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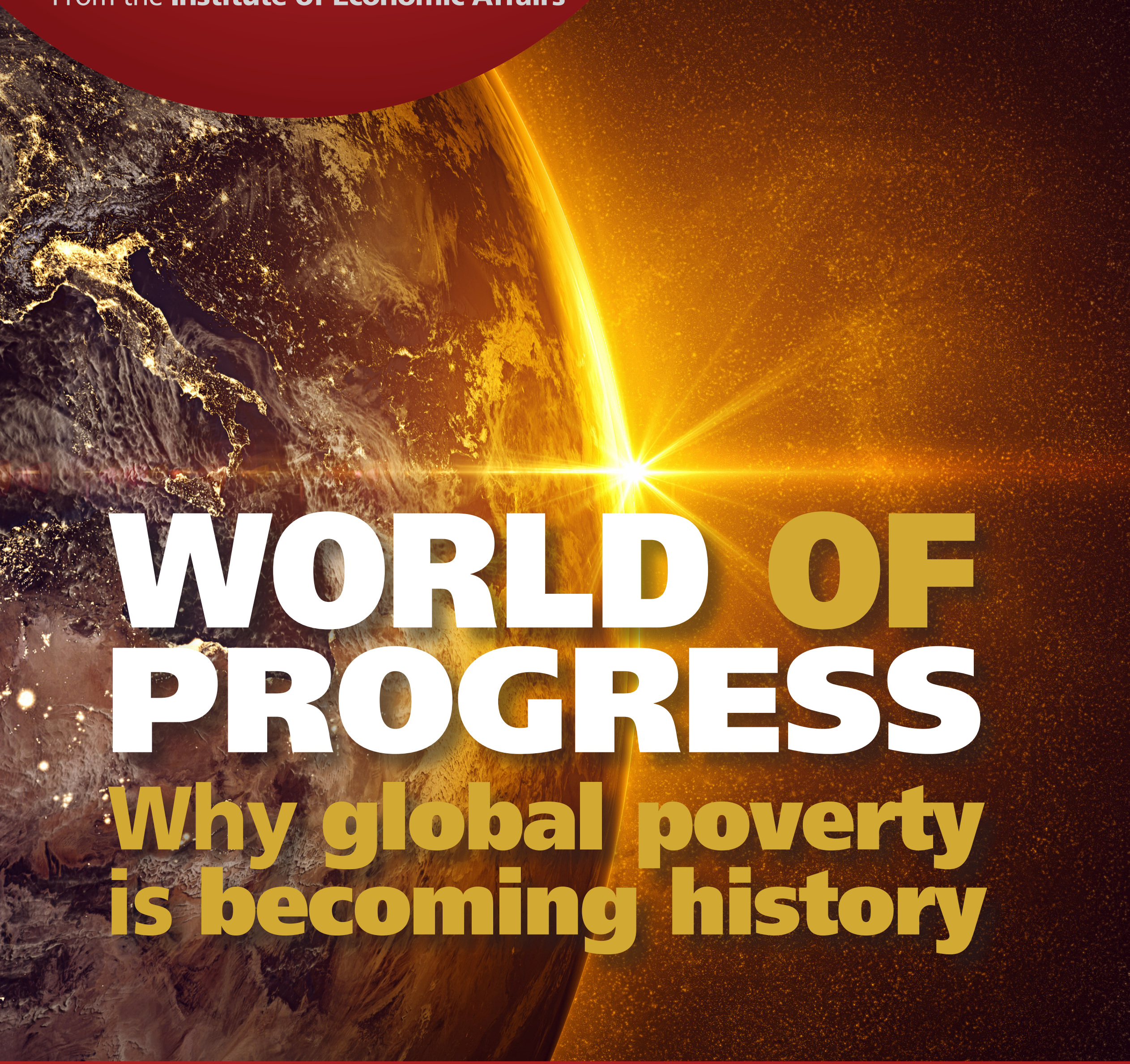
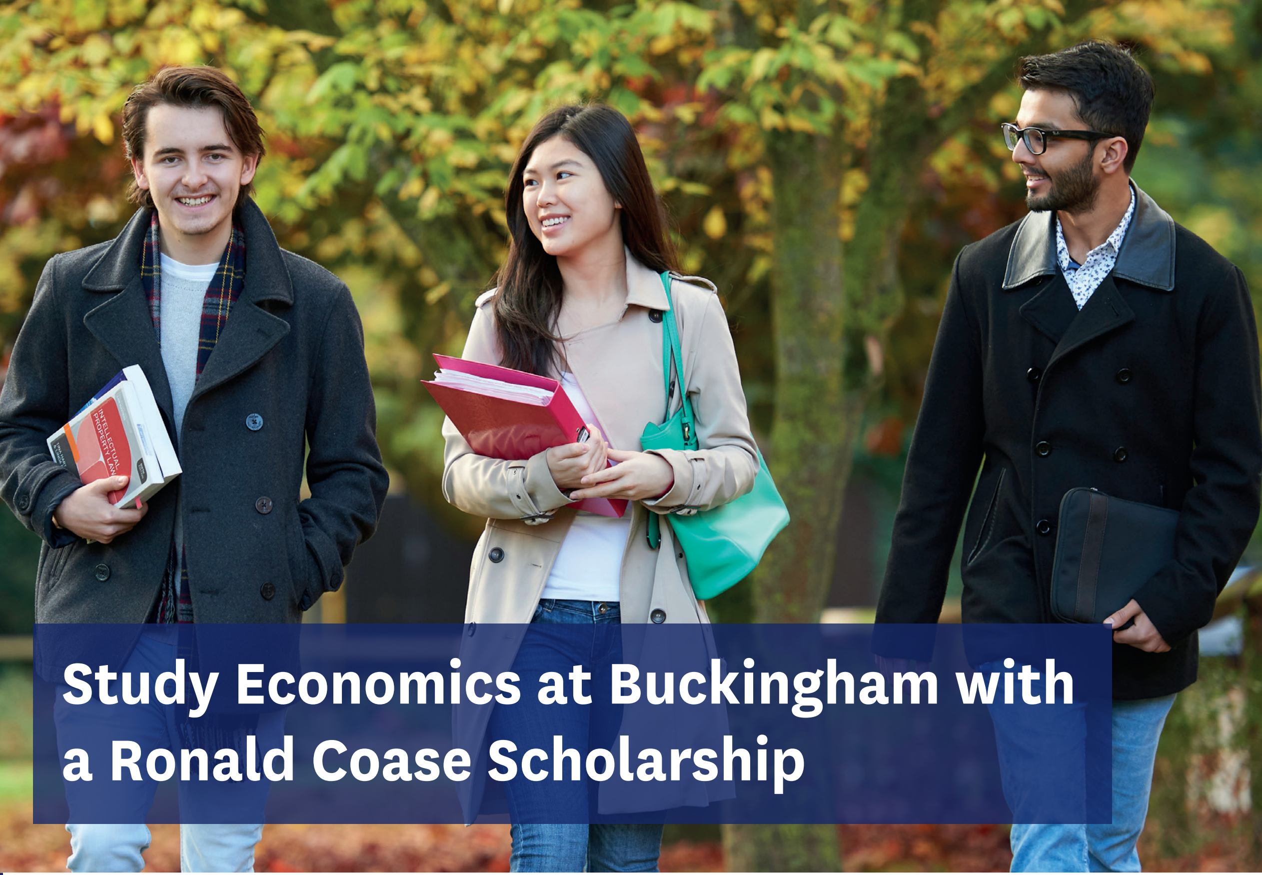


# WORLD OF PROGRESS

## Why global poverty is becoming history

**PLUS: BREXIT, FREE TRADE,** the **GIG ECONOMY** and more...



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# WELCOME

**'Nostalgia ain't what it used to be'** is a great line.

It perfectly pinpoints older generations' tendency to look back and think things were better "in their day".

But is that really the case?

- **In the past 20 years, global poverty has halved**
- **Child mortality and illiteracy have fallen dramatically**
- **In China hundreds of millions have risen out of destitution**

And it's predicted that the worst forms of **absolute poverty will be at negligible levels by 2030**.

And that's the thrust of our cover story in this latest edition of **EA** – **the world really is becoming a better place**.

The facts may surprise you (and older generations!) – but I'm sure this will make enlightening, and thoroughly encouraging, reading from **page 18**.

Elsewhere, we examine the **importance of free trade** – to both the UK and the global economy – and assess the **threat posed to it by protectionist politicians** from **page 11**. All this plus **Brexit** (**page 22**), the **gig economy** (**page 46**) and much more.

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**Hopefully these make the world a better place too!**

**Professor Philip Booth**
Editor
**September 2017**

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# FREE TRADE AREA

**Examining the fundamental importance of free trade to both the UK and the global economy**



**Editor** Philip Booth
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# REWRITING HISTORY

**There have been many socialist experiments – and all of them have failed.**

**However, after their failure, history seems to get re-written and the popularity of socialism lives on, says KRISTIAN NIEMIETZ**

Socialism is popular in Britain. More popular than capitalism, at any rate.

In a recent YouGov survey, 36 per cent of respondents expressed a favourable opinion of socialism and only 32 per cent an unfavourable opinion.

Capitalism, meanwhile, was viewed favourably by only 33 per cent, and unfavourably by 39 per cent.[1] How can an economic system that has been tried so many times, and that has always ended in failure, still be so popular?

Part of the reason has to be that socialists have long been very good at distancing themselves from real-world examples of socialism.

Mention the failure of the Soviet Union or a similar historical example, and self-described socialists will invariably answer something like: "But that wasn't *real* socialism! That was a perverted version. Real socialism has never been tried."

This claim would have more credibility if it had been applied consistently over time. But it hard to find any example of a socialist experiment which has not, at some point, been praised by Western intellectuals.

Socialist revolutions have often been followed by a brief honeymoon period, during which they had (or seemed to have) some initial success. At that stage, almost nobody claims that they are not *really* socialist.

It is only once the failures have become obvious that Western intellectuals disown the experiment, and they always disown it retroactively. They claim that the country in question has never been socialist in in the first place.

To be clear, when we talk about socialism here, we have in mind systems of state ownership and planning such as those used in Cuba, the Soviet Union and twenty-first century Venezuela – not social democracies such as Sweden where there is a large space in which a free economy operates, albeit with significant redistribution of income.

no person's gain is rooted in another person's loss. […] There is a universal and continuous incentive to every producer […] to improve his qualifications, and to render the utmost service […] Each [enterprise] becomes eager to help every other enterprise".

Alexander Wicksteed, a British writer who spent some time in Moscow, also argued:

"[F]or the first time in history the common man feels that the country belongs to him and not the privileged class that are his masters.

**SOCIALISTS HAVE LONG BEEN VERY GOOD AT DISTANCING THEMSELVES FROM REAL-WORLD EXAMPLES OF SOCIALISM**

### Western intellectual support for the Soviet Union and Mao

In the 1930s, Sidney and Beatrice Webb, co-founders of the Fabian Society, travelled to the Soviet Union, and subsequently wrote several books and pamphlets marvelling at it. In *'Is Soviet communism a new civilisation?'* [2], they described Stalin's empire as an earthly paradise, a society characterised by perfect harmony:

"[T]here is no longer any conflict of interests in production. Whether between enterprises or between grades or kinds of workers or producers, […] […] [T]he Marxian ideal of a classless society […] has been realized to an extent that is wonderfully refreshing to any Englishman of democratic aspirations".[3]

Testimonies like these abound. It was only in the 1950s that Western intellectuals fell out of love with Soviet socialism.

But a new utopia soon replaced it: Mao's China. Maria-Antonietta Macciocchi, an Italian journalist, and later an MEP, went on a pilgrimage there, and reported:

"[A] people is marching with a light step and with fervour toward the future. This people may be the incarnation of

[1] YouGov (2016a) Socialism and capitalism. Available at: https://yougov.co.uk/opi/surveys/results#/survey/94978480-d625-11e5-a405-005056900127/question/a3ee8500-d625-11e5-a405-005056900127/toplines

[2] Webb and Webb (1936) *Is Soviet communism a new civilisation?* Left Review pamphlet. London: Left Review. Available at http://webbs.library.lse.ac.uk/438/

[3] Hollander, P. (1990) *Political Pilgrims. Travels of Western Intellectuals to the Soviet Union, China, and Cuba*. Lanham: University Press of America, p. 115.

the new civilization of the world. China has made an unprecedented leap into history".[4]

Hewlett Johnson, an English priest of the Church of England reported:

## IT WAS ONLY IN THE 1950s THAT WESTERN INTELLECTUALS FELL OUT OF LOVE WITH SOVIET SOCIALISM

"It was not hard […] to understand the deep affection men feel for this man […] All men – intellectuals, peasants, merchants – regard Mao as the symbol of their deliverance, the man who […] raised their burdens. The peasant looks at the land he tills: Mao's gift. The factory worker thinks of a wage of 100 lb. rice instead of 10: Mao's gift".[5]

### Plus ça change

The same thing then happened all over again in Cuba, Albania, Nicaragua, Angola, Mozambique – name a socialist experiment, and I guarantee you can find prominent Western thinkers who backed it enthusiastically at some point.

The latest example is Venezuela. Until about three years ago, when the country (which sits on the world's largest proven oil reserves) was benefiting from an oil price boom, *Chavismo* – or 'Socialism of the 21st Century', as those 'in the know' would call it – was all the rage. In 2009, Noam Chomsky said:

"[W]hat's so exciting about at last visiting Venezuela is that I can see how a better world is being created […] The transformations that Venezuela is making toward the creation of another socio-economic model could have a global impact".[6]

In 2012, Owen Jones went on a pilgrimage to Venezuela as well, and reported:

"Venezuela is an inspiration to the world, it really does show that there is an alternative. I met so many people who told me how their lives had changed since the election of President Chávez."[7]

And the Labour leader Jeremy Corbyn commented when Chavez died: "Thanks Hugo for showing that wealth can be shared. He made massive contributions to Venezuela and a very wide world".

