear feedback mechanism, analogous to the profit and loss mechanism in markets, which reveals the errors of regulators and provides incentives to correct them. When errors occur they will often persist due to political inertia resulting from the inefficiencies of bureaucracy and vested interests.

Error is a part of being human. One can appreciate this point and, at the same time, reject calls by 'experts' who seek to regulate private life in the name of removing human fallibility.

After all, policymakers are also imperfect human persons who act in an institutional environment which does not provide incentives for people to correct their errors•

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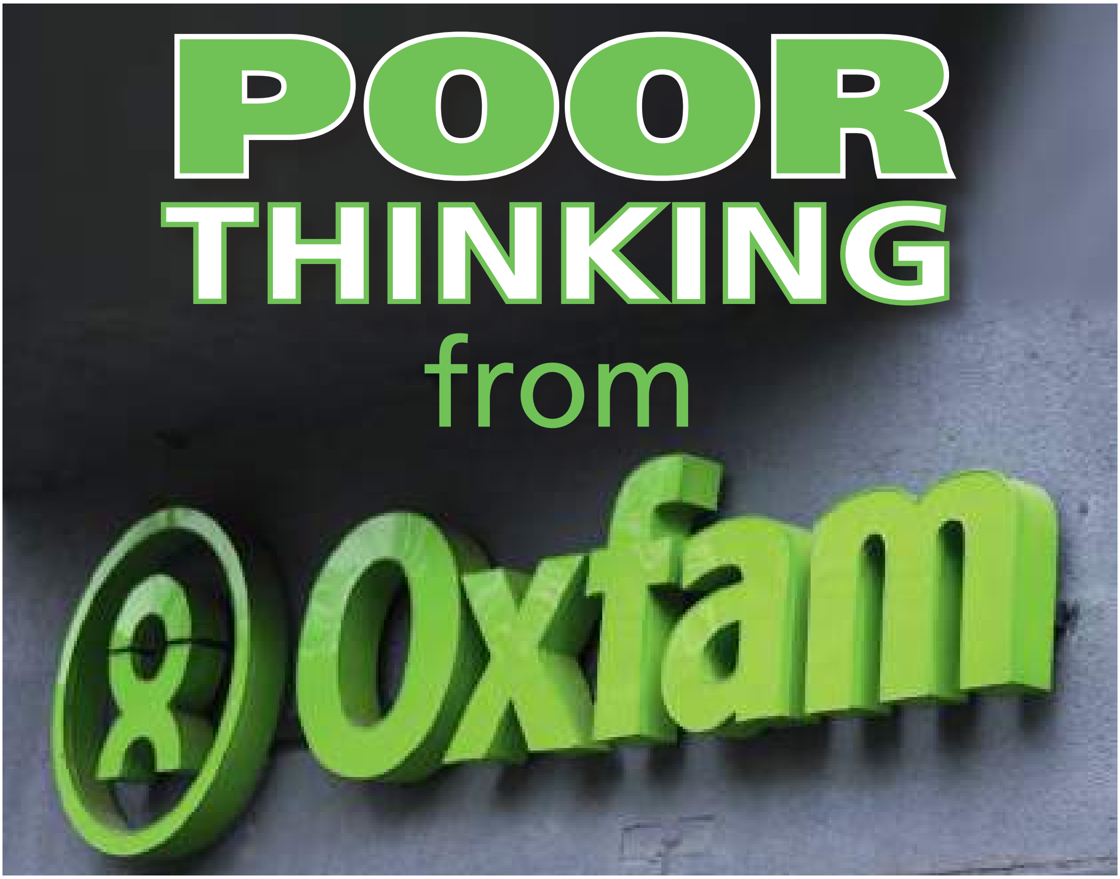
POOR THINKING from



Each year, Oxfam releases figures on wealth inequality which appear to be alarming. But PHILIP BOOTH and BEN SOUTHWOOD contend that they're completely meaningless when it comes to improving the lives of the world's poor...

Oxfam began as the Oxford Committee for Famine Relief. It still does valuable disaster relief work today, but it often functions like a political campaigning group.

Each year it releases a report on inequality just before the World Economic Forum in Davos. This purports to show the failure of the global economic system.

The conventional view of capitalism – shared by figures across the political mainstream such as Ed Miliband and Theresa May, despite their differences – is that it generates lots of wealth, but distributes it unevenly.

Oxfam's figures bring this into relief: the latest numbers show eight billionaires owning 0.25 per cent of the world's net wealth, the same as the 3.6 billion who make up the bottom half of the world's population put together.

Actually, this is 56 billionaires, Oxfam admits, when you count those with negative net wealth as having zero. Those with negative net wealth include, for example, recent Harvard graduates with big student debts and yet huge earning potential: they are supposed to be amongst the poorest people in the world according to Oxfam.

The irrelevance of Oxfam's figures

Indeed, it is worth thinking a little more about what Oxfam's figures mean (if anything).

Huge numbers of people in the world have little or no net wealth. This can be for several reasons. If you are reading this as a sixth-form student, you will probably find that out of a group of 200 of your peers only two or three of you have net wealth that is significant enough to be worth measuring.

People accumulate wealth over the life cycle and even the better off in this country do not tend to accumulate significant net wealth until they are in their 30s.

So, if you consider that half of the world's population is aged 28 or below, it is hardly surprising that if you add up net wealth figures across even a huge proportion of the world's population, you do not get a large number – basically, Oxfam is just adding up a lot of zeros.

In the developed world, many older people receive their pension from the state as well as free services. That is a source of income, but not counted in wealth figures. Many receiving state pensions in many countries neither have nor need other forms of wealth. This is one of the reasons why Sweden, with its high level of state pensions, has high wealth inequality: much of the population just do not need to save.

What is important for people is their income which finances their lifestyle. There are perfectly good figures available on income inequality which Oxfam could use if they wanted to talk about inequality. They show, of course, falling global income inequality as the poor have gained disproportionately from globalisation.

The rich often get rich by making the poor better off

Oxfam highlights how their top eight richest people are mostly Americans and half of them are tech billionaires.

But tech billionaires are a paradigmatic example of entrepreneurs who earned their fortunes by creating products that benefited everyone. Facebook has let us keep in contact with old friends and relatives in a way that was impossible before; Amazon means that we can purchase books that would only otherwise have been available in distant libraries, and get them delivered tomorrow.

THERE ARE PERFECTLY GOOD FIGURES AVAILABLE ON INCOME INEQUALITY... THEY SHOW FALLING GLOBAL INCOME INEQUALITY AS THE POOR HAVE GAINED DISPROPORTIONATELY FROM GLOBALISATION

In America, fortunes mostly reflect outsized contributions to society's wellbeing – additions to the total size of the economic pie – not closeness to government bigwigs, or exploiting resources with large costs to others.

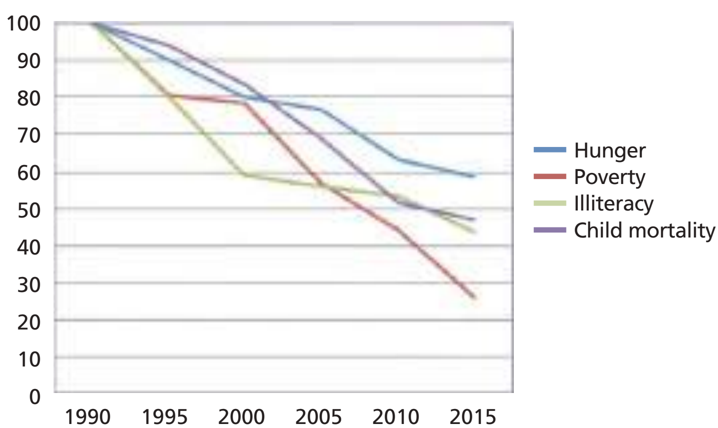
Globalisation has helped such tech billionaires become much richer than they would have become when markets were protected. But, this reflects the fact that their products are used worldwide and they help pull people out of poverty.

Over 60 per cent of Kenyans use mobile phones to make payments. Mobiles are used by farmers to compare and check prices so that they are not exploited by local monopolies.

Globalisation in general and mobile phone technology in particular are major contributors to the huge growth in incomes in poor countries in recent years.

Worldwide, there are 1.6 billion Facebook users – you are probably one of them.

Figure 1: Life in what Oxfam calls the era of 'neoliberalism'



Sources: Johan Norberg: *Progress* (Oneworld) FAO, World Bank, UNESCO, World Bank, EPA

IT IS NOT REDISTRIBUTION BUT MUTUALLY ENRICHING TRADE AND ECONOMIC GROWTH WHICH IS THE HOPE FOR THE POOR OF THE WORLD TODAY

But, the founder of Facebook is rich not because others are poorer. Trade is a process of mutual enrichment. Everybody is better off because of Facebook.

However, Mark Zuckerberg is much better off because he benefits from the fact that so many people have taken up the invention. Meanwhile, there will be many, many more entrepreneurs who have tried and failed – entrepreneurship is a risky business.

Globalisation and poverty

And it is this movement of many countries towards embracing market institutions – a movement that is by no means complete – that Oxfam fails to mention in their annual screed.

This year they highlighted Vietnam as a case of deprivation, and it is true that Vietnam is still a very poor country. But it started from a very low base: they only brought in broadly capitalist institutions in 1986. Since then, their income per capita has gone from $100 per annum to $2,000, and continues to grow at stratospheric rates, mirroring the widely-lauded situations in China and, to a lesser extent, India.

China and India are still poor by Western standards, but a report focused on how capitalism was failing them would rightly have been deemed ludicrous – everyone knows how well they've done since abandoning full state control of their economies, though, again, there is a long way to go.

Real national income per head in China in 1980 was $193 and today, it is $6,807 per head. This is not due to redistribution, it is due to trade and the liberalisation of some markets.

Extreme poverty has fallen from 44 per cent in 1980 to around 10 per cent today. Literacy has risen from 56 per cent to 85 per cent over the same period. If we are to do better still, it is not wealth taxes and tax havens that need to be the focus of our attention, but the basic policy environment that we know leads countries to eradicate policy.

Kenya and South Korea were about equally rich in 1960. Kenya has seen some significant improvements in very recent years, and is one of the better-off countries in East Africa.

But South Korea has grown to enjoy incomes fifteen or twenty times higher, almost on a par with Western Europe. It is institutions, the freedom of businesses to establish and mutually enriching trade that lead to the elimination of poverty, higher literacy rates and better health.

However, increases in income translate into increases in wealth only over a very long time because most people consume the vast majority of what they earn. And it is the growth in incomes that really matters. Redistributing wealth would be a poor policy choice.

Let us suppose that we went even further than Oxfam would like and redistributed the whole of the wealth of the richest people equally throughout the world and throughout the lifetimes of the world population.

Depending on how you do the calculation, you would end up giving everybody a pay rise of between 65p and £1 per year – or about 0.03 per cent for your average Kenyan.

And, at the same time, you would have destroyed the system by which entrepreneurial-led innovation promotes economic growth and which has enriched previously destitute countries in a way that Oxfam could never have imagined back in 1980.

Of course you could follow more moderate policies and just tax such people a little bit of their wealth – say 10 per cent – then the damage you cause might be somewhat less, but the amount you can redistribute becomes even more trivially small.

It is not redistribution but mutually enriching trade and economic growth which is the hope for the poor of the world today – just as it was in the past.

To put it another way, we should stop focusing on the rich as if they are the problem and, instead, focus on the policies which reduce the number of people who are poor•

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EMPLOYMENT REGULATION: Who pays the price?

When governments require employers to provide benefits such as paid holidays, security of employment and maternity leave, it must be a good thing. Employers have to provide them and employees benefit – or do they? PROFESSOR LEN SHACKLETON details the damaging aspects of employment regulation in the UK

Many people think the United Kingdom's labour market is an unregulated 'Wild West' environment where employers can do as they want and employees are downtrodden and exploited.

Granted, UK regulation is less than in some other European economies such as France and Italy, where tight employment restrictions are arguably one of the main causes of their poor economic performance. But it is nevertheless substantial, and has been growing sharply recently, as the table (overleaf) shows.

Why regulation?

Why do governments lay down rules about employment? The benefits which flow from voluntarily-negotiated contracts are essentially the same as those flowing from free trade between nations: we specialise in what we are good at and 'trade' with others in competitive markets. Both employers and employees gain from freely-negotiated contracts.

Textbooks point to possible 'market failures' in employment – things like monopsony (where workers face a single employer who dictates pay and conditions); externalities (where employer decisions, for instance about training or redundancies, impact on other people or businesses); and information problems (as when employers know more about work dangers than employees).

However the evidence that these problems are of much significance is slight: more commonly government interventions are proposed on redistributive grounds. The argument is that market outcomes are held to be 'unfair' in some way, and an intervention will improve matters. This is the justification used for, say, a minimum wage.

However, economics students will be aware that things are not that simple. A pay increase for low-paid workers benefits some workers who are not poor (as they live in households with other income sources), but penalises other poorer people who can no longer get entry-level jobs as employers cut back on their workforce, substitute machines for staff and become more selective in the criteria they use to pick recruits.

THINGS ARE NOT THAT SIMPLE. A PAY INCREASE FOR LOW-PAID WORKERS BENEFITS SOME WORKERS WHO ARE NOT POOR, BUT PENALISES OTHER POORER PEOPLE WHO CAN NO LONGER GET ENTRY-LEVEL JOBS

Who bears the costs?

The subtler effects of other types of employment regulation are often missed by politicians and the general public. A fundamental issue is the question of who bears the cost of regulation.

The complaints of business people against excessive regulation concentrate on the short run impact of a measure on their bottom line. These complaints are often dismissed as special pleading. Businesses can bear these costs, it is claimed.

But the longer-term impact of a measure does not fall exclusively on the owners of a business. Its impact is rather like the effect of a tax on the consumption of a product where the business may pay the government the monetary value of the tax, but its incidence – who bears the burden – is less clear. The same applies to a regulatory measure.

Take as an example a 'mandated benefit', a government obligation for employers to offer a benefit to employees.

A hypothetical example might be a requirement to give all workers free annual visits to a health spa. Of course, this example is not realistic, but there are very many government mandated benefits under UK employment law.

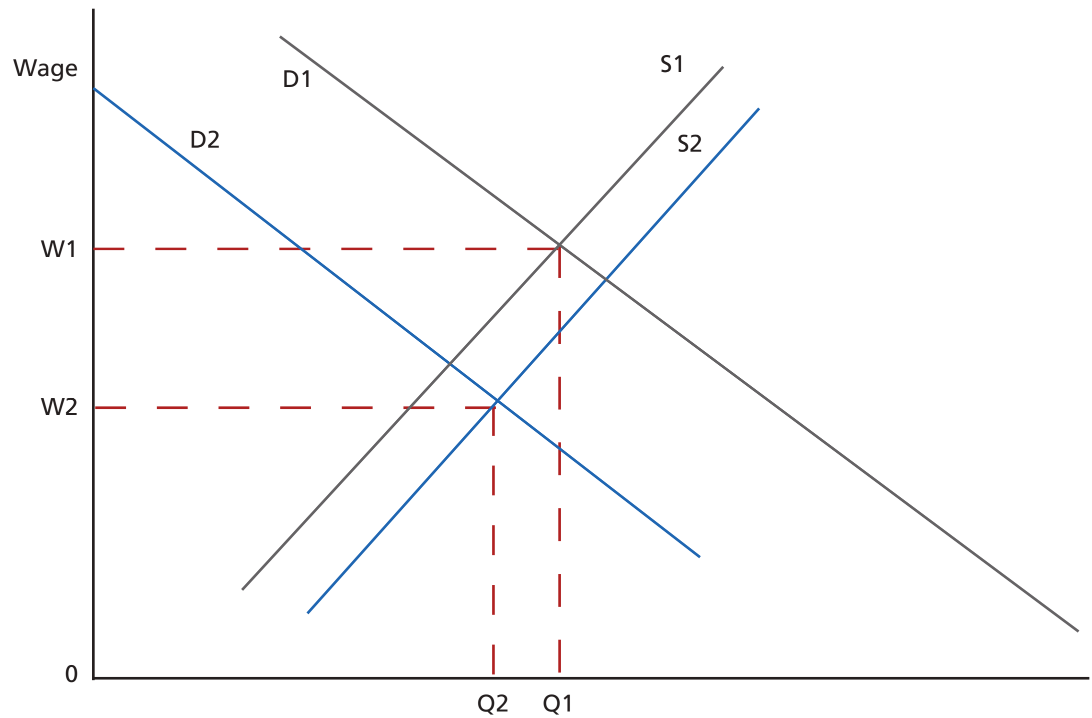
The cost might appear to be borne by the employer. However, in the long term the extra cost would reduce profits and lead businesses to switch resources to another use.

They will therefore try to pass the cost on through higher prices (or, equivalently, lower quality at the same price) to the consumer. This is likely to lead to some fall in the quantity demanded of the product or service, and thus output and employment.

But, in a competitive environment, where international competition for traded goods means that the scope for price increases is limited, what is more likely to happen is that the cost of the benefit is shifted to the workers themselves.

A simple diagram shows how this works. Initially the demand curve for this type of

Figure: The impact of a mandated benefit



labour is D1 and the supply curve is S1. The wage rate is W1 and employment is Q1.

The mandate to provide health spa holidays is introduced and this raises the cost of hiring labour. The demand curve shifts to the left, as it is less profitable to employ a given amount of labour at any given wage rate. The mandate's cost per unit of labour is shown by the vertical distance between demand curve D1 and the new demand curve, D2.

The supply curve will also shift if the employee values the mandated benefit, because at any particular wage rate the job is now a bit more attractive. The vertical distance between supply curve S1 and supply curve S2 represents the employee's valuation of the benefit.

The figure illustrates one possible outcome, where employees value the mandate less than it costs the employer to provide (this can often happen when governments impose mandates which reflect the choices of political activists rather than employees themselves).

In this case the wage rate tends to fall (from W1 to W2), but not to the full extent of the cost of providing the benefit. Part of the cost is borne by the employer, and thus profit-maximising employment falls from Q1 to Q2.

If, however, the employee were to value the benefit at exactly what it costs to provide, the wage would fall to the full extent of the cost.

As the employer would then bear none of the cost, it would be just as profitable to the employer to employ the same amount of labour. Demand would be unchanged and employment would remain constant. Employees would be just as 'well off' as before, only now part of their remuneration would be in the form of the benefit rather than cash.