The truth is that insofar as these successes were real, they were built on sand, or more precisely, on abnormally high oil prices.

Since oil prices have returned to a more normal level, the Venezuelan economy has contracted by about a quarter. Shortages of basic goods, especially food and medicines, were already an issue even during the oil price boom, but they have become a lot more severe since then. Over 80 per cent of the country live in poverty.

As was the case with every previous socialist experiment, Western intellectuals are now U-turning.

Noam Chomsky now claims: "I never described Chavez's state capitalist government as 'socialist' […] It was quite remote from socialism. Private capitalism remained [...] Capitalists were free to undermine the economy in all sorts of ways, like massive export of capital."[8]

### And socialists will keep experimenting on the people

So, once again, Venezuela was not 'real' socialism, 'real' socialism has never been tried, and all that.

But what really happens is that whenever an experiment that self-described socialists have once endorsed as the real thing turns sour, they retroactively define it as 'unreal'.

Venezuela is only the most recent example. It will not be the last●

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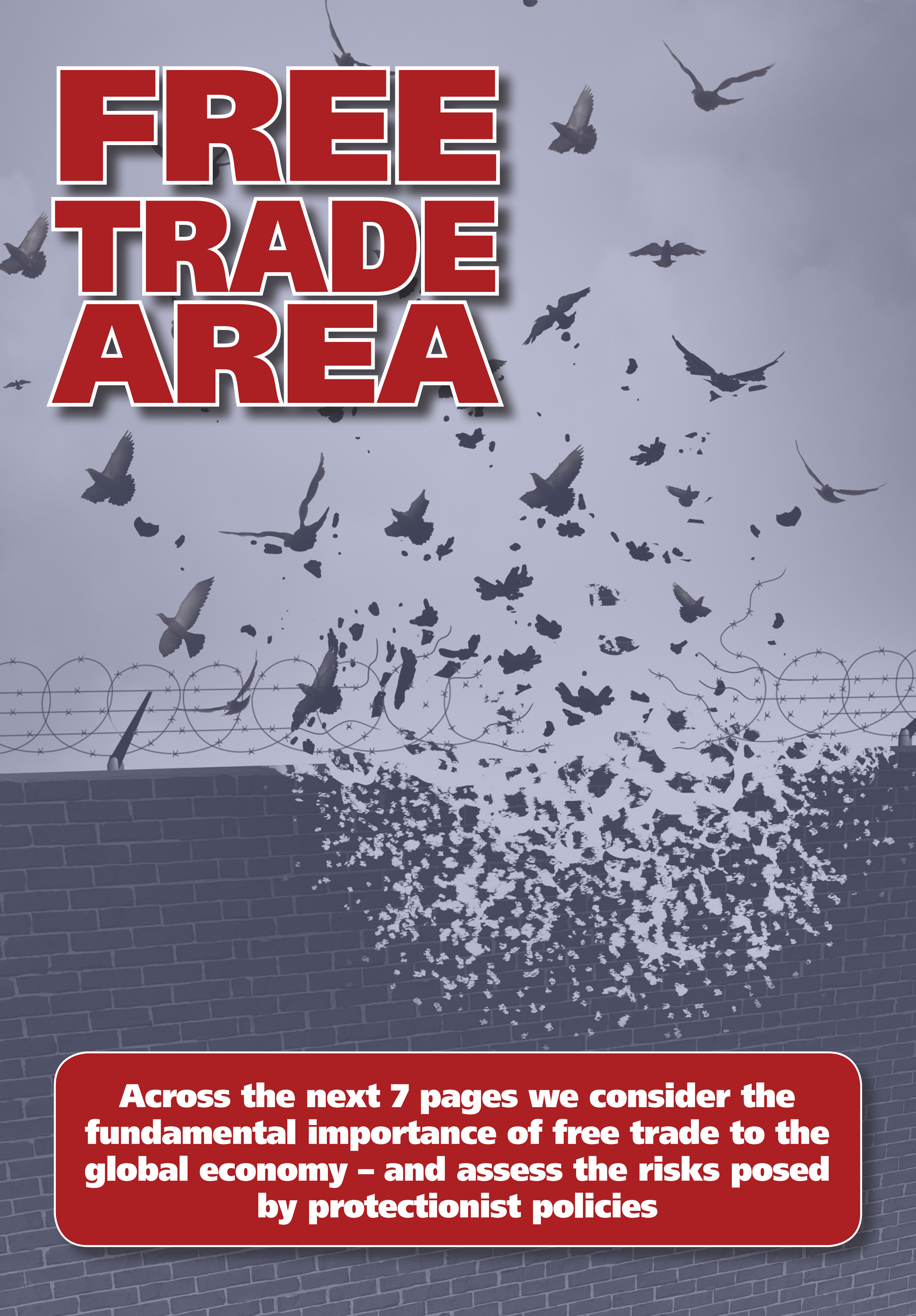
[4] Ibid. p. 278
[5] Ibid. p. 328
[6] 'Noam Chomsky Meets with Chavez in Venezuela', Venezuela Analysis, 27 August 2009. Available at https://venezuelanalysis.com/news/4748
[7] Venezuela Solidarity Campaign (2012) Viva Venezuela! Magazine 2(2). Available at https://issuu.com/venezuelasolidaritycampaign/docs/viva_venezuela_volume_2_issue_2
[8] Stossel, J. 'Chomsky's Venezuela lesson', 31 May 2017. Available at https://www.creators.com/read/john-stossel/05/17/chomskys-venezuela-lesson



# FREE TRADE AREA

**Across the next 7 pages we consider the fundamental importance of free trade to the global economy – and assess the risks posed by protectionist policies**

# In praise of NAKED TRADE

**As soon as Brexit is completed, the UK should scrap all import tariffs, says JAMIE WHYTE**

Peter Mandelson was the European Trade Commissioner from 2004 to 2008. You might expect him to know a thing or two about trade.

In an opinion article in the *Evening Standard* last spring, he lambasted the government's 'naivete' about international trade post-Brexit.

Having stated his credentials, Mr Mandelson explained that "international trade negotiation is a rough, tough business". He continued, "If Mrs May thinks other countries are lining up to do us favours just because we ask nicely, she will be disappointed."

This is a simple error, peddled by every anti-trade politician from Donald Trump to Marine le Pen that threatens the world with a new era of protectionism and falling incomes.

When a government allows its citizens to buy goods from foreigners, untaxed and otherwise unmolested, it is not doing the foreigners a favour. It is doing its own citizens a favour.

Imagine two fictional countries which, for simplicity, I will call the United Kingdom and New Zealand. For various reasons, lamb can be produced at a lower cost in NZ than in the UK. Whereas the price of UK lamb is £20 a kilo, NZ lamb of the same quality costs only £15 (in the UK).

Without tariffs on imported NZ lamb, UK lamb producers will go out of business. But UK consumers save £5 on every kilo of lamb they eat.

That £5 can then be spent on other things, making not only lamb consumers better off but also the Brits who supply them with other things – including, perhaps, former lamb producers in their new occupations. By consuming cheap imported lamb, the total consumption of UK citizens increases: they get their lamb and £5 to spend.

A 50 per cent tariff on NZ lamb, which pushes its price up to £22.50, will save UK lamb producers. But it will force consumers to spend £5 more per kilo of lamb. With less to spend on other things, total consumption is reduced and society is worse off.

A more fanciful example may make the case clearer.

Imagine that shoes began to sprout up from the floor of every closet in the country. Would the government benefit us if it taxed anyone who wore them by an amount slightly greater than the current retail price of shoes in the UK?

## WHEN A GOVERNMENT ALLOWS ITS CITIZENS TO BUY GOODS FROM FOREIGNERS, UNTAXED…IT IS DOING ITS OWN CITIZENS A FAVOUR

Shoe suppliers might be happy about the tax, of course. But the country would have been needlessly impoverished.

Imported shoes that arrive at half the price of locally made shoes differ from miraculous shoes only in their probability and the size of the gain. Taxing them so they cost more than domestically made shoes is rejecting a favour.

A government need not be kindly disposed to another nation to resist taxing goods imported from it. It need only be kindly disposed to its own population.

Mr Mandelson's failure to understand this may explain why, after several years of his rough and tough negotiating, Europeans still bear the cost of tariffs on all manner of imported goods.

### The opportunity from Brexit

This may also explain why Mr. Mandelson does not see the enormous trade opportunity offered by Brexit.

The real opportunity from Brexit lies in unilateral free trade. Britain should simply announce that it will do nothing to impede imports. The minute Brexit is completed, all import tariffs should be abolished. This is the position that New Zealand has adopted since the mid-1980s. When recently trying to negotiate the Trans-Pacific Partnership trade deal, a political commentator remarked that this unilateralism put New Zealand in the position of someone beginning a game of strip poker already naked.

It's witty but it simply repeats the Trump-Mandelson mistake. The goal of strip poker is to end the game with some clothes on. The goal of trade policy, by contrast, should be to get naked as quickly as possible. Which means there is no good reason to have trade negotiations at all. Everybody should simply stay at home and take their clothes off.

Politicians who impose import tariffs do not protect their populations. They protect politically influential domestic businesses at the expense of the general population. Tariffs are not only economically damaging but corrupt•

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# Does PROTECTIONISM work?

**Does it create more domestic jobs? And greater output? Not so, say CHRISTOPHER and RACHEL COYNE**

US President Donald Trump ran on a campaign pledge to "Make America Great Again" by, among other things, protecting US manufacturers from foreign competitors.

He reiterated his commitment to this position in his inaugural address when he stated: "We must protect our borders from the ravages of other countries making our products, stealing our companies, and destroying our jobs."[1]

In his first days in office, President Trump withdrew the United States from the Trans-Pacific Partnership and stated that he would work to renegotiate the terms of the North American Free Trade Agreement.

Acting on his campaign pledge to "bring back steel" to the United States, President Trump issued a memorandum to the Secretary of Commerce indicating that the agency should exclusively use US steel to build new pipelines and retrofit existing pipelines.

Underlying these statements and actions is the belief that government-imposed protectionist measures benefit domestic citizens.

The source of these benefits, it is argued, is more domestic jobs and greater output. But is this accurate? Not according to basic economics.

In order to understand why, it is important to understand how voluntary trade generates mutual benefits, as well as the important difference between the seen and the unseen.

## Gains from trade

All of us possess certain skills and talents to produce goods and services. Some of us are good at carpentry, while others are superior farmers. In principle, each person could produce everything that they consume, meaning that they could refrain from engaging in exchange with others.

This, however, would severely limit what could be produced and consumed. The carpenter might do a wonderful job building a house, but he would struggle to grow food, since that isn't his area of expertise. Likewise, the farmer would do an excellent job producing large crops but would find it difficult to build a house.

By engaging in voluntary exchange, however, both parties can benefit. The carpenter can focus on what he does best and so, too, can the farmer. They can each exchange part of their output for that produced by others, with both ending up with more than they would have had if they had to produce everything themselves.

The gains from trade still apply if one person – or country – is more efficient at producing everything: it is just that the argument is more complicated.

Even if the world's best brain surgeon was also genius with a sewing machine, it would be better for him to buy his clothes from elsewhere and concentrate on what he is relatively best at.

This basic logic can be expanded beyond two people with the same result. As the range of potential trading partners expands, it benefits those involved because they are able to take advantage of the diverse skills and knowledge possessed by a larger number of people.

If you think about it, most, if not all, of what citizens in wealthy societies consume is produced by others with different capabilities.

Standards of living are dramatically improved when people are free to take advantage of the gains from voluntary trade. In contrast, in poor societies there are almost always numerous barriers which prevent people from engaging in voluntary trade.

This same logic underpins both domestic and international trade. Just as trade between individuals living in Yorkshire and London benefits both parties involved, so, too, does trade between individuals living in London and New York City.

In short, geographic boundaries in no way undermine the reality that voluntary trade makes the parties better off and contributes to growth and prosperity.

Once one understands the gains from voluntary exchange, the harm caused by economic protectionism becomes obvious.

## MOST OF WHAT CITIZENS IN WEALTHY SOCIETIES CONSUME IS PRODUCED BY OTHERS

Protectionism undermines the benefits of voluntary trade by preventing individuals from improving their lives by engaging in value-added exchange.

This threatens the well-being of those parties who would have otherwise participated in the exchange absent the government mandate which prevented them from doing so.

### The seen and the unseen

Many who embrace protectionist measures fail to appreciate the importance of the seen and the unseen.

The "art of economics", Henry Hazlitt noted, "consists in looking not merely at the immediate but at the longer effects of any act or policy; it consists in tracing the consequences of that policy not merely for one group but for all groups."[2]

When it comes to protectionism, the focus is typically on a small group of easily observable beneficiaries at the neglect of the broader harms which are not as easily observable.

Consider the case of steel. As mentioned, President Trump has made a commitment to increase domestic steel manufacturing in the United States by establishing barriers to foreign imports.

Of course, some people, mainly US steel manufacturers and workers, will benefit from these protectionist measures. These benefits are easily observable since one can point to the number of people working in the steel industry and their output.