A final possibility is that employees value the benefit at more than it costs the employer to provide, which could arise if the provision of the benefit was subject to considerable economies of scale.

In such a case we get the odd prediction that wages would fall by more than the cost of the mandate and employment would actually increase. This is unlikely to arise in practice, because if it did the employer would already have had an incentive to provide the benefit without being required to by law: it would

Table: An A-Z of new employment regulation since 2010

This is a partial listing of new requirements placed on business since the 2010 general election. Some result from UK legislation and regulations, others from the European Commission, the European Court of Justice or decisions by employment tribunals or other UK courts.

Requirement	Comment
Abolition of default retirement age	Employers cannot oblige you to retire at a particular age.
Adoption leave extended and pay increased	
Agency Workers Directive implemented	Agency workers given employee rights after 12 weeks
Annual reports on whistle-blowing required	
Anti-slavery statements required annually	Medium-size and large firms
Apprenticeship levy	0.5% on wage bills over £3 million. Apprenticeship title legally controlled.
Auto-enrolment in pension schemes	Rising employer contributions over time to 3% of payroll
Director of Labour Market Enforcement appointed	
Fines for employers in tribunal cases	In addition to costs and payments to employees
Flexible working request rights extended to all employees	Employers have to justify why they cannot allow employees to change hours of work
Gangmasters and Labour Abuse Authority given extended remit and new powers	This is to tackle 'modern slavery'
Gender pay gaps required to be published by larger organisations	'League tables' to be published
Holiday pay extended to cover sales commission	Compulsory holiday pay increased
Jail sentences for employers of illegal immigrants	In addition to heavier fines
Levy on employing non-EU nationals	£1000 per year
Minimum wage non-compliance: stricter penalties	
National Living Wage introduced	For all over-25s, rising over time to 60% of median earnings
Obesity now classified as a disability and thus a 'protected status'	Discrimination based on obesity illegal
Occupational regulation extended	E.g. Childcare workers, private investigators now effectively licensed by the government
Parental leave sharing and extension to grandparents	
Part-time education or training compulsory for school-leavers up to age 18	
Recruitment advertising restricted outside UK	
Wider definition of employee	Tribunal cases have found some 'gig' workers (e.g. Uber) are employees and thus entitled to a range of benefits
Working Time Directive regulations extended	Restrictions on maximum hours worked
Zero hours contracts exclusivity outlawed	Status of all ZH contracts now under investigation by working party

be cheaper to provide the benefit and pay lower wages.

Many non-pay benefits are in fact provided by employers on precisely such grounds: examples include private health insurance, maternity pay in excess of statutory requirements, season ticket loans and gym memberships.

All three of these scenarios suggest that the equilibrium wage will fall. However, if the existing wage rate is very low, and there is a minimum wage rate, wages will not be able to fall, putting all the burden of adjustment on employment.

Lessons

This simple example shows that there are quite fundamental problems in evaluating the impact of employment regulation.

Rather than ultimately falling on profits, the cost of a mandate normally falls on some combination of consumers (in the form of higher prices or lower quality), employees (in the form of wage reductions and/or job losses) and potential employees (who cannot find jobs as employment opportunities dry up).

But in all cases employment and output decisions are affected, and a large number of such interventions can produce an economy where adjustments to fundamental changes in tastes, technology and international competition are difficult and unemployment amongst vulnerable groups and long-term unemployment increases.

Political discussion of employment regulation ignores this as politicians assume (or pretend) that employers bear the cost of growing regulation and there is no wider impact•

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FOR MORE:

This article summarises the forthcoming IEA book ***Working to Rule: the damaging economics of UK employment regulation***, which will be published this spring and will be available for free download at

www.iea.org/publications

Why RENT CONTROLS WON'T WORK

There are loud and frequent calls for the government to introduce rent controls.

But KRISTIAN NIEMIETZ contends that this isn't the answer to Britain's housing crisis.

In fact, he argues, they'll only make matters worse...

Most readers of this column either already know this from first-hand experience, or they soon will: renting a flat is outrageously expensive in the UK.

UK rents are the highest in Europe, both in absolute terms and relative to income levels.[1] On average, British tenants pay 40-50 per cent more than their counterparts in France, Germany, Belgium and the Netherlands.

It is only if you count Monaco as a country that the UK gets pushed into second place, and even then, a number of Inner London boroughs have actually overtaken some Monaco boroughs (Pastor Real Estate, 2014).

So it is not surprising that rent controls are back on the political agenda. The re-introduction of rent controls is now official Labour Party and Green Party policy, and presumably, other parties will follow in due course.

It is easy to see why: rent controls are extremely popular with the general public, and especially with younger voters. Among those aged 18 to 35, only 4.4 per cent oppose rent controls (based on Hilton 2016).

The case for rent controls

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[1] 'Revealed: The most expensive rents in Europe', *Daily Telegraph*, 24 June 2015. Available at http://www.telegraph.co.uk/finance/property/11694273/Revealed-Themost-expensive-rents-in-Europe.html
'UK tenants pay more rent than any country in Europe', *The Guardian*, 24 June 2015, available at http://www.theguardian.com/money/2015/jun/24/uk-tenants-pay-morerent-than-europe

is intuitively clear. Rents are too high, so the state should cap them – problem solved. Plenty of organisations have long been banging the drum for rent controls, and the latest organisation to jump on this crowded bandwagon is the Communication Workers Union (CWU), with a paper written by Alex Hilton (2016).

In describing the problem, this paper is spot on. Britain's exorbitant rents are a huge social and economic problem. They undermine the living standards of renters, and at the lower end of the income distribution, they have become the main cause of poverty and hardship.

They cost taxpayers billions, because they make millions of people dependent on Housing Benefit. They undermine labour mobility, because the problem is most pronounced in those parts of the country which have the best jobs and earnings prospects, thus locking people out of these areas.

They inflate consumer prices across the board, because the same factors which raise private rents also raise commercial rents in sectors like retail, and this then gets passed on to consumers. The list goes on.

So yes, the problems identified by the CWU are very real indeed. But rent controls are not the solution. Like most prices, rents are really messengers of scarcity.

A high price is a messenger who tells consumers: "There is very little of this good, and lots of people want it, so use it as sparingly as you possibly can". This messenger also tells (current and potential) suppliers: "There is very little of this good, and lots of people want it, so if you can possibly spare some of it, do it."

A price control, then, is a form of shooting the messenger – except, it is worse than that. It means forcing the messenger to tell a lie.

A controlled price is a messenger who, at gunpoint, is made to tell consumers: "Everything is fine! This good is available in great abundance. So don't hold back, don't be shy, please help yourself to some more."

His message to (current and potential) suppliers is: "This good is available in great abundance, so even if you can spare some of it, don't bother too much."

Rents are not an exception. The reason why rents, or rather, housing in general, is extremely expensive in the UK is simply that there is not enough of it. Relative to population size, the UK has the smallest housing stock in Western Europe. So of course housing is more expensive here than in places that have more of it.

Rent controls could not change that underlying reality. They would not add a single flat to the country's housing stock. On the contrary: they would entice the 'marginal landlord' – the person for whom the decision to be a landlord is a borderline decision – to leave the market.

Think of somebody who partitions off a part of their property, and converts it into a self-contained flat, but who would actually quite like to use that living space for themselves and/or their family – that person would no longer have the same incentives to do so.

BRITAIN'S EXORBITANT RENTS ARE A HUGE SOCIAL AND ECONOMIC PROBLEM...AT THE LOWER END OF THE INCOME DISTRIBUTION, THEY HAVE BECOME THE MAIN CAUSE OF POVERTY AND HARDSHIP

On the demand side, rent controls would also entice the 'marginal tenant' to either enter the market if they are not already participating, or to demand more of the product than they currently do. To cut a long story short, with rent controls, more people would chase fewer flats.

This is exactly what has happened wherever rent controls have been tried. One of the most consistent findings in economic research is that rent controls cause more problems than they solve.

It is a similarly consistent finding that housing supply is mainly driven by the severity of land use restrictions. The UK has been building fewer new homes than other countries for decades, because the UK imposes exceptionally severe restrictions on housebuilding.

- UK rents are the highest in Europe both in absolute terms and relative to income
- British tenants pay 40-50 per cent more than their counterparts in France, Germany, Belgium and the Netherlands
- Rent controls do not solve the problem of high rents, which is created by land-use planning controls restricting the supply of property
- Indeed, rent controls exacerbate the problem by encouraging more demand and reducing supply, thus worsening the accommodation shortage
- A recent Communication Workers Union paper provided an excellent description of the problems in the UK market for rented housing, but solutions which, if implemented, would be a disaster

For example, it is virtually impossible to build anything near London, Oxford, Cambridge, Bristol or Bath, because these cities are surrounded by greenbelts, where development is only permitted in exceptional circumstances (though it should be noted that 'greenbelt' is a misnomer because a lot of greenbelt land is not remotely green).

Add to that height restrictions and obstacles to densifying urban areas, and it is no wonder that levels of housebuilding are so low in the UK.

This is the reason why the UK has such high housing costs, and easing those restrictions is the only way the problem can be solved. Silencing the messenger, or rather, forcing them to say that the problem does not exist, is not a solution.

The CWU paper is a missed opportunity. As far as the description of the problem is concerned, this paper is entirely correct, timely and relevant.

The problem with the paper is that it plays to the gallery of trendy anti-capitalism. The author does not deny that there is a supply side problem, and he does not defend the British planning system.

But he does not take this part of his argument any further, because he is too eager to signal his anti-market credentials. He wants to portray the problems in the UK rental markets as problems of 'neo-liberal' free market economics, yet if he went further in acknowledging the effect of planning constraints, he would not be able to sustain that favoured narrative.

Government intervention has caused Britain's housing shortage in the first place, yet Hilton wants to make a case for yet more government intervention.

This leads him to disregard solutions that would work, and that have demonstrably worked in other places, in order to advocate a non-solution that is destined to fail, and that has demonstrably failed elsewhere•

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FOR MORE...

For a more detailed response to the Communication Workers Union's proposals and further references, see Niemietz, K (2016), *The Key to Affordable Housing. A critique of the Communication Workers Union's rent control proposals.* Current Controversies Paper No.53, London: Institute of Economic Affairs.

CONFERENCE CALL...

This Spring, the IEA has been staging sixth form conferences the length and breadth of the UK – with more to come in the weeks and months ahead.

At our conferences, sixth form A-Level and IB Economics students hear from speakers at the top of their fields on topics such as *"Robots and Jobs: See it from an economist's point of view"*, *"Is there such a thing as the gender wage gap?"* and *"Market Failure and Government Failure in healthcare"*.

These conferences are **free to attend**. If you're interested in attending one – or you'd like to host a conference at your school - please contact Sophie Sandor: **ssandor@iea.org.uk**

SCHEDULE

March 2017
Monday 13 — **City of London School**

April 2017
Wednesday 5 — **Harrogate Grammar School**

May 2017
Thursday 4 — **Mander Portman Woodward, West London**

October 2017
Wednesday 11 — **Concord College, Shrewsbury**

November 2017
Thursday 9 — **Loretto School, Edinburgh**
Thursday 16 — **Solihull School, West Midlands**
Tuesday 21 — **Millfield School, Somerset**
Friday 24 — **Bromley High School, South London**

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Last summer saw our second annual **THINK** conference – with 450 school pupils, university students and young professionals joining us to hear from some of the world's **biggest names in economics**.

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We'll be announcing speakers and programme details during the build up to **THINK**. To find out more, keep up to date with announcements and buy tickets (which are currently on sale at a discounted price for a limited time only!) please visit **thinkiea.com**

AND you can **watch videos of the talks from THINK 2015 and 2016** by visiting the home page of the **THINK** website!

INTERESTED in INTERNING?

DEADLINE FOR ALL SUMMER 2017 PROGRAMMES: 31 MARCH 2017

Here at the IEA, we have internship opportunities all year round – so if you're interested in applying or just want to find out more, please visit the 'Students' section of our website.

Whatever kind of internship you undertake, you'll be a part of the IEA family and able to take part in the activities staged by the Institute. Interns also remain a strong part of the IEA network as alumni.

SUMMER INTERNSHIP

You can apply for the following dates in 2017:

Tuesday 8 August – Friday 25 August

Tuesday 29 August – Friday 15 September

Each summer, the IEA welcomes nearly 80 interns from around the world for a packed programme of lectures, seminars, debates, discussions, events and social activities.

Each intern produces a supervised research project, chosen by themselves, and mentored by one of the IEA's senior research staff. Research topics have been very eclectic – ranging from the effect on women of micro financing in Bangladesh to the role of merchant jurors in the adjudication of 18th century commercial disputes!

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SIXTH FORM INTERNSHIP

You can apply to one of three weeks in 2017:

Monday 10 July – Friday 14 July

Monday 17 July – Friday 21 July

Monday 24 July – Friday 28 July

We provide a dedicated week of work experience for 120 sixth formers in three groups held across the summer. The week includes lectures and discussions with expert economists. There's the chance to hear from people from academia, politics and the Treasury about career opportunities and much more. And, at the end of the week, there's a debate with your fellow interns.

GENERAL ACADEMIC INTERNSHIP

These are open to those who are just finishing undergraduate studies or undertaking postgraduate studies. You can apply at any time for an unpaid internship which will run for an agreed period of time outside of the summer months.

We do not accept any academic interns between the 20 June and the 20 September. Internships normally last between six and eight weeks. You will receive academic support and be able to attend regular events held at the IEA. However, the programme of lectures and discussions will not be as structured as the summer programme.

You can apply for any of these internships by sending an up-to-date CV and a letter of no more than 500 words explaining why you would like an internship and your research topic interests to internships@iea.org.uk. Please also indicate which dates are best suited for you.

Please note: All our internships take place in the IEA offices and are unpaid.

FALSE ALARM!

Many commentators try to fill us with a sense of economic foreboding because of the debt we're accumulating. But they're wrong to do so - and are only looking at part of the picture, suggests TIM CONGDON

2016 was a year when consensus pundits deserved three times to have egg on their faces.

Top opinion-formers were shocked when the British people voted to leave the European Union on 23 June and when the American electorate decided on 8 November that Donald Trump should be their next president. Everyone can remember these upsets.

But another of 2016's surprises has been almost forgotten. At the start of the year influential economists were loud in expressing concern that a recession – perhaps a big recession – was imminent.

Like the "experts" on Brexit and Trump, they now look silly. The year enjoyed steady growth of demand and output. Indeed, leading indicators of economic activity still looked good for 2017 in the closing weeks of 2016.

Some of the brashest warnings about a slump came from economists with links to the Organization of Economic Cooperation and Development (OECD), and the Bank for International Settlements (BIS).

Perhaps the most prominent of these was William White, then chair of the OECD's review committee and previously chief economist at the BIS. *The International Business Times* of 20 January reported that in his judgement, "Global debts have built up to such an extent that the world is facing another financial crash, worse than the one in 2007-08."

In an interview given to Ambrose Evans-Pritchard of *The Daily Telegraph*, just ahead of the World Economic Forum meeting in Davos in late January 2016, White used lurid phrases.

To quote, "in the next recession…many…debts will never be serviced or repaid, and this will be uncomfortable for a lot of people who think they own assets that are worth something…The only question is whether we are able to look reality in the eye and face what is coming in an orderly fashion, or whether it will be disorderly. Debt jubilees have been going on for 5,000 years, as far back as the Sumerians."

Yes, it is true over the last 5,000 years many debts have not been honoured in full or even at all. But it is also true that the activities of lending and borrowing, and of incurring debt and worrying about it, have grown enormously since the dawn of civilisation.

Indeed, in the last three centuries the Industrial Revolution has been accompanied by a no less remarkable Financial Revolution. People have converted debts into marketable securities, and then bought and sold these securities to their mutual benefit, while banks have been established with the explicit purpose of making profits by creating new debt.

Astonishing though it may seem, for many centuries most debts have been serviced properly and repaid. There was in fact nothing special about early 2016 to justify White's alarmism.

But the debt anxieties that now seem to figure regularly in BIS and OECD commentary need to be subjected to more general criticism. The underlying assumption behind "debt-ism", as the relevant body of ideas might be called, is that people borrow only to consume.

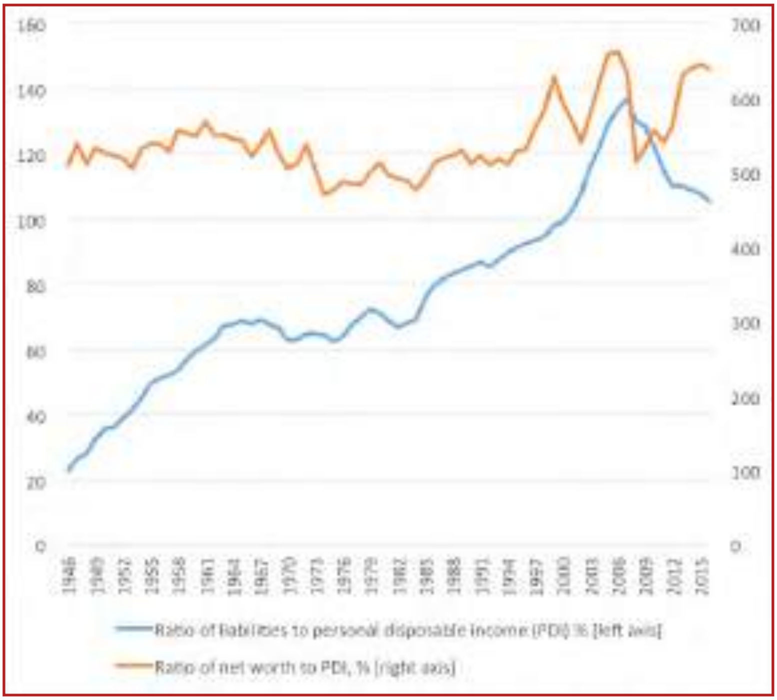
ASTONISHING THOUGH IT MAY SEEM, FOR MANY CENTURIES MOST DEBTS HAVE BEEN SERVICED PROPERLY AND REPAID. THERE WAS IN FACT NOTHING SPECIAL ABOUT EARLY 2016 TO JUSTIFY ALARMISM

As debts pile up in this sort of world, the debt-to-income ratio rises and serves as an index of financial unsustainability. The debt-ists surely have common sense on their side when they say that, sooner or later, creditors will want their money back. At the least, creditors will demand that the rise in indebtedness comes to a stop.