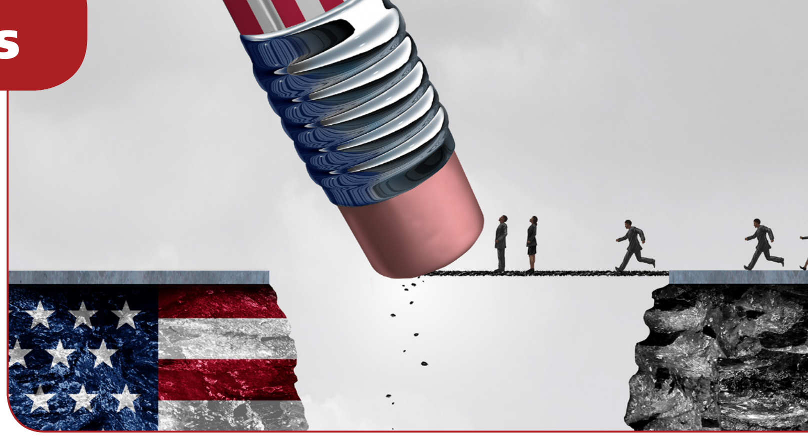
However, there are several harms from protectionism which are not as obvious. For example, US consumers of steel will pay higher prices than they would have in the absence of the trade barriers.

Moreover, though output in the domestic steel industry will be higher than it would be without the barrier to trade, there is an opportunity cost to the resources used to produce this output. If resources were not used to produce steel they would be reallocated to the production of other goods and services.

The main implication is that the artificially high output in the steel industry results

[1] Transcript of speech: http://time.com/4640707/donald-trump-inauguration-speech-transcript/

[2] Henry Hazlitt (1979) *Economics in One Lesson.* New York: Three Rivers Publishing, p. 17.



in a loss of output in other domestic industries where resources would otherwise have been employed.

Since these costs do not manifest themselves in an explicit manner, they are difficult for most people to grasp in discussions of international trade. In addition to all this, domestic producers who use steel (for example in the car industry) will have to pay higher prices or will have lower quality steel.

Their products will therefore be more expensive thus reducing domestic production and also exports of those products that use steel.

The difficulty of appreciating these unseen costs is exacerbated by a focus on nation states instead of the individuals living within those states.

Many discussions of international trade focus on the supposed competition between different nation states – for example, "China versus the US" – while neglecting the welfare of the human beings that live in these geographic areas.

## The case for free trade

The case for free trade is straightforward. Unfortunately, good economics often does not make for good politics.

Politicians enhance their chances of election by fostering fear and framing international trade as a negative-sum "war" between countries with the supposed solution being the implementation of protectionist measures which forcibly prevent people from trading with others. For the reasons discussed above, however, these measures produce narrow benefits for a few while imposing costs on many.

Moreover, when government begins to implement trade barriers on international exchange it encourages special interest groups to actively lobby for policies that insulate them against international competition.

Domestic producers shift their attention away from ensuring that they are producing a superior product towards influencing politicians who can protect them from losing market share. When this happens citizens, and the broader economy, suffer.

Those who care about individual freedom and choice, as well as improvements in well-being, should embrace international free trade.

Protectionist measures create significant harms. Moreover, once in place, these policies are extremely difficult to remove due to vested interests who benefit from their continuation.

For this reason it is important to appreciate the gains produced by free trade and the significant harms caused by protectionism. Protectionism is not a path to prosperity but, instead, a surefire recipe for economic stagnation•

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## Further reading on free trade and protectionism

Jagdish Bhagwati (2007) ***In Defense of Globalization***, Oxford University Press.

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# IS FREE TRADE UNDER THREAT?

**RAZEEN SALLY** on the USA's crucial role in the global economy

The outlook for free trade is not good. There are optimistic scenarios, but we need US leadership.

Here I present three scenarios for international trade. Let's begin with the state of play.

Firstly, global trade growth has slowed down markedly – what is dubbed Peak Trade. International trade grew twice as fast as world output in the quarter-century before the global financial crisis. It slumped during the crisis, picked up again, but, since 2012, has barely kept pace with world GDP growth.

Secondly, protectionism has increased since the financial crisis. It has not escalated to 1930s' heights, nor has it reversed existing globalisation. Rather post-financial-crisis protectionism has been "creeping" up, mostly through anti-dumping duties and insidious non-tariff barriers.

Thirdly, President Trump has announced the USA's withdrawal from the TPP (Trans-Pacific Partnership). This is highly unfortunate for two reasons. The TPP is the most ambitious trade deal in over twenty years. Furthermore, it was a geopolitical signal of US re-engagement in Asia.

This leaves the field open for China to assume trade leadership in Asia. It is already doing so on infrastructure. China is the leading power in the Regional Comprehensive Economic Partnership (RCEP), which brings together the ASEAN countries plus six others.

But RCEP is shaping up to be a typically "trade-lite", intra-Asian trade agreement. While it will eventually remove most import tariffs, it is likely to do little to tackle non-tariff and regulatory barriers.

My "more likely" scenario is of trade winds blowing in a more protectionist direction, starting in the USA. In addition to withdrawal from the TPP, President Trump wants to renegotiate NAFTA, has threatened high tariffs against China and against US companies that relocate production abroad, and says he will ignore the World Trade Organization (WTO).

Mr Trump's senior trade-policy appointees are fellow economic nationalists. All are obsessed with trade deficits, China-bashing, and industrial policy to revive US manufacturing.

New US protectionism could begin with a spike in anti-dumping and countervailing duties, aimed first at China. Import taxes, euphemistically called a "border tax adjustment", could be part of a US tax-reform package.

And other countries would follow the US protectionist lead, starting with the EU and China. If this happened, it would only accelerate trends since the financial crisis.

Creeping protectionism would no longer be creeping: it would accelerate, affecting bigger chunks of international trade and disrupting global value chains. Peak Trade would be worse: there would be a bigger world trade slowdown.

But there are powerful countervailing forces. The most potent is existing globalisation through global value chains. US companies are woven thickly into them, and they are likely to lobby against Trumpian protectionism.

US producers and consumers will suffer from US protectionism and from

## US LEADERSHIP IS STILL ESSENTIAL FOR INTERNATIONAL TRADE

retaliation from other countries. The Congressional Republican leadership, as well as Republican and Democrat governors in the states, could restrain the economic-nationalist impulses of President Trump.

A more pessimistic scenario would be a full-blown trade war: unrestrained US protectionism, escalating tit-for-tat retaliation by the EU, China and others, perhaps the break-up of NAFTA, and the severe disruption of global value chains.

This would be a lurch back to 1930s' style protectionism, de-globalisation and depression. I still think this is unlikely.

A more optimistic scenario would be of others taking up the baton of open-market trade leadership. The EU might be up for it, and China might be too. International co-operation would be more equally shared and the WTO revived.

But I doubt very much that this will happen. Both the EU and China have ever-bigger internal weaknesses that limit their ability to lead abroad. In the absence of the USA, prospects for international trade co-operation are bleak.

US leadership is still essential for international trade. Without it, the world economy would be more unstable and less open. The USA is still the "indispensable nation"•

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# The FRIEDMAN Factor

**TIM CONGDON LOOKS AT THE LONG STANDING DEBATE OVER THE QUANTITY THEORY OF MONEY**

Official monetary statistics were first published in the United Kingdom in 1963, following a recommendation in the 1959 Radcliffe Report on *The Working of the Monetary System*.

Kaldor was of course aware of the quantity theory of money, expressed in the well-known equation MV=PT, where M is the quantity of money, V is the velocity of circulation, P is the price level and T is the volume of transactions.

**THE RADCLIFFE REPORT SAID CHANGES IN VELOCITY…COULD OFFSET ANY EFFECT FROM A CHANGE IN THE QUANTITY OF MONEY**

The Radcliffe Report brought together a range of views on monetary policy, but it was heavily influenced by the evidence of Nicholas Kaldor, then a Cambridge don and soon to become a leading adviser to the 1964–70 Labour government.

In the late 1950s the then Conservative government was struggling to curb inflation, and it acted on recommendations from Dennis Robertson (also a Cambridge don) and others to limit the rate of money growth.

Kaldor pooh-poohed Robertson's ideas, the quantity theory of money and indeed monetary economics in general.

He persuaded the Radcliffe Committee to believe – in the words of its report – that "we cannot find any reason for supposing, or any experience in monetary history indicating, that there is any limit to the velocity of circulation".

By implication, attempts to control inflation by restricting the rate of money growth were misguided. Taken at face value, the Radcliffe Report said that changes in velocity were unpredictable and could offset any effect from a change in the quantity of money.

At roughly the same time, in the US, Milton Friedman and Anna Schwartz were compiling and interpreting money data for their own country going back to the Civil War.

The fruit of their research was soon to be published in *A Monetary History of the United States, 1867–1960*, one of the most celebrated economics books of the twentieth century.

In a subsequent entry in *The New Palgrave Dictionary of Economics*, Friedman said that a large body of information supported "the generalization that changes in the velocity of circulation proceed slowly… [S]ubstantial changes in prices or nominal income are almost always the result of changes in the nominal supply of money."

### Kaldor versus Friedman – the evidence

Whatever else might be said for or against the Radcliffe Report, we do now have one blessing from its work.

Over 50 years of good-quality data are now available for the UK. They enable us better to judge whether the velocity of circulation is subject to a limit of some sort, and hence to arbitrate on the dispute between Friedman and Kaldor.

Key numbers are brought together in Table 1, which shows the average annual per cent changes in the quantity of money and nominal gross domestic product from 1964.

I have split the 52-year period into nine sub-periods, to give a sense of the shorter-term relationships that might be relevant to the business cycle.

So, we have eight six-year periods and a shorter one (of four years) at the beginning.

It cannot be disputed that velocity changed and indeed changed substantially, both over the whole period and in the shorter periods I have identified.

Over the whole period, the ratio of money to GDP (that is, the inverse of velocity) increased by 1.8 per cent a year or overall by about 150 per cent.

Further, the record of several of the sub-periods does not look good for the quantity-theory argument.

In the 1970s the quantity of money grew more slowly than national income, whereas, in the two six-year periods starting in 1980, money rose in a typical year by 4 or 5 per cent more than national income.

## THE DATA DEMONSTRATE THE VALIDITY OF FRIEDMAN'S OBSERVATIONS

But do the figures mean that, if Friedman and Kaldor were still alive, Kaldor could claim victory?

These are matters of opinion to some degree, but my verdict is "certainly not". Even a cursory glance at the data demonstrates the validity of Friedman's observations.

Yes, the velocity of money changed in this long period of time, but the change in velocity did "proceed slowly", just as Friedman would have expected.

Moreover, it was trivial relative to the much larger movements in both money and national income. Money went up over 140 times and nominal GDP by 60 times, both enormous numbers relative to the decline in velocity.

Even more striking is the obvious connection between the changes in money and national income in the sub-periods. The sub-periods of high money growth

**Table 1: The quantity of money and nominal GDP in the UK, 1964-2016**

| | Average, % annual change | |
|---|---|---|
| | **Broad money** | **Nominal GDP** |
| Q1 1964 to Q2 2016 | 10.0 | 8.2 |
| Q1 1964 to Q4 1967 | 8.8 | 7.5 |
| Six years to: Q2 1974 | 14.2 | 11.9 |
| Q2 1980 | 13.4 | 18.9 |
| Q2 1986 | 14.4 | 10.1 |
| Q2 1992 | 13.9 | 8.9 |
| Q2 1998 | 7.4 | 5.1 |
| Q2 2004 | 6.6 | 4.9 |
| Q2 2010 | 7.1 | 3.3 |
| Q2 2016 | 3.7 | 3.6 |

(the four six-year periods from the end of 1967) were also the sub-periods of high increases in nominal GDP and, unsurprisingly, of inflation.

When money growth slowed after the early 1990s, so too did the rise in nominal GDP. Inflation came down and economists applauded the stability of the Great Moderation.

## Nominal national income does not tell the whole story about 'T'

A technical point reinforces the correctness of quantity-theory thinking in the UK context.

The equation of exchange (MV = PT) has "T" as one of its terms, where – as noted above – "T" stands for the volume of transactions.

It has to be conceded to the critics that this notion of "transactions" is ambiguous and awkward. Strictly speaking, every economy has transactions in inputs and assets, and these are not the same thing as output or income.

But economists have a tendency to see output and income (and income per head and living standards) as the Alpha and Omega of their subject. By concentrating on the relationship between money and national income, I have succumbed to this tendency.

An important characteristic of growing economies needs to be highlighted. Over time an increasing share of national wealth is quoted on the stock exchange or becomes easier to buy and sell as the technology of payments improves.

Long-run patterns in most economies are for financial services activity to expand relative to output in general and for transactions to increase relative to national income. When we allow for these patterns, the explanatory power of money becomes impressive, perhaps even remarkable.

In 1964 national income was almost £30 billion and the value of bank clearings (which were the bulk of transactions) was just under £360 billion.

So transactions were 12 times as large as nominal GDP. Today the multiple is nearer 40 times.

It follows that, in the half century or so since then, the quantity of money has become larger relative to national income, but smaller relative to total transactions.

Much careful and detailed work is needed to understand these developments, but the falling cost of transactions – mostly because of advances in computer power and information technology – has clearly been a major influence.

## When the facts stay the same, don't change your mind

In the 52 years to mid-2016, the quantity of money, national income and the value of transactions advanced on average annually by 10 per cent, 8 per cent and 11 per cent respectively.

The half century saw stop-go and boom-bust cycles, and much economic turmoil and stress, but through it all basic and traditional economic theory worked.

The similarity of the annual rates of change provides persuasive evidence in favour of the quantity theory of money.