If so, borrowing must be reversed and spending reduced. The high debt-to-income ratio does then presage a downturn in demand and a recession.

Such reasoning is misguided, on two grounds. First, most people do not borrow in order to consume, but to acquire a capital asset.

The principal assets in question here are houses, but people also borrow to finance the purchases of cars and other consumer durables, and even to start new businesses.



The debt-to-income ratio ceases by itself to be an index of financial unsustainability; the ratio of assets to income must be brought into the picture. If assets are well above debt, there ought to be nothing to worry about.

Good data on the household sector balance sheet are available for the USA back to 1946, when debt amounted to a mere 23 per cent of personal disposable (i.e., after tax) income and assets were many times larger at just over five times income.

Between 1946 and 2007 the debt-to-income ratio soared to 137 per cent. At least superficially this was a vast deterioration which, in accordance with debt-ist theory, created the background conditions for the Great Recession.

However, it must be emphasised that in 2007 the American household sector held assets equal to more than eight times income, much above the ratio of five times in 1946. Over the six decades from the end of the World War II, debt had risen explosively relative to income, but the value of assets had gone up as well. Looking at debt in isolation was misleading.

Indeed, a remarkable feature of the numbers must be highlighted. The historical experience is that assets increase by amounts so much larger than debt that the net-wealth-to-income ratio and the debt-to-income ratio can and usually do rise together!

This is clear from the figure. Just before the Great Recession Americans were ostensibly in a curious position. Relative to their incomes, they had more debt than ever before. Yet they were also wealthier, again relative to incomes, than in any previous epoch!

The net-wealth-to-income ratio for 2006 was 6.6 times, which was above the previous peak of 6.3 in 1999, comfortably ahead of the high values of well over five seen during the 1960s and noticeably above the 1946 value of 5.1 when our analysis started.

The second difficulty with White's thesis is logical. Some people can borrow only if others can lend. When a nation's debt-to-income ratio is cited, the tendency is to suppose that everyone in the nation has some debt. This may be an excusable mental habit, but it is lazy and wrong.

Many people have no debt at all, whereas others may have debt that is a high multiple of – say, four or five times – their income. (Think of young people just after they have used mortgage debt to buy their first home.)

Any assessment of sustainability must investigate the specific and particular financial position of borrowers, and accept that most individuals are forward-looking and rational.

The wider messages of this article are straightforward. When economists try to forecast, they are right to look at how much debt people have, but debt must be set within the context of the balance sheet as whole.

The behaviour of asset prices is critical, justifying further research on the determinants of asset price movements. High levels of debt did not *by themselves* signal a global downturn at the start of 2016, and neither do they give that signal in early 2017.

Further, when scary tittle-tattle is reported in the *Financial Times* and *The Daily Telegraph* and attributed to the World Economic Forum, don't expect it is anything more than gossip about guesses•

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"INSPIRATIONAL"
"ENGAGING"
"INTENSE"
THINK
"EXCITING"
"STIMULATING"
"INCISIVE"
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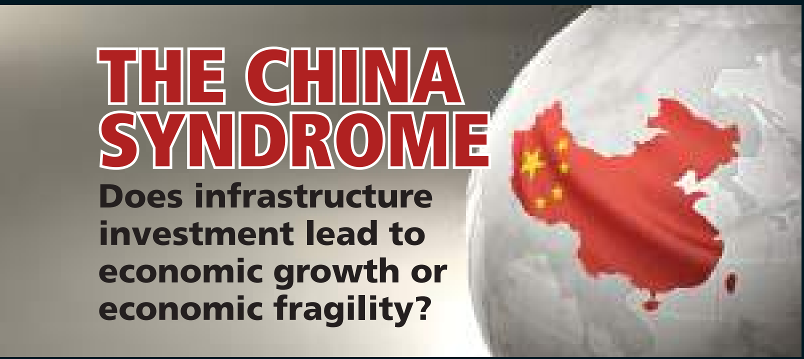
Summarising and signposting essential reading we've seen elsewhere...



THE CHINA SYNDROME

Does infrastructure investment lead to economic growth or economic fragility?

It is often claimed that public infrastructure spending is desirable because it has positive spillovers – such as lower transport costs and increased productivity – which make the social benefits of such expenditure higher than the private benefits.

China is held up as an example, having seen double-digit growth rates in infrastructure investment in recent years, alongside very high rates of GDP growth.

However, the effectiveness of Chinese infrastructure spending has seldom been tested empirically. This paper examines 95 road and rail projects undertaken in China between 1984 and 2008. The authors seek to estimate how many of the projects, once completed, were of net economic benefit.

They find that 75 per cent of the projects suffered cost overruns, and that half encountered a schedule delay. This is a better performance than Western countries – where 70 per cent of infrastructure projects suffer delays – but the authors speculate that incentives in China may be such that project managers are encouraged to work quickly at the expense of road safety and environmental impact. It is worth noting that China has one of the highest road fatality rates in the world, at 18.8 deaths per 100,000 inhabitants per year.

When it comes to project benefits, the authors find that the average traffic shortfall against forecast was only 5 per cent. However, the average conceals the wide discrepancy between individual projects: 64.7 per cent had traffic starkly below forecast – with their average shortfall at 41.2 per cent – whilst the remaining 35.3 per cent had excess traffic averaging 61.4 per cent, which led to congestion.

A project is judged to be of net economic benefit if it has a benefit-cost ratio (BCR) in excess of 1 – meaning, quite simply, that the benefits exceed the costs. The authors find that 55 per cent of the projects studied had a BCR below 1. Given uncertainty over project operation and maintenance costs, they calculate that only 28 per cent can be considered of genuine economic benefit.

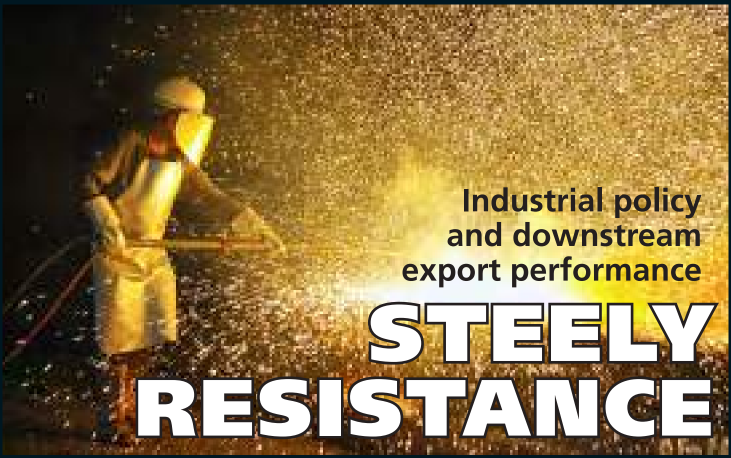
The paper concludes that the link between Chinese infrastructure spending and economic growth is weaker than often assumed. Furthermore, it argues that heavy infrastructure spending has contributed to increasing macroeconomic vulnerability.

China's ratio of total debt to GDP has reached 282 per cent, dangerously high for a middle-income country with an ageing population. Much of this is public debt or debt from state-owned entities such as banks.

Combined with massive monetary expansion, heavy indebtedness could make a potential future crash deeper and more prolonged.

ANSAR, A., B. FLYVBJERG, A. BUDZIER and D. LUNN

Oxford Review of Economic Policy 32(3): 360-390, 2016



Industrial policy and downstream export performance

STEELY RESISTANCE

The use of industrial policy to promote targeted domestic industries fell out of favour in much of the West from the 1980s, as empirical evidence showed that state subsidies and trade protectionism made industries less efficient and raised costs for consumers.

However, in recent years industrial policy has seen a revival, exemplified by calls in Europe and the United States for protective tariffs against Chinese steel imports and by the creation of a Department for Industrial Strategy following the Brexit vote.

Whilst advocates of industrial policy often point to the presumed benefits that intervention may have

RED TAPE TANGLE

Labour market regulations and capital intensity

Microeconomic theory suggests that labour market regulation which raises the cost of employment – such as statutory pay floors, limits on working hours and rules on the scope and duration of work contracts – will lead employers to substitute capital for labour.

Substitution may have a differential impact according to skill levels, with low-skilled workers more vulnerable to replacement by capital than high-skilled workers.

This paper tests the hypothesis empirically by examining a panel of 14 OECD countries between 1988 and 2007. The sample includes both countries where employment markets are tightly regulated, such as France and Spain, and those that are relatively more liberal, such as Britain, Denmark and the United States. The authors analyse data across a range of manufacturing and service industries.

The paper finds that employment protection legislation is associated with higher capital-to-labour ratios. Importantly, capital intensity in both R&D – where labour costs are a large share of total costs – and ICT are negatively associated with labour market regulation. Increased labour market regulation tends to lower the capital share in research and information technology.

Overall, increased labour market regulation is associated with a higher share of high-skilled employment in total employment and a lower share of low-skilled employment. This may be because capital is primarily a complement to high-skilled labour whilst it acts as a substitute for low-skilled workers. Of course, if low-skilled workers are made unemployed then the share of high-skilled workers will increase.

The authors then estimate the impact of a hypothetical labour market liberalisation programme.

They define liberalisation as closing the gap with the level of regulation that exists in the United States, which has the least restrictive employment legislation according to the OECD.

Liberalisation would increase the share of low-skilled employment in total employment and lower the high-skilled share, though the effects are more complex in R&D and ICT sectors. All of these effects would be particularly pronounced in the high-regulation economies.

The paper underscores the paradox of employment protection legislation, which ostensibly aims at protecting the most vulnerable workers, but which may in fact worsen their employment outcomes.

Whilst the authors do not examine the impact of regulation on total employment, the high-regulation countries in their sample exhibit consistently higher unemployment rates – particularly among the young – than more liberal economies.

CETTE, G., J. LOPEZ
and J. MAIRESSE
NBER Working Paper 22603. Washington, DC: National Bureau of Economic Research, 2016

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on targeted sectors, it is important to examine the effect of such policies on the economy as a whole.

This paper estimates the impact of industrial policies targeting the steel industry – including import tariffs, government ownership, cartelisation, price controls, non-tariff barriers and subsidies – on the export performance of domestic users of steel, such as the construction and manufacturing sectors. The author uses a sample of 22 countries from 1975 to 2000.

There is wide variation in the number of interventions applied in each of the countries studied, ranging from two or fewer in America, Canada and New Zealand, to more than five in Italy, Belgium and France. The paper also documents a general decline in the use of industrial policies from the mid-1980s.

The author finds that steel interventions perceptibly affect the export performance of downstream producers.

Specifically, his estimates suggest that a one standard deviation increase in industrial policy is associated with a 1.2 per cent decline in exports for the average steel-using firm in that country, a decline which is as high as 6 per cent for those sectors which are heavy users of steel. These negative results are driven by the performance of developing countries.

When further tests are performed, the paper finds that Germany, Belgium and the Netherlands also exhibit significant harmful effects from steel intervention on export performance.

Two interventions are found to be particularly harmful to exporting industries, namely steel export subsidies – which raise the domestic price of steel since steel producers forego the subsidy when they sell domestically – and government ownership of the steel sector, which could lead to inefficient and costly production.

BLONINGEN, B
The Economic Journal 126(595): 1635-1659, 2016.


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In DEFENCE of CENTRAL BANKS...

At a time of increasing suspicion of 'experts' it should come as no surprise that the quintessential technocracy, the modern central bank, has come under fire.

Prime Minister Theresa May took aim at the Bank of England's prolonged monetary easing at her party conference speech last October. And gone are the days when the doyen of 20th-century central bankers, Alan Greenspan, could claim rock star status.

What explains the shift? It is tempting to ascribe it to the wider mood of discontent and anti-establishment sentiment claimed to have been behind the Brexit vote and Donald Trump's victory.

But the recent performance of monetary authorities is also likely to be a factor. In the 1980s and 1990s, central banks were widely perceived to have successfully vanquished inflation and enabled an extended period of growth and macroeconomic stability.

However, following 2008, central banks largely failed to see the downturn coming, they failed to adhere to the Taylor rule for monetary stability, and they failed as regulators, whether by commission or omission.

After 2008, central bank activism has depressed interest rates to an unprecedented extent, with negative consequences for savers and with a potentially destabilising impact on asset prices. Yet, growth has been sluggish. It is no wonder that the public is losing faith in the wisdom of technocrats.

But one should be careful not to draw extreme conclusions from the experience of 2008. It is convenient for politicians to call for a curtailment of, or even an end to, central bank independence.

However, central bank independence was arrived at after recurrent episodes of high and rising inflation, followed by recessions. These years confirmed the unsuitability of elected officials for interest rate management.

The heart of the matter is what economists call the time-consistency problem, namely that it is optimal for politicians to promise one thing (to do whatever it takes to keep inflation low) and later do another (to ease interest rates in order to foster a short-term boom that will make them more popular).

What is good for the economy in the long term (price stability) can be in conflict with what is best for politicians' own prospects in the short term (re-election).

By making central banks independent, we not only can get lower inflation, but the markets will see that lower inflation is a credible promise.

Whatever the problems, recent experience of central banking does suggest that independent central banks, once given a mandate for price stability, are better able to meet it than politicians.

There are important questions about the extent to which central banks ought to be autonomous from elected governments.

Nonetheless, there should be no mistake that central bank independence, as far as maintaining a stable price level is concerned, has been an unambiguously positive development•

DIEGO ZULUAGA SAYS CENTRAL BANKS SHOULD BE KEPT OUT OF POLITICIANS' HANDS

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Full version at:
www.iea.org.uk/in-defence-of-central-bank-independence/

CUBA after CASTRO

IS 'DEMOCRATIC SOCIALISM' A REALISTIC OPTION FOR CUBA? ASKS **KRISTIAN NIEMIETZ**

After Fidel Castro's death, my social media feed was dominated by Castro-apologists for well over a week. An unexpected exception was author and commentator Owen Jones, of all people. He wrote:

"Cuba […] is a dictatorship. Socialism without democracy […] [is] paternalism with prisons and persecution. Socialism means socialising wealth and power – but how can power be socialised if it's concentrated in the hands of an unaccountable elite? […]

Cuba could democratise and grant political freedoms currently denied as well as defending […] the gains of the revolution. […] [T]his is the next stage of the revolution."

Jones wants to leave Cuba's economic system more or less as it is, but he wants to combine it with Western-style democracy and civil liberties. Could that work?

Let's imagine the Cuban government took up Jones's advice, and allowed a free press (including foreign newspapers), internet access for private households, freedom of assembly, freedom of speech, freedom to travel, freedom to emigrate, and so on.

This would undoubtedly make Cuba a much better place in many ways. But it would not solve the country's economic woes, because these have nothing to do with the fact that Cuba is not a democracy.

China is not a democracy, but that has not stopped it from growing at phenomenal rates since the 1980s. South Korea and Chile only became democracies when their economic take-offs were already well under way.

Cuba's under-development has nothing to do with the lack of democracy, and everything to do with the fact that it is a socialist economy.

So imagine this scenario: Cuba would still be as poor as it was before, but people would now have unlimited access to American and European newspapers, websites, movies, social media, etc.

News sources, including foreign-owned ones which might have an overt anti-socialist agenda, would be free to remorselessly expose the scale of economic failure. They would be free to attack the government, including in a sensationalist way.

Imagine Sun-style or Daily-Mail-style headlines, denouncing shortages of goods and services. And, crucially, people would now be free to leave. Indeed, some news sources, perhaps owned by exiled Cubans living in Florida, might explicitly encourage them to leave, perhaps by painting an overly rosy picture of life in Miami.

How likely is it that Cuba could remain *both* socialist and politically liberal for longer than five minutes?

Jones's ideas are not new. What he describes is essentially the agenda of East German protest groups in the 1980s: they wanted to keep a socialist economy, but combine it with civil liberties, political freedoms and human rights.

But it turned out that as soon as the Berlin Wall was open, the game was up. Socialism and freedom just do not mix well. They did not mix in East Germany, and they will not mix in Cuba•

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Full version at: www.iea.org.uk/cuba-after-castro-democratisation-as-the-next-stage-of-the-revolution-not-happening-comrade-jones/

Not such a TARIFFIC idea...

Tariffs primarily hurt the consumers of the country imposing them on imported goods. That is such an important insight that it deserves reiterating.

Both the Remainers who want us to stay within the EU's customs union, as well as Brexiteers who advocate using tariffs to "punish" the EU in the event that it turns down tariff-free trade arrangements, seem to completely misunderstand this crucial point.

A report from the think tank Civitas, for example, purports to show that the UK is in a position of huge strength in seeking a free trade deal with the EU.

Why? "If we leave the EU without a trade agreement," it says, "it will cost the remaining EU members £12.9bn in tariffs whereas it will cost us only £5.2bn".

No. The implicit assumption here is that the cost of tariffs is borne by exporter producers rather than our domestic consumers.

Certainly, in the short term, it would be extremely inconvenient for UK and EU producers to find tariffs applied to their goods as this would affect demand patterns.

RYAN BOURNE FEARS CONSUMERS WOULD PAY THE PRICE FOR PROTECTIONISM

But producers can ultimately sell their goods elsewhere and, if they cannot, post-tariff prices will almost certainly rise. Consumers, on the other hand, cannot avoid tariffs.

As tariffs raise prices, the consumer is forced to either buy less of the relevant good or less of some other good (or substitute inferior goods for the goods with the tariffs applied).

The price increase can be thought of as a reduction in consumer income and choice – it hurts the economy negatively twice: first through raising consumer prices directly and secondly through insulating domestic firms from competition in a way that reduces innovation and productivity.

The £12.9bn figure, far from showing the cost "to the EU" of us imposing tariffs, shows the huge cost the UK government would impose on its own domestic consumers were it to be stupid enough to participate in tit-for-tat protectionism•

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Full version at:
www.iea.org.uk/repeat-after-me-tariffs-primarily-hurt-domestic-consumers-not-foreign-exporters/

THE EURO: And its threat to the future of Europe

JOSEPH E. STIGLITZ ***W.W. NORTON & COMPANY 2016***

Since the onset of the euro zone crisis, two schools of thought have emerged, offering different diagnoses of the single-currency area's woes. The first focuses on the supply side, namely, the rigidity of labour and product markets in many of the worst-affected euro zone economies.