True enough, that evidence still allows discussion and differences of view, and Kaldor and the Radcliffe Committee might still have their defenders. But surely the facts are very much in Friedman's favour•

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# WORLD OF PROGRESS

## Why global poverty is becoming history

**Poverty has fallen at an extraordinary rate over the past 30 years. Not only do people underestimate the rate at which it has fallen, but many people believe that poverty has actually increased.**

**Here, CHELSEA FOLLETT explains why the world is rapidly getting better...**

Angus Deaton, the Nobel-prize winning economist, recently reiterated his belief that on the whole the world is getting better – if not, as he accepted, everywhere or for everyone at once.

Perhaps that comes as no surprise, but the idea that the world is getting better with regard to the extent of poverty is actually a deeply unpopular view.

Ask most people about global poverty, and chances are that they will say that it is unchanged or getting worse.

A survey released late last year found that 92 per cent of Americans believe the share of the world population in extreme poverty has either increased or stayed the same over the last two decades.

Americans aren't alone in that belief. Across all surveyed countries, an only slightly smaller majority – 87 per cent – believe that extreme poverty has risen or remained an intractable problem.

There are a number of cultural and psychological explanations for the persistence of such pessimism.

Bad news makes for good headlines, and tends to dominate media coverage. Psychologically, people tend to idealise the past, and recall dramatic and unusual events more easily than steady long-term trends.

They may also use pessimism as a means of virtue signalling. Psychologist Steven Pinker argues that this tendency is at least partly to do with the "psychology of moralisation" whereby people compete for moral authority.

Critics of the present state of affairs who argue that things are getting worse may be seen as morally engaged, whereas those who say things are getting better may be seen as apathetic.

Indeed, of those rare people who realise that extreme poverty has declined, almost all under-estimate the extent of that decline. In fact, global poverty has halved over the past 20 years – but only one person in 100 gets this right.

Unsurprisingly, people in areas that have seen the most dramatic reductions in poverty are the most likely to be more aware of what is really going on.

But, even in China, where hundreds of millions of people have risen out of destitution over the last four decades, half of the population remains ignorant of the broader collapse in world poverty that has occurred within their lifetimes.

### The 'new normal' of prosperity really is different

Throughout most of human history, extreme poverty has been the norm. This famous hockey-stick chart, (Figure 1) arguably the most important graph in the world, illustrates what happened when the Enlightenment and Industrial Revolution caused income to grow exponentially – forever changing the way we live.

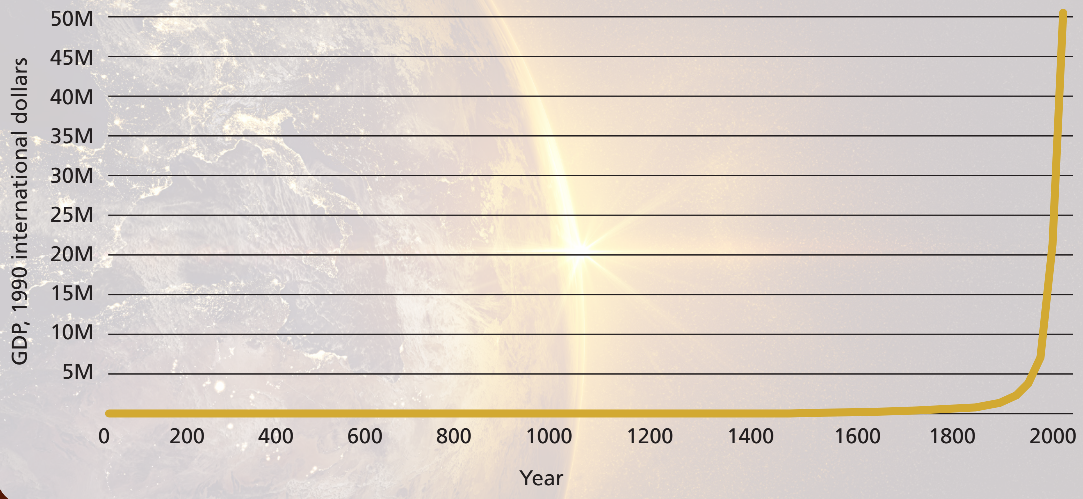
Humanity, as this chart shows, has produced more economic output over the last two centuries than in all of the previous centuries combined. And this explosion of wealth-creation led to a massive decrease in the rate of poverty.

In 1820, more than 90 per cent of the world population lived on less than $2 a day and more than 80 per cent lived on less than $1 a day (adjusted for inflation and differences in purchasing power). By 2015, less than 10 per cent of people lived on less than $1.90 a day, the World Bank's current official definition of extreme poverty.

Not only has the percentage of people living in poverty declined, but the number of people in poverty has fallen as well – despite rapid

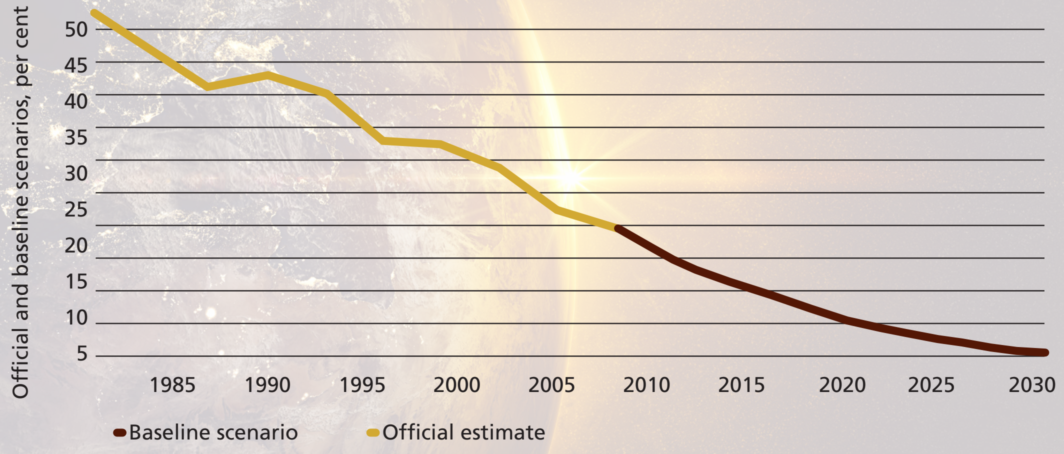
# THE MOST IMPORTANT GRAPH IN THE WORLD...

**Figure 1: GROWTH IN WORLD GDP OVER THE LAST 2,000 YEARS**




# POVERTY: THE TRAJECTORY...

**Figure 2: FALL IN WORLD POVERTY PROJECTED TO 2030**



population growth. There are also more people alive who are not in penury than there have ever been.

In 1820 just 60 million people lived a life that was not marked by desperate poverty. In 2015, that figure was 6.6 billion.

Globally, poverty is about a quarter of the level in 1990 (Figure 2). Not only that, as poverty has fallen, child mortality, illiteracy, and even pollution in wealthy countries have fallen dramatically.

If progress continues on its current trajectory, the Brookings Institution estimated in 2013 that extreme poverty (this time defined as living on $1.25 a day, again adjusted for inflation and differences in purchasing power) will all but vanish by 2030, affecting only 5 per cent of the global population.

In the best-case scenario, they predicted that by 2030 poverty will decrease to a truly negligible level, affecting only 1.4 per cent of the planet's population.

The facts are unambiguous: despite public perceptions to the contrary, extreme poverty has declined significantly, to the point where its end – for all practical purposes - may actually be in sight.

So next time you hear someone bemoaning a supposed rise in world poverty, encourage them to have a look at the evidence for themselves.

Understanding the facts is important. If we do not understand what has happened in the economy, even where the data are very clear, we are unlikely to make good recommendations in relation to public policy going forwards.

And, for many people who are on the edge of extreme poverty, the difference between good policy and bad policy can be the difference between life and death●

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## DID YOU KNOW?

- **Global poverty has halved over the past 20 years**
- **In China, hundreds of millions of people have risen out of destitution over the last four decades**
- **Humanity has produced more economic output over the last two centuries than in all the previous centuries combined**
- **Child mortality, illiteracy and pollution in wealthy countries have fallen dramatically**
- **By 2015, less than 10 per cent of people lived on less than $1.90 a day, the current official definition of extreme poverty**
- **In 1820 just 60 million people lived a life free from desperate poverty. In 2015, that figure was 6.6 billion**

## ELEVEN LINKS TO A BETTER WORLD…

### For more reading on this topic, check out:

www.theatlantic.com/business/archive/2017/03/angus-deaton-qa/518880/
www.cato.org/events/everything-getting-better-why-do-we-remain-so-pessimistic
www.glocalities.com/news/press-release-global-povert-survey.html
www.humanprogress.org/static/2636
www.humanprogress.org/static/3003
www.humanprogress.org/blog/the-most-important-graph-in-the-world
www.economist.com/blogs/dailychart/2011/06/quantifying-history
www.humanprogress.org/static/3469
www.humanprogress.org/static/3180
www.humanprogress.org/static/2579
www.brookings.edu/wp-content/uploads/2016/06/The_Final_Countdown.pdf

# BREXIT, STAGED RIGHT

**ROGER BOOTLE is one of the City of London's best-known economists.**

**He runs research consultancy Capital Economics, he's an acclaimed author and a specialist adviser to the House of Commons Treasury Committee.**

**Here PHILIP BOOTH questions him about Britain's future outside the EU, his biggest concerns about Brexit and the economic prospects for the next generation...**

***You are a strong supporter of Brexit. What for you is the clinching economic argument?***

I think the evidence is that, at least in the last couple of decades, the EU has been a restraint on the growth of its members rather than a factor helping to increase growth.

It is true that the most important restraining factor has been the euro, from which, of course, the UK is excluded. But the EU also imposes extensive regulations which carry substantial costs.

Moreover, given the EU's predilections, and its historical record, I think it likely that it will continue to act in a way inimical to economic growth. When presented with major challenges, it is likely to adopt the wrong measures.

There are two key challenges coming up: (1) the ageing of the population which reduces potential growth rates and puts severe strain on the public finances (2) The potential revolution to be unleashed by Artificial Intelligence and Robotics. I think it will probably make a mess of both.

Furthermore, I doubt whether, if we had stayed in the EU, we would have been able to stay out of the euro for very long. So we would eventually have been landed with the costs of the single currency's failings.

***What sort of trading arrangements do you believe Britain should seek over the next few years, with both the EU and other countries or blocs?***

I think Britain should seek the freest possible trade with the greatest number of countries. The government has been right, in my view, to rule out membership of the Single Market and to make it clear that the UK will not want to impose the Common External Tariff on imports from the Rest of The World and will want the freedom to negotiate its own trade deals with countries around the world. Simultaneously, it wants to achieve a free trade deal with the EU. It is not going to be easy to square this circle, but it's certainly worth trying.

***How do you see trade patterns changing as a result of Brexit?***

A good deal of our current trading arrangements will remain relatively unaffected by Brexit.

But for those parts of the economy that are potentially going to suffer an impact, much will depend upon the trade and tariff regime that is agreed by the EU and the UK.

As the UK drops the Common External Tariff on imports from the rest of the world, it is likely that these imports will increase, at the expense of both UK production and imports from the EU.

Clearly, if the UK does not get a free trade deal with the EU, then there is the potential for EU–UK trade to fall back somewhat. But I would not expect this effect to be major since in most cases the relevant tariffs that might be imposed are relatively low.

In any case, whether we were set to leave the EU or not, the relevance of the EU in our overall trade was set to fade, in keeping with the falling importance of the EU in the world. I suppose Brexit is going to accentuate this trend.

## A GOOD DEAL OF OUR CURRENT TRADING ARRANGEMENTS WILL REMAIN RELATIVELY UNAFFECTED BY BREXIT

***It is often said that the biggest barriers to trade come in the form of regulatory barriers rather than tariffs. How should the UK ensure that we do not suffer from 'regulatory protectionism'?***

Regulatory protectionism is my biggest concern about Brexit. If we manage to secure a comprehensive free trade deal with the EU then this danger would be largely obviated.

Without such a deal, we would be reliant on the WTO ensuring that the EU was not able to impose forms of trade discrimination against us.

***Will the coming generation of school leavers be better off than your generation of school leavers over their lifetimes?***

I am confident that the coming generation of school leavers will be much better off over their lifetimes than my generation has been. Of course, this has been the fate of just about every generation since the Industrial Revolution.

More recently, though, both here and in America, many people have become pessimistic about the scope for further economic advance. They seem to believe that the Industrial Revolution should be regarded as a one-off and that the world has gone ex-growth.

I think this pessimism has been severely overdone. You should never bet against the power of human ingenuity. I suspect that over the next 10–15 years we will see the communications revolution having its full effect on our productivity.

And the advent of Artificial Intelligence and the development of robotics offer the scope for further large gains. Meanwhile, medical science is advancing in leaps and bounds. The coming generation will lead longer and healthier lives●

## YOU SHOULD NEVER BET AGAINST THE POWER OF HUMAN INGENUITY

# ITINERARY...

**Over the next six months we will, once again, be visiting schools right across the country.**

Sixth Form A-Level and IB Economics students will have the chance to hear from top economists on topics as varied as "Robots and jobs: see it from an economist's point of view", "Is there such a thing as the gender pay gap?", and "Market failure and government failure: the case of healthcare". **These conferences are FREE to attend.**

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

## SCHEDULE

| | | |
|---|---|---|
| **2017** | | |
| Wed | October 11 | **Concord College, Shrewsbury** |
| Thu | November 9 | **Loretto School, Edinburgh** |
| Thu | November 16 | **Solihull School, West Midlands** |
| Tue | November 21 | **Millfield School, Somerset** |
| Fri | November 24 | **Bromley High School, South London** |
| **2018** | | |
| Tue | January 16 | **Holmes Chapel Comprehensive School, Cheshire** |
| Mon | January 22 | **Ardingly College, Sussex** |
| Tue | January 30 | **Brentwood School, Essex** |
| Tue | February 20 | **The Portsmouth Grammar School** |
| Mon | March 5 | **Tonbridge School, Kent** |
| Wed | March 7 | **Harris Westminster Sixth Form** |
| Wed | March 14 | **Oakham School, East Midlands** |
| Tue | March 20 | **Highlands School, North London** |

# THiNK BIG!

**In July we held our third – and biggest ever – annual THINK conference in London.**

More than 600 16-25 year-olds flocked to the Royal Geographical Society to listen to some of the most exciting economists and thinkers from across the world.