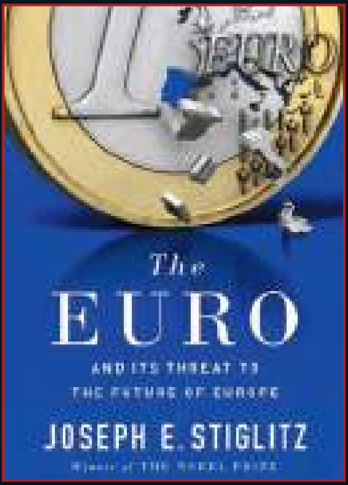
The second interpretation blames bad governance for the euro crisis. Without common mechanisms to address macro-economic imbalances, it is argued that the euro zone will be unable to spur investment and growth in many of its member countries.

The case made by the Nobel Prize Winner, Joseph E. Stiglitz, sits firmly within the latter school of thought.

In Stiglitz's view, the acuteness and length of the recession in the single-currency area can be explained by flawed structures – especially the lack of greater risk-pooling among member countries – and a counter-productive policy response.

He argues that so-called austerity, the emphasis on balanced budgets and structural reforms in the countries that have received external assistance – Greece, Ireland, Portugal, Spain and Cyprus – was an ideological choice made by technocrats with little economic backing.

Stiglitz further claims that the rules of euro membership, which restrict budget deficits and national debts, have prevented the expansionary fiscal response that was required to restore these countries to health, leading instead to mass unemployment and low growth.



The reasoning behind restricting euro governments' fiscal autonomy is to ensure that no country would find itself at risk of default, which would compromise its membership of the single currency and thus threaten the integrity of the euro zone itself.

This is indeed what happened when member countries, starting with Greece, were revealed to have had consecutive budget deficits well in excess of the 3 per cent limit. As investors began to fret over the likelihood of one or more euro zone departures, the future of the single currency became uncertain.

Yet, Stiglitz gives these arguments short shrift. He entirely overlooks the central role of public authorities in the years before the crisis, exemplified by the Spanish government's aggressive promotion of home ownership through public banks; the Greek administration's reckless borrowing to finance the expansion of the public sector payroll; and the dangerous nexus between private banks and the government in Italy.

He also fails to consider that, in the early years of the downturn, these same governments attempted to overcome their problems by increasing public expenditure still further. It was only when they lost their ability to borrow at competitive rates in international markets that they changed tack. By this time, some had entered into sovereign rescue programmes.

Stiglitz believes that the euro zone needs centralising reforms – such as the mutualisation of national debts and the introduction of controls on cross-country trade – to overcome its current predicament.

Otherwise, he would rather member countries give up the single currency and return to national monies. It is difficult to imagine governments agreeing to such a transfer of powers and mutual risk sharing at a time of continued economic weakness and increasingly unstable politics.

Moreover, Stiglitz's proposals would entail the abolition of the central building blocks of the EU, not least the free movement of capital. Those who disagree with Stiglitz's diagnosis and worry about the implications of his reform agenda can thus draw comfort from the fact that it is unlikely to become a reality in the near future.

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THE CASE FOR A 100 PERCENT GOLD DOLLAR

MURRAY N. ROTHBARD **LIBERTARIAN REVIEW PRESS 1974**

Murray Rothbard wrote *The Case for a 100 Percent Gold Dollar* in 1962, initially as a contribution to a volume of edited essays.

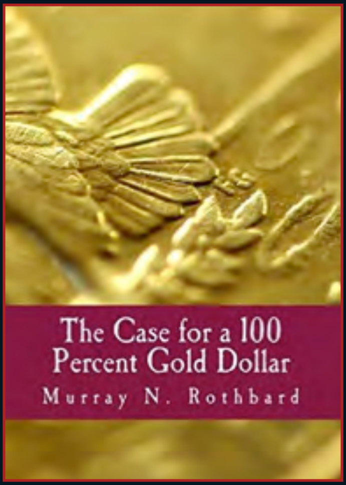
This was part of Rothbard's most productive year as he was putting together his overall socio-economic paradigm, which later came to be anarcho-capitalism.

Most of the essays in the book sought some form of system-wide monetary policy and policy transition. And most took the position that we need a change in or the relationship between monetary and fiscal policy.

Rothbard was the outlier here. He championed the full gold standard. His preferred policy was not a historical gold standard. To his mind, these had always been compromised by being government-established monetary systems with bailout guarantees for banks, government coinage, limited convertibility, unclear legal language concerning the status of deposits, and centralisation in general.

Rothbard's favoured gold standard was different. He believed in only private coinage. He wanted a clear legal distinction between instantly redeemable deposits and loan-banking in which the depositor is taking a risk in exchange for interest payments. He wanted banks to operate like any other business that would be subject to bankruptcy when they make entrepreneurial errors.

The vision is inspiring and he makes a powerful case that it could work, if only we were willing to give it



a try. Rothbard marches through the history of the government's destruction of the old gold standard. As imperfect as it was, it was better than what came after World War II, which was barely rooted in gold at all.

And here is the critical point: it is impossible to understand Rothbard's position on the gold standard without considering the system of monetary management in place when he formed his position. However vaguely and loosely, the dollar was still based on gold after the war. It was defined as 1/35 of an ounce. Rothbard wanted to take an existing system, dramatically improve it, clean up the legal regime behind it, and make it a permanent feature of a free-market economy.

Today we live in a very different world. The gold standard, even the small remnants of it that survived until the time Rothbard was writing 1962, has been obliterated from the world economy. There is a global market for gold today that exists in all its sophistication as an institution completely set apart from monetary management.

Hence, "returning to a gold standard" is not a matter of improving an existing system but of completely replacing our system.

My own sense, after long thought, is that none of this would be possible. More importantly, it might not even be desirable given the extraordinary innovation in cryptocurrency that works to realise the Rothbardian-style dream of sound money without reliance on gold.

We have the ability to reform the system today, not with top-down imposition but with bottom-up innovation.

Where, then, is the value in Rothbard's monograph? His history is compelling. His vision is persuasive. His institutional commitments are sound. His dream of a separation of money and the state is exactly right.

Ironically, however, all of this can be realised without insisting that gold be the foundation of it. Technology has given us the path to rescue the best parts of his theory while forging a much more realistic plan for a genuine free-market monetary system.

*This essay is now available at: **www.mises.org/library/case-100-percent-gold-dollar-0***

Jeffrey Tucker
Director for Digital Development
Foundation for Economic Education


Soundbite

The HIDDEN COST of HEALTHY LIFESTYLES

When the NHS was created in 1948, Aneurin Bevan believed that healthcare spending would fall as the population became healthier.

In the years since, infectious diseases have been virtually eradicated, diets have improved, smoking rates have plummeted, and life expectancy has risen from 68 years to 81 years. And yet healthcare spending has manifestly not fallen.

The NHS budget, which represented less than three per cent of GDP in the early 1950s, exceeds seven per cent of our (much larger) GDP today.

The belief that the NHS's financial problems would be alleviated if people led healthier lifestyles continues to be widely held. When policies to clamp down on bad habits are proposed, campaigners cite the cost of smoking, drinking and obesity as their justification.

When government preventative health budgets are cut, those who work in the sector claim that it is a 'false economy' that will cost the government more in the long run by creating more illness.

None of this makes sense to economists who understand that healthier lifestyles not only increase healthcare costs but also put a strain on other government departments by raising demand for pensions and social care.

As Jane Hall explains in the *Oxford Handbook of Health Economics*, most preventive medicine, if successful, adds to government spending in the long run. 'Although it is frequently argued (but not by economists) that prevention will save expenditure on future treatment,' she writes, 'the current body of evidence demonstrates that it is more likely to generate additional health care costs.'

Economic studies have found that 80 per cent of preventive health initiatives increase overall healthcare expenditure. In financial terms, a stitch in time does not save nine.

CHRISTOPHER SNOWDON INVESTIGATES

The reason is simple. A large proportion of a person's healthcare costs are spent in the last year of life. These end-of-life costs cannot be prevented, only delayed, and are much the same regardless of the age at death.

The years of life gained by lifestyle changes and medical technology tend to come when the person is retired and is a net recipient from the welfare system.

The person who would have lived to the age of 68 when the NHS was founded now lives an extra thirteen years. This means an extra thirteen years of healthcare provision, pension payments and other benefits – all at a time when the person is paying no income tax.

When campaigners talk about the costs of smoking, drinking and obesity, they ignore the costs of old age that taxpayers would have to meet if nobody smoked, drank or gained weight. Most studies have shown smoking to be cost-saving overall and the same may also be true of obesity.

All told, only a fraction of the £24 billion paid in alcohol and tobacco duty each year is needed to pay for public services related to drinking, smoking and obesity. The rest of it is essentially a subsidy paid by those who drink and smoke to those who do not.

Whilst it would be repugnant for the government to actively encourage unhealthy living to save itself money, those who believe that taxes would be lower if unhealthy habits were stamped out are mistaken.

There is a case for spending government money on preventative health care and there is a case for taxing alcohol and tobacco consumption.

However, the case for both these policies cannot be made from the perspective of saving government money in the long run. As far as externalities arising from eating, drinking and smoking are concerned, they may exist, but they do not relate to costs imposed on taxpayers.

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HELL
TOUPEE?