Many attendees had travelled impressive distances to discuss new economic ideas – and many views were challenged and friendships forged along the way.

Highlights included best-selling author **Professor Luigi Zingales** on 'Crony Capitalism', government advisor **Dr Daniel Susskind** on the 'Impact of Robots on Jobs', BBC and Sky News regular **Kate Andrews** on 'Ensuring the Best Healthcare for All', The Economist's **Soumaya Keynes** on the 'Economics of Free Stuff', and IEA Director General **Mark Littlewood** on 'Misleading Statistics and Fake News'.


You can watch videos of all the talks from **THINK** by visiting the Institute of Economic Affairs' YouTube channel: **https://www.youtube.com/iealondon/**.

# YOUR TURN TO INTERN?

## SIXTH FORM INTERNSHIP

**If you're in Year 12 or 13 and are looking for work experience next summer then this is the perfect opportunity for you!**

We provide a dedicated one-week internship at our offices in London especially for sixth formers. There are 120 places in total across 3 different weeks in July.

You'll be one of 40 interns on each wave of the programme and the week includes lectures, workshops, debates and discussions with expert economists. To find out more visit www.iea.org.uk/internships.

**The deadline for Summer 2018 applications is Friday March 30.**

*"I've learnt so much from all the lectures and activities. All the speakers have been so passionate, it's really inspired me and given me a real insight into the work of the IEA. Thank you for the opportunity to participate in such a great internship."*

**Charlotte, IEA Sixth Form Intern, July 2017**

*"It was such a fantastic experience with engaging speakers proposing new ideas/ policies, some of which I had never considered before. It was especially beneficial to meet so many lovely people and make connections in London."*

**Louise, IEA Sixth Form Intern, July 2017**

## SUMMER INTERNSHIP

**Each summer, the IEA welcomes nearly 80 undergraduate interns (two groups of 40) from around the world for a packed three week programme of lectures, seminars, debates, discussions, events and social activities.**

Each intern produces a supervised research project, chosen by themselves, and is mentored by one of the IEA's senior researchers.

Want to apply? If you are an undergraduate student and you're interested in learning about ideas, then this is the internship for you. Visit **www.iea.org/internships** to find out more.

**The deadline for Summer 2018 applications is Friday March 30.**

## GET OUT OF THE ARMCHAIR!

**Our annual Hayek Lecture is coming up and you're invited!**

We'll be joined by world renowned economist **Dr Steven Landsburg**, author of *The Armchair Economist*. He'll be speaking on the topic "Is the World Over or Underpopulated – and How Would We Know?"

This lecture is **FREE to attend** and will take place on **Thursday November 23,** from 6.30pm to 8.15pm, at Church House (Great Smith Street) in Westminster, London.

**Places are limited so email events@iea.org.uk to RSVP as soon as possible for one of the highlights of the IEA calendar.**


**In his forthcoming IEA book, *The Henry Fords of Healthcare*, NIMA SANANDAJI shows how healthcare experts in the East drew inspiration from car manufacturers to boost quality and drive down health costs.**

**Can the West learn the same lessons?**

The debate on how to improve health services and reduce costs in the UK and other European welfare states has been going on for many decades.

Ideas such as increasing spending on preventive health care, better use of digitalisation to reduce bureaucracy, streamlining of work routines and 'pay for performance' schemes have been suggested.

Such reforms can marginally improve health delivery, but fail to solve the true problems of European health care systems.

In the forthcoming IEA publication, *The Henry Fords of Healthcare* I show that a new approach is needed: disruptive innovations brought in by entrepreneurs acting in an environment where they are able to try new health delivery models.

While the idea of allowing true entrepreneurial capitalism in healthcare might be seen as extreme in a Western setting, it is currently enjoying a wave of success in places such as India, Thailand, China and the Middle East.

When it comes to healthcare, the new market economies of the East are many steps ahead of the West.

European health care is under strain

**WHEN IT COMES TO HEALTH CARE, THE NEW MARKET ECONOMIES OF THE EAST ARE MANY STEPS AHEAD OF THE WEST**

In the UK most of health care is organised, financed and provided directly by the National Health Service (NHS).

This centrally planned system has major problems with long waiting times, inefficiencies, care quality and patient safety incidents.

Similar problems also exist in other European welfare states. Ageing populations and patient knowledge of the availability of higher quality treatments are driving up demand.

Since healthcare in Europe, particularly in Western Europe, is mainly financed through taxes, the rising costs are putting the social contract of European welfare states under strain.

If current trends continue, while many Europeans can expect to live longer, they might also experience many years of illness.

## Trapped in Baumol's cost disease

The healthcare models in European welfare states differ from one another. Some, as with the one in the UK, are heavily centrally planned. Others, such as that in Sweden, do have a larger role for private companies operating with public funding.

Still others have a combination of private providers and private funding with protection for those who are less well off.

Although systems with greater private provision are more open to improvements, they too are weighed down by heavy public regulation. These regulations hinder cost-saving innovations.

Because of this, healthcare is often said to suffer from Baumol's cost disease. This phenomenon was described by the famous economist William J. Baumol together with William G. Bowen in the mid-1960s.

It leads to the situation whereby salaries in areas of the economy that experience no labour productivity growth tend to increase to reflect the general rise in salaries in the economy that is driven by increases in productivity in other sectors. This means that the relative cost of those services where there is little productivity growth increases.

A cause for alarm is that Baumol's cost disease might lead to a need for a continual increase in the tax burden to finance the same quality of health services over time because, it is often argued, healthcare is one of those sectors where productivity growth is very difficult.

However, is it necessarily the case that healthcare suffers intrinsically from stagnant productivity growth?

If healthcare were funded and provided differently, perhaps innovation and productivity growth would be much more likely. This is especially so given that technology and globalisation both open up entirely new ways of providing care. In The *Henry Fords of Healthcare* I explore the possibilities.

## True entrepreneurship in healthcare

Devi Shetty is one of the entrepreneurs who is changing the scope of healthcare delivery.

After learning in school about the South African doctor who had just performed the world's first heart transplant, young Devi decided that he would pursue a career as a heart surgeon.

He followed up his dream by completing his graduate degree in medicine in India, training to become a cardiac surgeon in the UK and consequently returning to his home country in 1989.

Shetty soon became a famous cardiac surgeon, having performed the first neo-natal heart surgery in India on a nine-day-old baby, and also having operated on Mother Teresa after she suffered from a heart attack and subsequently serving as her personal physician.

However, Shetty realised that heart surgery was simply too expensive for private citizens or for the government health system in India.

In an interview with the *Wall Street Journal*, he explained that almost none of the patients that came to see him could pay the cost of open-heart surgery: "When I told patients the cost, they would disappear. They literally didn't even ask about lowering the price", he remarked.

To solve this dilemma, the entrepreneurial surgeon employed economies of scale.

Shetty turned to his father-in-law, the owner of a large construction company, and explained that he needed to create a heart hospital that was big enough so that high volumes could push down the price of treatments.

The father-in-law agreed, and in 2001 the new hospital – Narayana Hrudayalaya – opened on 25 acres that previously had been marshland around a cement factory.

"Japanese companies reinvented the process of making cars. That's what we're doing in health care", Shetty explained. "What health care needs is process innovation, not product innovation."

The interview was recorded eight years after the flagship hospital opened. Already by then, the hospital, which had 42 cardiac surgeons, was performing thousands of heart operations each year.

Shetty and his team had streamlined procedures, creating an environment where each employee became specialised in performing the same part of the job over and over again. By employing streamlined procedures and economies of scale they had reduced the cost of cardiac surgery dramatically.

While surgeons in the US typically perform one or two surgeries a week, the surgeons in Shetty's hospital performed two or three operations a day, six days a week.

The operations at the hospital were continually scrutinised, in order to find opportunities to cut costs and increase quality. The average price charged for coronary artery bypass graft surgery was merely $2,000 in Narayana Hrudayalaya, compared to $5,000 in other private hospitals in India and between $20,000-42,000 in the US.

Yet, the mortality rate 30 days after coronary artery bypass graft surgery, one of the most common procedures, was not only on a par with but even somewhat lower than the average in the US.

### The Henry Fords of Healthcare

Devi Shetty is not alone. A number of entrepreneurs in developing economies have taken advantage of economies of scale and streamlined procedures in health care, paving the way for a revolutionary change in health delivery.

## BY EMPLOYING STREAMLINED PROCEDURES AND ECONOMIES OF SCALE THEY REDUCED THE COST OF CARDIAC SURGERY DRAMATICALLY

Govindappa Venkataswamy, an Indian eye doctor who passed away in 2006, founded Aravind Eye Hospitals – one of the largest networks of eye hospitals in the world.

A Harvard Business School Case Study has found that the hospital, which was founded in 1976, already by 1992 had screened 3.65 million persons and performed 335,000 cataract surgeries. Impressively, nearly 70 per cent of the operations had been performed at very low cost or free for the poor.

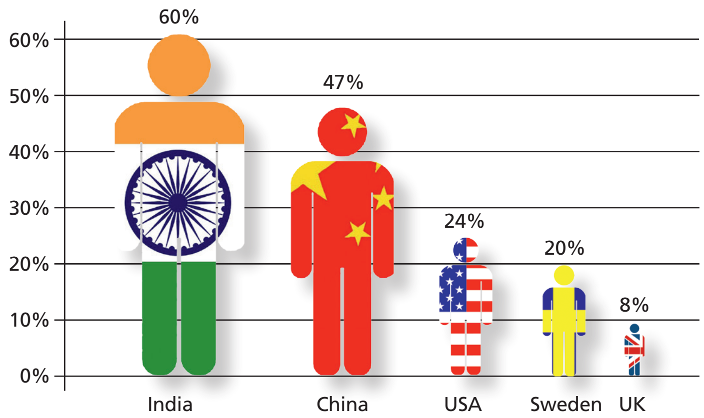
While Shetty cites Japanese car manufacturing as a role model, Venkataswamy was reportedly impressed by the service efficiency of McDonalds.

He sought to transplant it to the Aravind system in order to cope with the high demand for eye surgery and limited funds to finance it.

Chen Bang has similarly spread affordable eye treatment in China. Bang was an investor when he met a retired ophthalmologist who explained the economies of scale in the eye care business. The result was Aier Eye Hospital – the largest private eye hospital group in China.

The firm has gained a significant share of the entire Chinese eye treatment market by implementing a similar vision for economies of scale as Aravind Eye Care. Forbes reported in

Figure 1: Number of people who believe that the healthcare system in their country is improving...




*based on figures from a Global Attitude survey at the end of 2016*

2016 that the group had 80 eye hospitals in operation, and planned to build 200 more by 2020.

A case study by the International Financial Corporation explains how the efficient service delivery of the Chinese hospital network is benefiting the poor:

"Aier adapted a multi-tier network of hospitals to ophthalmology and introduced it to China. The network model lowers costs through efficiencies as lower tier hospitals in smaller cities refer patients to larger, more sophisticated hospitals. [...] A strong reputation for quality enables Aier to subsidize prices for lower-income patients with higher prices for discretionary procedures like LASIK surgery. [...] As a result, Aier accepts patients, regardless of income level."

This illustrates the ability of entrepreneurial health firms to adapt to the need of patients with different income levels. Other similar health entrepreneurs can be found in Thailand and the Middle East.

## Time to learn from the East

Why is it that these entrepreneurs thrive in the new market economies of the East rather than in the West?

One answer is that necessity breeds innovation. Another is that countries such as India and China have had failing state health systems. This disadvantage has been turned into an advantage, as entrepreneurs have designed new health systems from the ground rather than adapted to existing models. The result is a model with which many people are happy.

A Global Attitude survey at the end of 2016, for example, showed that 60 per cent of people in India and 47 per cent in China believed that over the coming years the quality of the healthcare that they and their families would receive would improve. This can be compared with 24 per cent in the US, 20 per cent in Sweden and just 8 per cent in the UK. (see Figure 1)

The UK and other Western countries have good reason to be inspired by the developments happening in the East.

For similar change to happen in the UK, the existing NHS system doesn't have to be completely overhauled. Public funding can for example continue to play an important role aslong as the right incentives are created within the system.

The important lesson from the East is that it is not enough to have a market in health. We also need a market that functions properly.

To a significant degree private firms operating in Western healthcare are bound by regulations and primary care (GP) services that hinder basic organisational innovations. They can thus not improve health delivery outcomes more than marginally.

The UK and other European countries should open up their healthcare systems to truly disruptive innovation. Economies of scale and streamlined procedures combined with new technologies can cure Baumol's cost disease•

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## FOR MORE

*The Henry Fords of Healthcare* will soon be available for free download from the IEA at:

**www.iea.org.uk/research**

# GETTING TO THE (non-decimal) POINT

**We should be sceptical of spurious accuracy in economic forecasts. Economists have an important contribution to make – but they would be listened to more if they understood their own limits, says PHILIP BOOTH**

If you google "economic forecasts", you will get 27,000,000 responses.

Many readers of this column might wish to have a career in forecasting. But, it is important for any expert to know their limits.

It could be argued that economists "oversell" themselves and pretend they can predict things which they really cannot predict. If economists had a proper professional body, this would be a serious matter. If a lawyer, for example, practises outside their area of competence, they can be taken to task by their profession.

Certainly, economic experts did not come off well in the financial crash.

The fact that most mainstream economists missed the signs of the crisis and did not forecast it is well known.

Indeed, it is so well known that, in November 2008, HM Queen visited the London School of Economics and asked about the crash: "Why did nobody notice it?".

That was a good question. The first sentence of the last Bank of England Financial Stability Report issued before the financial crisis started in the UK read: "The UK financial system remains highly resilient."

Just as the crash was not predicted, forecasters hardly covered themselves in glory.

In 2009, the Bank of England believed that there was a negligible probability of inflation rising over 4 per cent within two years. In fact, it rose to 5 per cent.

The over-estimate of growth figures by the OBR after its inception in 2010 was enormous. This was not equal and opposite errors in every year, suggesting that the timing of growth was different from forecast, but errors in the same direction year-after-year. In other words, something was missing in the model.

Further errors were made around the Brexit vote. Just before the Brexit vote, the Bank of England expected the economy to grow by 2.3 per cent in 2017. After the Brexit vote, they adjusted that to 0.8 per cent before upgrading the forecast to 1.4 per cent in November 2016 and 2 per cent in February 2017.

There are at least two overlapping problems when it comes to economic forecasting.

The first is that economists focus in their thinking on what is measurable rather than on what is important.

The second is that economists have come to both over-value formal modelling and over-value spurious precision in modelling. These were important topics discussed by F. A. Hayek, not least in his Nobel laureate lecture.

## Don't ignore the difficult to measure

Let us take the example of monetary growth and inflation.

Presciently, Mervyn King noted back in 2002 that central bank models do not include money despite money being the main driver of inflation.

King, who became Governor of the Bank of England in 2003, said he believed inflation was a disease of money and that there were real dangers in central banks relegating money to a 'behind-the-scenes' role.

How right he was. Indeed, at least in the US, excess monetary growth almost certainly contributed to the asset price inflation that was a cause of the crash.

Mervyn King was an expert, but he was an expert who knew that what was not in the model was more important than the variables that were modelled. Unfortunately, central banks – including his own – did not heed his advice.

The reason that macro-economic models do not include money is that the relationships between the supply of money and the economy are not easy to model.

Typical models based on aggregate demand and supply and output gaps are easier to construct and test. But, in focusing on what is measurable, such models miss what is important.

### Know your limits

Modelling in economics is not like modelling physical sciences.

Economic outcomes depend on the behaviour of seven billion people all with a will of their own. Economists over-estimate their ability to model with accuracy, but what economists can judge is “tendencies” or “patterns”.

We know that a minimum wage will probably increase unemployment. However, we don’t know by how much, amongst which groups, over what timescale, and so on.

There are too many factors and interactions to understand the magnitude of the effect with any precision. Will people try to work more if there is a higher minimum wage? Will companies lay off workers, reduce hours, reduce fringe benefits or try to work employees harder?

Will labour-intensive industries gradually be replaced by more capital-intensive competitors? Will immigration reduce – or perhaps increase?

The range of questions that have to be considered to understand the precise impact of a policy change is enormous and beyond economic modelling.

Indeed, in an era when economists are wheeled out more and more to present their forecasts, in the physical sciences it is being appreciated that we know less than we thought we did.

It is very clear, for example, that the impact of man-made climate change is very difficult to predict. Just to give one example, it now appears more likely that climate change will lead British summers to be wet and windy rather than hot and dry – but views on that might change again. What will happen to winters is anybody’s guess.

These things depend on the interaction between the Gulf Stream, the melting of the polar ice caps, the position of the jet stream and the salt content of sea water. Something is likely to happen, but quite what and to what extent, we don’t know.

A good dose of humility would be good for economic modellers. Perhaps a bit more focus on theory and less on number crunching would help them understand better what the effects of policy changes will be.

Economists should not need to pretend that we can predict things that do not really matter to several decimal places to justify our value to the world.

After all, the really big questions, such as “what institutional frameworks best promote economic development for poor people?”, do not require answers to three decimal places●

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**Whilst the U.S. unemployment rate has returned to pre-recession lows, there is concern among policymakers about other developments in the American labour market, notably the secular decline in the labour force participation rate since the turn of the millennium.**

A growing number of economists are trying to explain the drop in the share of working-age individuals in employment or seeking employment, and whether factors such as the ageing of the population, increasing reliance on disability benefits, occupational licensure and other workplace restrictions might be playing a role.

New technologies are another prominent candidate explanation for this structural shift. Some recent studies appear to have shown a link between so-called 'jobless' recoveries – where employment creation after a recession is low compared with GDP growth and previous experience – and the replacement of middle-skill routine jobs by labour-saving technologies.

But this evidence is limited to the United States, and recent labour-market outcomes have varied considerably across countries. For instance, in the UK unemployment has likewise declined to pre-crisis levels but the participation rate is at all-time highs, contradicting US experience.

This paper tests whether the American evidence is replicated elsewhere in the world. The authors look at 71 recessions in 17 developed countries between 1970 and 2011.

They consider three questions: whether recent recoveries have produced slower employment growth than earlier ones; whether employment growth was especially slow in industries featuring a preponderance of routine jobs, which are more susceptible to automation; and whether middle-skill workers in those industries and across the economy were differentially affected.

The paper finds the US experience not to be applicable to the countries in their sample.

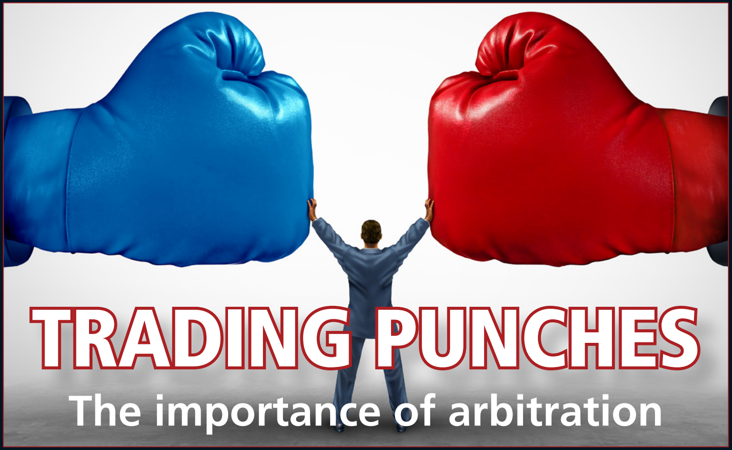
Firstly, there is no sign of a slowdown in employment creation in the wake of recent recessions relative to earlier ones.

Secondly, the authors find that routine-intensive industries did not experience slower employment growth than non-routine-intensive ones over the sample period. Furthermore, job growth during recoveries did not slow down after 1985.

Finally, whilst there is some evidence of recessions becoming worse for middle-skill workers after 1985, the authors find that job recoveries were the same for those workers as for other workers and did not worsen over the period of study.

The paper suggests that US-specific factors may be driving the joblessness of recent economic recoveries•

**GRAETZ, G., & G. MICHAELS**
(2017)
*Is modern technology responsible for jobless recoveries?*
*American Economic Review 107.5 (May): 168-73.*
*http://eprints.lse.ac.uk/69043/1/dp1461.pdf*




**Before Donald Trump was elected to the presidency, the US and the EU were negotiating a preferential trade agreement known as the Transatlantic Trade and Investment Partnership, or TTIP.**

Because tariff barriers between the two blocs are already low, much of the discussion focused on how to increase competition and facilitate investment by curbing regulatory barriers and providing greater legal certainty to firms from the other side of the Atlantic.

The latter involved introducing an investor-state dispute settlement (ISDS) clause into the agreement. This was very controversial and led to widespread protests in continental Europe.


**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.**

The concept of consumer surplus is widespread in economics, and much public policy – from airfare liberalisation to the break-up of monopolies – is designed with consumer-surplus considerations in mind.

It is often regarded as a sign of market power if companies are able to capture more of the consumer surplus.

Yet to quantify this measure for any real market is a challenge, because in most instances the only price we know is the price that consumers actually pay. We need to know the price consumers are willing to pay to estimate consumer surplus and this is different for every consumer and not revealed in market transactions.

This paper examines one of the rare markets in which consumer surplus can be estimated: the market for transport services intermediated by Uber.

Two features of this ride-sharing application make it a fruitful subject of research: firstly, the app can and does record when customers log on, whether or not they end up requesting a ride; secondly, the service uses variable – so-called 'surge' – pricing to balance supply and demand – higher prices bring more cars on the road but they also discourage the potential customers who value a ride the least from requesting it.

The two features together mean that Uber data can be used to calculate willingness to pay, and therefore demand functions and consumer surplus.

The authors study the impact of Uber on consumer welfare in four US cities, and they find consumer surplus of $2.88bn in 2015, or $6.8bn when the findings are extrapolated to all trips taken by Uber customers in America that year.

This figure is six times Uber's revenues from commissions and twice the revenue obtained by Uber drivers.

The paper thus not only documents a remarkable instance of economics at work, but it also provides strong evidence of welfare gains to consumers from new technologies•

**COHEN, P, R. HAHN, J. HALL, S. LEVITT & R. METCALFE**
*(2016)*
*Using big data to estimate consumer surplus: the case of Uber*
*NBER Working Paper 22627 (September)*
*National Bureau of Economic Research*
*http://papers.nber.org/tmp/5610-w22627.pdf*

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ISDS is an example of international commercial arbitration, a process of dispute settlement by the parties to a contract outside the domestic jurisdiction of either party. Disputes are instead settled by private tribunals in international centres viewed as neutral by both parties.

The justification for international arbitration is that it facilitates trade and investment by assuring foreign investors of a fair litigation process should disputes arise. Furthermore, international arbitration often relies on legal systems, such as English contract law, that firms know and which provide more flexibility than many domestic legal systems, especially those of developing countries.

This paper tests the argument that international arbitration makes investment easier by comparing foreign direct investment (FDI) flows into countries that have and have not signed the main international convention on enforcement of foreign arbitral awards.

The paper finds that international commercial arbitration does have a significant effect on foreign investment flows. On average, bilateral investment flows are 2.6 times higher if both countries are signatories to the convention than if none or only one of them is. If only one country is a signatory, FDI flows are still 51 per cent higher than if neither are signatories.

With regard to the impact of such agreements on the number of projects undertaken, the authors find the effect to be especially strong for projects above $60 million.

This paper provides support for the settlement of international trade and investment disputes by private tribunals, specifically, and for the use of international institutions as a complement to domestic statutory bodies more generally. Both are found to be beneficial to foreign investment and thus to growth•

**MYBURGH, A & J. PANIAGUA**
(2016)
*Does international commercial arbitration promote foreign direct investment?*
*Journal of Law and Economics*

# ARCHITECT OF PROSPERITY: John Cowperthwaite and the Making of Hong Kong

*NEIL MONNERY* *LONDON PUBLISHING PARTNERSHIP 2017*

**The small autonomous region of Hong Kong is one of the largest successes in recent economic history.**

It is a mountainous spur and scatter of islands, bereft of any resources except one of the finest natural harbours in Asia. It faced repeated crises during and after World War II, especially due to the Chinese Communist Revolution.

Despite these unpromising beginnings and subsequent trials, Hong Kong achieved staggering economic success.

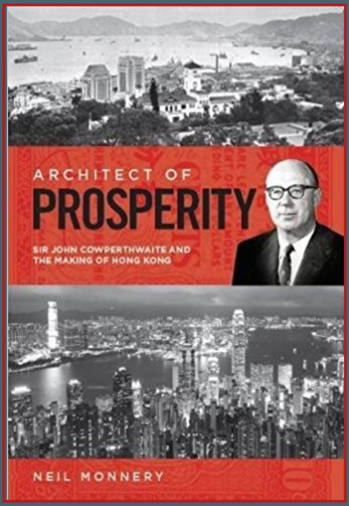
Its population rose from around 600,000 in 1945 to over seven million today. It boasts one of the world's most beautiful and modern skylines and elegant and effective infrastructure systems.

And its income per capita has risen to levels one-third higher than its former overlord the UK, with an average life expectancy greater than Switzerland.

This book tells the story of Hong Kong's success, focusing on the career of Sir John Cowperthwaite who played key roles in the colony's administration from 1945 to 1971.

Monnery tells the story with verve and accuracy, providing one of the best compact economic histories of Hong Kong in the second half of the twentieth century. It reads as something of a morality tale.

Cowperthwaite faithfully kept to five principles: low taxes, minimal government services, free trade, fiscal prudence and laissez-faire (e.g. no policies to favour industries or shape the economy). As the colony grew richer, the government




provided more education, health care and infrastructure.

Monnery shows that Cowperthwaite made mis-steps. He was caught off guard by banking crises, not really understanding finance. He fought against developing an underground metro system, which is now one of Hong Kong's greatest assets.

Still, Monnery argues that Cowperthwaite's laissez-faire, low-tax regime was responsible for Hong Kong's astounding success.

The problem with this thesis, however, is that another Chinese autonomous region – Shenzhen, on the mainland just north of Hong Kong – has operated under a different system and enjoyed even greater success!

In just under forty years, Shenzhen has gone from a small village to a modern city of 18 million, boasting world-class technology firms and a total GDP almost equal to that of Hong Kong.

Evidently, being the main foreign investment/manufacturing/export centre of the world's fastest growing economy, as Hong Kong was from 1945 to 1980 and Shenzhen was from 1980 to the present, is a hugely favourable situation for rapid economic growth. This seems to hold whether under laissez-faire colonial rule or "socialism with Chinese characteristics."