RAZEEN SALLY CONTEMPLATES THE NEW GLOBAL ORDER IN THE AGE OF TRUMP

Donald Trump's election is perhaps the biggest political shock worldwide since the fall of the Berlin Wall.

It raises huge questions about the future of the seventy-year-old US-led global order. Will it collapse into a 1920s/30s scenario of global disorder – power conflicts, economic de-globalisation and depression?

Instead of a highly premature doomsday scenario, here are four preliminary observations.

- Firstly, we should all be worried by Mr Trump's terrible character and judgement. Ordinarily, this would disqualify him from the highest public office in the world.
- Secondly, his election brings some good news. Now is the best chance in perhaps a generation to inject a strong dose of economic liberalism into US domestic policy – on tax reform, deregulation, the environment, energy, education, health care and labour markets. Mr Trump has picked many good people for high office. They could work productively with a Republican Congress to bring economic liberalism back to America.
- But thirdly the Age of Trump brings very worrying news on international politics and economics. Most alarming is his isolationism on geopolitics and globalisation.
- And fourthly, bundling the last three factors together is a recipe for wildly contradictory signals – economic liberalism at home and isolationism abroad – and heightened policy unpredictability and volatility.
  That is bad for global order.

Now let's look at the two most vexing issues, geopolitics and globalisation.

Since 1945, US leadership has provided essential public goods for a stable and open global order. But US leadership has been declining since the beginning of this millennium. Concurrently, the world has become more multi-polar, especially with China's spectacular economic ascent.

So what comes next with President Trump? Will he head towards disengagement or re-engagement with the world? It is too early to tell.

But some who predict continued, even accelerated, US decline and disengagement say the world will remain stable and open. They argue that others will pick up where the USA leaves off and that international cooperation will be more equally shared.

But, I doubt that very much. Europe, with the European Union at its core, is ever-more divided and weak. India, Brazil and Russia will remain sub-regional and at best regional powers.

That leaves China as the sole contender for pan-regional and international leadership. But it is weaker than most outsiders think. China's conspicuous lack of an open society is its Achilles heel. That limits its ability to lead abroad.

This all leaves no alternative, for the foreseeable future, to US leadership for a stable and open global order.

The risk of accelerated US withdrawal from global leadership is real. It must not happen – for the sake of the world. It is up to decision-makers and opinion-formers, inside and outside the USA, to prevent a Trump presidency from heading in this direction.

What about the Trump trade agenda? This goes in exactly the opposite direction to emerging economic liberalism at home.

Mr Trump's message is economic nationalism abroad – loud and clear. He has announced the US's withdrawal from the Trans-Pacific Partnership, wants to renegotiate NAFTA, has threatened high tariffs against China and says he will ignore the World Trade Organization.

A protectionist turn in US trade policy is likely. And other countries will follow the US lead, starting with the EU and China.

If this happens, it will only accelerate trends since the global financial crisis. Protectionism will affect bigger chunks of international trade and disrupt global value chains. There will be a bigger world trade slowdown. That will drive world GDP growth even lower, in the West and the Rest.

Containing this new protectionism is imperative. That requires effective lobbying inside and outside the USA. And, not least, it demands effective communication of sensible ideas on trade●

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QUALIFIED SUCCESS?

GABRIEL HELLER SAHLGREN EXAMINES THE COMPETITION BETWEEN EDUCATIONAL QUALIFICATIONS

In the last couple of years, the qualifications system in England, Wales and Northern Ireland – all of which allow schools to choose between multiple providers – have faced criticism from politicians and in the media.

Many argue that qualification and assessment choice introduces perverse incentives for exam boards to decrease standards and inflate grades in a 'race to the bottom'.

To address these concerns, some support abolishing independent exam boards in favour of a single government board.

Others have suggested a franchising model under which boards would compete for politicians' business to deliver qualifications and examinations on a fixed-term contractual basis only.

From an economic perspective, whether or not a service should be outsourced depends on who can deliver it most efficiently.

This, in turn, depends on so-called external 'transaction costs' – the costs of monitoring to ensure that the service is provided in accordance with the buyer's expectations.

If the total price for purchasing the service externally, including the transaction costs, is lower than in-house production costs, it makes more sense to go for outsourcing.

A key aspect of this is the level of 'contract incompleteness'. Many quality aspects of complex public services are difficult to measure, which makes it difficult to hold external providers to account. If this is the case, outsourcing could in fact lead to lower quality.

In practice, however, most public services do not warrant government provision on this basis. This includes qualifications and assessment where there are few non-measurable elements involved, considerable scope for innovation, and strong reputational mechanisms to ensure that boards do not cut corners. Nationalising exam boards would just raise costs and decrease innovation.

But should the government or schools choose the exam board? In the franchising alternative, government would pick winners via a tendering process, in contrast to the current user-choice model where schools do the choosing.

The case for choice rests on the assumption that it improves matching between pupils and the qualifications offered, while also generating stronger competitive pressures among exam boards.

Yet, in some situations, choice may not generate the desired outcomes. For example, the impact of competition on quality depends on how schools weight quality vis-à-vis price. If they are very sensitive to price, exam boards may focus on competing along this margin – which could potentially decrease quality.

Still, there is no evidence that the existing model has produced a race to the bottom. Given the strict regulatory framework in place, this is not surprising.

Certainly, the equivalency framework and the way school league tables are constructed have incentivised schools to choose what they perceive to be easier subjects – a problem that would remain if choice between exam boards were abolished.

At the same time, there is little evidence of excessive price competition in the current system either; rather, independent exam boards have invested heavily in technology to increase the effectiveness of the overall system.

Rather than abolishing the qualifications market, it would therefore be preferable to improve it.

Instead of seeking strict comparability, the accreditation framework could focus on specified minimum standards.

Boards could then compete by providing higher, but not lower, standards in national and alternative qualifications.

With such a focus, it would also be possible to lower the regulatory barriers to new providers, which would provide stronger incentives among existing providers to compete and innovate.

It would then be useful to reform league tables to avoid perverse incentives. For example, outcomes could be published separately for different qualifications.

The goal should be to improve the market – not to abolish it●

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SHOCK and ORE

ROMESH VAITILINGAM REVEALS THE 'UNSEEN' EFFECTS OF INDUSTRIAL POLICY

There has been much discussion over the last year about whether the government should support the steel industry in the UK.

Professor Bruce Blonigen of the University of Oregon recently published a paper in the *Economic Journal* called *When Industrial Policy Harms Performance: Evidence from the World Steel Industry*.

It suggests that before we use industrial policy to support a country's steel sector we should consider the second round effects – such policies can have damaging effects on the export competitiveness of downstream manufacturing sectors that make use of steel.

Throughout history, governments have used industrial policies to guide the development of key sectors in their economies and to spur economic development.

These policies can vary substantially. They include subsidising production, limiting import competition and promoting export sales.

Blonigen's cross-country analysis indicates that sectors in which steel is a major input, such as fabricated metals and machinery, suffer particularly badly.

He also finds that export subsidies and government ownership are the industrial policies that have the most harmful effects on downstream export competitiveness – and the effects are most evident in less developed countries.

So, why do such policies exist? The first explanation for the existence of harmful industrial policies is that governments are not seeking to improve the welfare of their country, but have other objectives in mind, such as responding to political lobbies.

The other possibility is that policy makers simply do not understand the effects of such policies. This is especially so given that a layering of industrial policies often accumulates over time, leading to the presence of multiple policies at cross-purposes with each other.

Recent efforts by the South African government to target industrial policies at its lagging manufacturing sector illustrate these concerns.

The government found that a prior policy programme targeted at its steel sector, which is a source of key inputs to many manufacturing sectors, had led to uncompetitive steel prices and hurt downstream manufacturing sectors.

Rather than eliminate the industrial policies in their steel sector, the government layered additional policies in the steel-using sectors in the hope of restoring the health of these downstream sectors.

Is this South African example typical? Evidence is scant to non-existent on the net effects of industrial policies on economic growth and development.

While there are many studies of the effects of specific industrial policies, particularly import tariffs, the difficulty of collecting information on the wide variety of industrial policies in a consistent fashion has hindered systematic analysis.

Using a new hand-collected database of industrial policies used in the steel sector in major steel-producing countries, the author of this new study is able to overcome a number of these data difficulties and provide estimates of the effects of industrial policy in one of the sectors most often targeted by governments for industrial policies.

Because steel is a primary input in so many manufactured goods, the research focuses on how industrial policies in a country's steel sector affect the export competitiveness of downstream manufacturing sectors that use steel.

The research finds:

- The use of industrial policy is harmful to downstream sectors. A one standard deviation increase in steel industrial policy usage leads to an immediate 1.2 per cent decline in export competitiveness for the average downstream manufacturing sector.
- This effect is five times as high (or roughly 6 per cent) for major steel-using downstream sectors, such as fabricated metals and machinery.
- The long-run effect of increased industrial policy usage for the average downstream sector is a decline in their exports by more than 15 per cent.
- These industrial policy effects on downstream export performance seem more obvious in less developed countries. However, there are significant effects of steel industry intervention on downstream competitiveness in a few developed countries as well.
- Export subsidies and government ownership of the industry have the most harmful effects on downstream export competitiveness.

Overall, policies to support the steel industry may or may not help that particular industry. However, they certainly seem to adversely affect other sectors of the economy●

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