The real story of Hong Kong is less the virtues of its small government approach than the adaptability of its business community. Every step of the way, when hit by crisis, the business community adapted, even up to the present day with a movement into higher-value-added exports.

Can it last? Or will Hong Kong become just another Chinese city, overtaken by Shenzhen and Shanghai?

On the one hand, as long as Hong Kong's currency, legal system, and property are seen as more stable and secure than those of mainland China, resources will continue to flood in to keep Hong Kong afloat.

But Hong Kong's adaptability may fade in a new world driven by financial technology, artificial intelligence, and greater competition from cities in mainland China and throughout south-east Asia.

We shall need another book on Hong Kong a decade hence to tell us if its adaptability to change can continue in the future•

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# THE WEALTH OF NATIONS

***ADAM SMITH* W. STRAHAN AND T. CADELL 1776**
***(now widely available in different versions, including online)***

**Adam Smith's political economy enjoys a universality that makes it, in many regards, applicable to present times and contemporary problems (public debt reduction, free trade, containment of public spending, etc).**

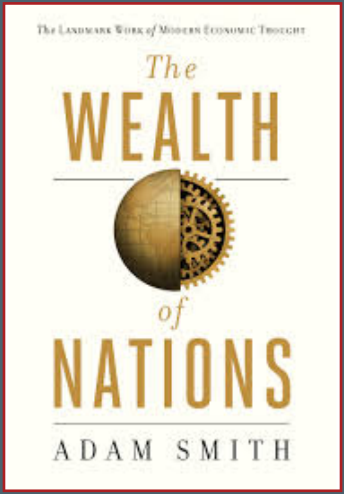
After the publication and rapid success of *The Wealth of Nations*, restrictions to trade came to be regarded as the result of a silent domestic conspiracy between opportunistic businessmen and politicians, with direct harmful consequences to the common good.

To Smith, the pursuit of self-interest (not to be confused with selfishness) is not intrinsically evil: what is needed is a system that channels that self-interest in such a way that makes it an ally of general prosperity.

Such a system requires a realistic anthropology and a legal and ethical-institutional framework that allows the market economy to operate in a beneficial way.

When that happens, the market mechanism does the rest: by pursuing its self-interest, individuals will frequently be promoting society's interest "more effectually than when he really intends to promote it." (WN IV.ii.9).

According to Smith, under the conditions of natural liberty trade occurs through free and voluntary exchange between the agents involved, which makes the result mutually acceptable. No individual would take part in an exchange if he knew he would end up in a worse




position than before.

But the interplay of personal interests does not occur only in the market. It also takes place in political processes. Hence Smith's emphasis on the impartial spectator and on rules of conduct that make possible co-operation in society.

An open and competitive market, based on free trade and voluntary co-operation, provides the best propects for prosperity. National defence, the administration of justice and the rule of law are necessary pillars for sustaining that framework and thus are the central tasks of the state.

The main argument in *The Wealth of Nations* can thus be summed up as the idea that liberty and the pursuit of self-interest under an adequate institutional framework do not lead to chaos but rather lead individuals – as if guided by an "invisible hand"–- to produce order through a decentralised process of social co-operation based on the market.

The concept of the "invisible hand" refers to the complexity of social order. A complexity that should lead aspiring central planners to be particularly careful about, to use Bastiat's expression, "what is seen and what is not seen" before intervening in the market economy.

It is however important to note that Smith's view of the market economy is in fact quite distant from the contemporary neo-classic model of "perfect competition" beloved of textbooks.

Smith emphasises, unintended consequences and the dense web of human motivations and sentiments that underlie social interactions. This makes Smith closer to the dynamic view of the market process held by the Austrian School.

*The Wealth of Nations* should be regarded an an explanation of how human interests can be harmonised through the market process but not as a claim that they are always or naturally in harmony. Smith's emphasis on the need for an adequate institutional framework is a realistic approach.

Human nature does not change, and Smith's analysis and understanding of human nature was correct. As such, *The Wealth of Nations* remains highly relevant to any student of economics•

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# Can you bank on the BANK OF ENGLAND?

**In recent decades governments have developed mechanisms to try to make their monetary policy and inflation promises more believable or "credible". Unfortunately, since the financial crisis, it appears the Bank of England has not been taking the inflation targeting part of its mandate seriously, says ANDREW LILICO**

**"Credibility" is the term economists use to refer to the belief, by economic agents, that promises will be kept even if keeping them is unattractive at the time.**

If a government promises "credibly" not to raise corporation tax for the next five years, then economic agents believe corporation tax will not be raised even if the government becomes in urgent need of extra revenue or even if opinion polls suggest voters would be very keen to see corporations punished by tax rises.

If a government promises "credibly" to balance the budget for the next two years, economic agents believe the budget will be balanced even if there is a big recession and tax receipts fall significantly.

It is, in fact, very difficult for politicians to make credible promises because circumstances often change in such a way that it would be beneficial for the government to renege on their commitments.

However, it can be useful for the government to make credible promises. In the case of corporation tax, for example, a low and stable rate might attract more investment.

But, if investors do not believe that the government will keep the promise when times get difficult, the investors may stay away.

## Credibility and inflation

One of the most important and widely-discussed forms of credibility concerns monetary policy. Governments and monetary authorities can make various promises in this area.

For example, they might promise to keep fixed the rate of exchange of the domestic currency (say, the pound) to, say, the dollar or to gold. They might promise to keep interest rates no higher than 2 per cent for the next three years. Or they might promise to keep inflation within, say, 1 percentage point of some inflation target (e.g. 2 per cent).

If economic agents can feel confident that an inflation target will be met, whether or not the politicians find it convenient to meet it, those economic agents can plan with much greater confidence.

Suppose your boss offers to raise your salary from £20,000 this year to £21,000 next year – a 5 per cent rise.

Will that mean you are better off next year or worse off? If you are confident inflation is going to be 2 per cent next year, that 5 per cent rise means your boss is raising your salary in real (inflation-adjusted) terms. But if inflation might be 10 per cent, despite the promise to keep it to 2 per cent, that 5 per cent rise could actually be a pay cut in real terms.

So instead of you, say, consuming a bit extra now in anticipation of your greater riches next year, you should probably cut back a bit to save up for when you get poorer.

If you don't know which is the right strategy, because you don't know how much to trust the government, you may well end up making costly mistakes.

Multiplied across the economy, such mistakes, arising from the lack of credibility of inflation promises, can damage economic efficiency significantly, leading to lower growth and lower economic welfare in general.

One well-known form of inefficiency that we try to avoid using more credible monetary policy concerns unemployment.

Firms offer employment and workers accept it based on nominal wage offers plus their expectations about inflation. If inflation is lower than expected, workers will mistakenly have turned down jobs expecting to be able to get higher salary offers later that never come (because the original offers were actually more lucrative, in real terms, than expected) and unemployment will rise.

## SUCH MISTAKES, ARISING FROM THE LACK OF CREDIBILITY OF INFLATION PROMISES, CAN DAMAGE ECONOMIC EFFICIENCY SIGNIFICANTLY

If inflation is higher than expected, workers will mistakenly accept job offers they should have rejected in favour of a better offer later, and unemployment will end up very low but at the cost of excessively low wages.

Unemployment will only be at an equilibrium full-employment level consistent with healthy wage growth if the expectations of workers and firms about inflation are correct.

We can see how credibility can be lost by grasping how tempting it will be for the monetary authorities to allow inflation to overshoot, especially if the economic situation is fragile.

An inflation over-shoot means unemployment being lower at the cost of somewhat lower real wages. It is like everyone having an unexpected wage cut to pay for the jobs of some extra employees.

### Has the Bank of England lost credibility?

It is for this reason that governments have gone to great lengths to try to make their monetary policy credible.

In recent years, they have done that by delegating decisions to independent central banks and giving them targets to meet which can only be changed through a transparent process.

In the UK, after five years of pursuing a system of inflation targeting from 1992, a system was introduced in 1997 whereby the Chancellor of the Exchequer set an inflation target for the Bank of England which was also made independent.

If the Bank did not make sure inflation was close enough to the target, the Bank's Governor had to write an open letter to the Chancellor explaining why and what would be done to bring inflation back to target.

Initially it was expected that having to write such a letter might be a rather serious matter, resulting in the Chancellor criticising the Bank and perhaps some members of the Bank's Monetary Policy Committee being dismissed if the miss were seen as the result of policy errors or if inflation did not return to target swiftly.

For almost exactly the first ten years of the system, up to April 2007, inflation was always so close to the target that no letter was written.

But then, when inflation

Figure 1: Inflation versus target and the "letter-writing trigger"


finally was far enough from the target to require a letter, the system collapsed.

In the past ten years there have been 22 letters written. Not a single one has resulted in any criticism of the Bank by the Chancellor, let alone any MPC member being disciplined or dismissed.

The Bank made no discernible effort to prevent inflation from reaching 5 per cent in 2008 or 2011 (indeed, in 2011 it did not raise interest rates a single time as inflation rose) and little obvious effort in 2015 to prevent inflation from under-shooting.

Inflation is above target at the time of writing; and it was clear a long time before it went above target that this was likely to happen. There has been no reaction from the Bank.

The average deviation from target over the last ten years is 0.35 per cent – and there is a clear bias in how the Bank treats positive and negative deviations (*see Figure 1*).

That lack of credibility could be very important if the Bank needs to keep inflation down in the future.

In the 1960s and 1970s the UK authorities lost monetary credibility with failed promise after failed promise. When Margaret Thatcher came into office, unions and firms and investors had become used to politicians failing to keep their promises. So, when she said inflation would fall, they didn't believe her.

As she made her famous 'the Lady's not for turning' speech in October 1980, inflation was 15 per cent and falling.

But because unions and firms expected her to be just like the rest, they had raised wages by 23 per cent over the previous year.

When inflation did, in fact, fall back to below four per cent by 1983, workers had priced themselves out of the market. Unemployment soared to above three million and stayed there for 51 successive months. At the same time, the government (and companies) had to pay inflated prices to borrow money.

Thus, monetary credibility is easily lost and, once lost, expensive to recover.

There has been little to no monetary credibility in the UK for around 10 years. For a while, when it remains convenient to keep inflation close to target anyway, that may not obviously matter. But, at some point, there will, alas, be a reckoning•

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# Is PAYING TAX a BURDEN?

## JAMIE WHYTE TAKES A RENOWNED ECONOMIST TO TASK

**Myth busting is a risky business. If the myth you try to bust is in fact an important truth, you end up looking silly.**

Ha-Joon Chang, the Cambridge University economist, ran this risk in *The Guardian* with an article entitled "The myths about money that British voters should reject".

The last of his myths is that "tax is a burden".

Many of us certainly feel that paying tax is a burden. Where are we going wrong in our thinking?

Dr Chang explains thus: "But would you call the money that you pay for your takeaway curry or Netflix subscription a burden? You wouldn't, because you recognise that you are getting your curry and TV shows in return. Likewise, you shouldn't call your taxes a burden because in return you get an array of public services..."

Dr Chang is not the first person to have expressed this view of taxation but I hope he is the first academic economist to do so. It involves two serious errors.

First, spending money on a takeaway curry or Netflix actually is a burden. Suppose I buy a takeaway curry for $10. One good thing has happened. I have got myself a curry. But something bad has also happened. I have lost $10 that I could have spent on something else.

Of course, since I chose to buy the curry, I must figure that I had no better use for that $10. But this does not stop spending $10 from being a burden. If the curry had cost only $1, I would have been $9 better off. The burden would have been $9 lighter.

Dr Chang must behold people who shop around for low prices with utter dismay. If only they realised that paying for things is not a burden!

His second mistake lies in failing to see the fundamental difference between buying a curry and receiving services, such as healthcare and education, that are funded from your taxes.

To see what the difference is, imagine a man with a gun knocked at your door and presented you with a new laptop computer and demanded $1,000 in payment. If you don't pay, he tells you, he will lock you in a metal box for a year.

Would this be a burden to you? If you were planning to buy precisely this kind of laptop computer, and planning to buy it right now, and could not have found it a better price than $1,000, then you might not be too upset.

But this is unlikely. There is a good chance you didn't want a new laptop now. You might have planned to use the $1,000 to buy a new suit or to go on holiday. Or, if you did want a laptop, you probably wanted a different model.

Though taxes are now rarely collected by armed men arriving at your door, they are still extracted by the threat of imprisonment and, if you resist, violence. The services we get from the taxes extracted from us are thus compulsory purchases.

That paying for something is burdensome, and that being forced to pay for something is even more burdensome, are facts you might expect a renowned Cambridge University economist to know. Which just goes to show how risky the myth busting game can be•

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**Full version at:**
**www.iea.org.uk/sorry-ha-joon-chang-but-tax-really-is-a-burden/**

# a GENDER item

**Justine Greening, the women and equalities minister, is being criticised because she has rejected most of the 17 recommendations of the Women and Equalities Select Committee for ‘addressing the structural reasons why women are paid 18 per cent less than men’.**

Ms Greening, or the Treasury, has woken up to the fact that some of these measures would have a significant cost.

For instance Recommendation 6(c): ‘The three months’ non-transferrable paternal leave should be paid at 90% of salary (capped) for four weeks and then at the same level as Shared Parental Leave’ and Recommendation 6(d): ‘Payment of paternity leave should increase to 90% of salary (the same as maternity pay), capped for higher earners’.

Provisional estimates suggest that these measures would cost hundreds of millions of pounds.

Committee members are apparently outraged that these measures have been rejected. It is suggested that they are vital to persuade men to take on a bigger share of childcare and thus let women return to work earlier and enable the gender pay gap to narrow.

But Ms Greening is right to reject these measures, which would have a trivial or zero effect on the pay gap.

Few of the recent measures have had a clear effect on reducing the gender pay gap, which has fallen over time mainly as a result of factors such as the changing educational ambitions and achievements of women, changes in industrial structure (favouring brainwork rather than manual labour), changes in demography (fewer children, longer lives) and lifestyle changes (more single people, easier divorce, cohabitation).

I have no doubt it will continue to fall further, but politicians need to remember that this aggregate statistical artefact is not under their control. It depends on individual and family decisions rather than the efforts of the government.

What would be needed to close the gender pay gap completely? Men and women would need to have the same qualifications, in the same disciplines, choose the same types of occupations have the same preferences between paid work and home work, take the same amount of time out of the workforce, have the same career plans and expectations and so on.

It is arguably just as likely that in a generation there will be a gender pay gap in favour of women as that there will be complete parity between the pay of men and women. What would our politicians say to that?•

## LEN SHACKLETON ON THE GENDER PAY GAP

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**Full version at:**
**www.iea.org.uk/the-gender-pay-gap-is-not-a-problem-it-is-the-result-of-free-choices/**

# ZIP IT!

## KRISTIAN NIEMIETZ SAYS THE LEFT SHOULD STOP BANGING ON ABOUT AUSTERITY

**I'm not convinced by Keynesian economics. But let's assume, just for ten minutes, that it could be proven, beyond the shadow of a doubt, that Keynesian economic policy recipes would have dragged the UK economy out of the Great Recession quickly and painlessly.**

What would be the implication? Would this mean we should now give up on fiscal restraint and open the public spending floodgates?

Absolutely not. It would only show that in retrospect, it would have been better to do so during the recession. But even then, that would be water under the bridge.

Traditional Keynesians do not believe that a country can borrow itself rich. They do not believe that permanently spending money you do not have is the path to prosperity.

They believe that a government can spend its way out of a recession. They believe that during a recession, the economy is in a state of shell-shock.

Consumers do not want to spend until employers start to hire, and employers do not want to hire until consumers start to spend. And they believe that prices do not adjust in order to help the economy recover.

According to Keynesians, government spending can provide an initial shove to get things moving again.

But traditional Keynesians would concede that such a situation does not occur very often. It requires a specific type of recession. Their theory is not applicable to "normal" economic times.

In fact, when the economy is growing and at the sort of levels of employment that exist in the UK, traditional Keynesians would argue that the government should aim for a budget surplus.

Maybe there was a case for a Keynesian stimulus package in 2009. I don't believe it, but I can't definitely rule it out. But, this is history now. We are back in normal economic times.

This means that even under Keynesian assumptions, there no longer is a case for running a deficit. We should all be fiscal hawks now•

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**Full version at:**
**www.iea.org.uk/why-the-left-needs-to-stop-banging-on-about-austerity/**


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SOBER
ASSESSMENT

# CHRISTOPHER SNOWDON ON THE UNEXPECTED EFFECT OF MINIMUM ALCOHOL PRICING

**A minimum price for alcohol is viewed by some as a boon for Britain's struggling pub industry.**

When David Cameron was weighing up the policy in 2013, the chief executives of several pub chains publicly urged him to go ahead with it.

Minimum pricing involves setting a floor price of around 60p on every unit of alcohol. The idea is to take 'cheap' drink off the market to protect heavy drinkers from themselves.

Since alcohol is almost invariably sold for more than 60p per unit in pubs and clubs, some people assume that narrowing the price gap will increase sales in the hospitality industry.

This logic is appealing because a drink bought in a supermarket is a substitute for a drink bought in a pub, but economic analysis suggests that minimum pricing could have quite the opposite effect on pubs.

To see why, we must consider the counter-intuitive finding that low income consumers in China buy more rice when the price of rice goes up, as shown by Jensen and Miller (2008)*.

A rise in price should lead to fewer sales, so how do we explain this 'Giffen behaviour'?

Like most economic issues, it comes down to limited resources. If your budget for food is tightly constrained, you need to get the most calories for your dollar. Carbohydrates such as rice are the cheapest sources of energy in many countries.

When times are good, the poor can afford to buy meat as well, but if the price of carbohydrates rises, they have a choice between eating less meat or eating less food.

Let's say that 50 cents buys you rice containing 2,000 calories or meat containing 500 calories. If you have a food budget of one dollar a day, you can buy both, but if the price of rice suddenly rises by 50 per cent, what do you do?

2,000 calories of rice now costs you 75 cents. If you keep buying your 50 cents of meat, you will have to buy a third less rice and go hungry. It makes more sense to sacrifice the relative luxury of meat.

This may seem an extreme example that has little to do with the pub trade in wealthy countries, but it is really just a question of budgeting. If you have a set budget and fixed preferences, a rise in prices is likely to push you towards the cheapest option.

Assume a particular individual wants to drink ten beers a week and has £20 to spend. You have one beer a day from the supermarket at £1 each but on Saturday you go to the pub and have four beers at £3.50 each.

The effect of minimum pricing is to raise the price of your supermarket beer to £1.50. If you want to keep drinking ten beers a week, without spending anymore, you will have to cut down to two bottles in the pub and buy an extra two bottles from the supermarket.

In practice, that is only one option reflecting one set of preferences. A consumer might instead decide to increase their beer budget or to do without a couple of beers mid-week.

But of all the options available, surely the least tempting is to cut down to five or six beers a week and buy them all in the pub - and yet that is what the consumer would have to do for minimum pricing to benefit pubs.

In the same way, if the price of food in supermarkets rose by 50 per cent, it is unlikely that people would flock to restaurants. They may well eat out less to save money for groceries. So it may well be with alcohol.

Minimum pricing will leave people who buy cheap alcohol in supermarkets with less disposable income. Alcohol, as a commodity, is unlikely to be a Giffen good.

Minimum pricing is unlikely to increase overall alcohol consumption, and it is possible that people who only buy cheap alcohol from supermarkets may drink less overall.

But for consumers who have a particular desired consumption level and are quite indifferent as to where they drink it, buying more of the cheapest option and less of the pricier option is a rational response, even though the cheapest option is more expensive than it used to be.

When budgets are tight, we cut down on the luxuries first●

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* Jensen, R. and Miller, N. (2008) Giffen behaviour and subsistence consumption. *American Economic Association* 98: 4 (1553-77)


# GIG ISSUE

## JAMIE WHYTE ON THE PERILS OF REGULATING THE GIG ECONOMY

**Matthew Taylor was a policy advisor for Tony Blair from 1998 to 2006.**

The current Conservative-led government commissioned him to write a *Review of Employment Practices in the Modern Economy*, which was published in July this year.

In it, Taylor recommends laws aimed at giving workers in the "gig economy", such as Uber drivers, a better deal.

Specifically, he says the law should guarantee them many of the same rights as regular employees, including holiday pay, sick leave and the equivalent of a minimum wage.

There is nothing unusual about this. Regulating to give people a better deal has become the main occupation of politicians, and recommending such regulations the main occupation of their advisors. Alas, the endeavour is doomed to failure.

The reason is entirely general but let's stick with employment law.

Imagine you were negotiating an employment contract. After haggling with your would-be employer, you settle on a salary of £30,000. Then you surprise her by saying you want six weeks' holiday rather than four.

She will, obviously, revise her pay offer. The most she was willing to pay for 48 weeks' work was £30,000. Now it turns out she will get only 46 weeks' work from you: 5 per cent less. So she will cut your salary – by 5 per cent most probably.

In short, you face a trade-off. You can have more money and less leisure or less money and more leisure. The choice is yours.

Except … it isn't. Employment contracts that do not provide at least 5.6 weeks' paid holiday are illegal in the UK. You are required by law to take the less-money-and-more-leisure option.

This law cannot help employees. If this is an employee's preferred option, then he is no better off, since he was already free to negotiate it. If he would prefer more money and less leisure, the law positively harms him.

Trade-offs are economic realities. If you take more holidays you produce less and are, therefore, worth less to your employer. No act of parliament can overcome this fact. It can only force you to take one trade-off rather than another.

Uber does not now provide sick leave, holiday pay and so on. If the government forces it to, it will need to claw back the cost of these things by worsening the deal drivers get in other respects

– probably by reducing the share of fares they keep.

Some will suggest that further regulations should prevent Uber from responding in such a way. Uber would then have to pass the extra cost onto customers through higher prices. These higher prices would reduce demand for the labour of Uber drivers, whose incomes would therefore decline.

The trade-offs we face are a consequence of nature and the state of technology.

Some trade-offs are unlikely ever to change. If you are in London you cannot simultaneously be in Paris. The cost of being in one place is not being in the next best place you could have been, and I guess it always will be.

But other trade-offs have improved. Smoking increases your chance of getting lung cancer from 0.3 per cent to 7 per cent. Some people are willing to accept this increased risk for the sake of the pleasure smoking gives them.

But, if what they like about smoking is simply inhaling hot nicotine infused air, they can now get a much better deal. Vaping technology allows you to inhale such air while increasing your chance of getting cancer by much less. Vaping has improved this trade-off.

Every advance in the efficiency of production improves the trade-offs we face.

Televisions once cost 20 times what they cost today. In today's money, buying a TV in 1970 meant forgoing £3,000 worth of other stuff. Now you need forgo only £150 worth of other stuff to have a TV.

In 1700, most human labour went into producing food. Modern agricultural techniques have reduced this to less than 5 per cent, leaving us free to do other things.

It is such advances, not regulation, that provide us with better deals. Regulations merely limit our choices among the deals that are available to us.

In employment, they make it harder for employers and employees to find mutually agreeable terms. This is why countries with highly regulated labour markets, such as France and Spain, have high rates of unemployment.

In his *Review*, Taylor notes that the UK has a low rate of unemployment because its labour market is lightly regulated. Then he recommends regulating it more heavily.

It's perverse but unsurprising. Having accepted a commission to tell the government how to regulate us into better jobs, what's a man supposed to do? Say it can't be done?●

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# PRODUCTIVITY PUZZLE...

**As the US economist Paul Krugman once famously remarked, 'productivity isn't everything, but in the long run it is almost everything'.**

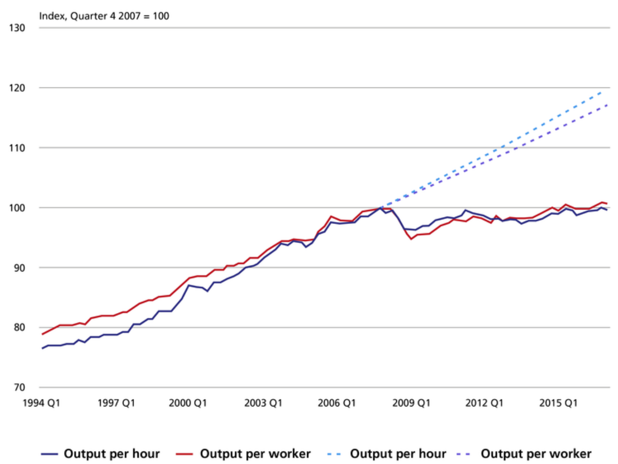
Gains in productivity are the surest way to boost real wages and living standards. At face value, then, the UK has a major problem: output per hour and output per worker have both stagnated since the recession of 2007-08 (see Figure 1).

What's more, the UK's productivity performance appears to be much worse than its peers. In 2015, output per hour worked in the UK was nearly 16% below the average for the rest of the G7, with particularly large shortfalls relative to France (23%) and Germany (27%).

The gap is narrower using the alternative measure of output per worker (due to longer hours and shorter holidays in the UK), but it is still large. And while productivity growth has slowed in almost all countries since the mid-2000s, the deterioration relative to the previous trend has been more severe in the UK.

**Figure 1: Output per hour and output per worker, UK**

**Seasonally adjusted, Quarter 1 (Jan to Mar) 1994 to Quarter 1 2017**




*Source: Office for National Statistics*

# JULIAN JESSOP CONTEMPLATES AN ECONOMIC CONUNDRUM

There are several plausible explanations. It is always worth asking first whether the data are reliable. One possible failing is the under-recording of output. Improvements in the quality of goods produced or increases in the output of service sectors (particularly the digital economy) are not always accurately captured in the official statistics.

However, it is unlikely that these measurement problems have become significantly worse since the recession, or that they are that much greater in the UK than in other major economies.

Averages could also be misleading. For example, a country suffering from high unemployment, and where only the most productive people have jobs, might report a higher average level of productivity than a country nearer full employment.

However, people in comparable jobs in these two countries might still be equally productive. This could help to explain the differences between the UK and France, where unemployment is much higher.

A further issue is the sectoral pattern. The UK's poor recent performance can partly be explained by declines in sectors where productivity has traditionally been highest – notably finance & insurance and oil & gas – and by shifts in economic activity towards labour-intensive service sectors where the scope for productivity improvements is generally lower.

And these shifts have been more important in the UK than in most other countries, exacerbated since 2008 by the hugely increased regulation of the financial sector and the particular way in which green energy has been promoted in this country.

But accepting that there is still something more to explain, there are two other factors behind the UK's poor productivity.

First, an important difference between low-productivity and high-productivity countries is usually (though not always) the level of investment. Here it is surely no coincidence that investment accounts for a relatively small share of UK GDP and that this share has yet to recover fully from the slump during the recession.

One interpretation is that the low rates of investment in the UK are largely the fault of austerity in the public sector and of short-sighted managers in the private sector, and that the answer is therefore more public investment and more state intervention.

However, market-oriented solutions are likely to be more effective. It is far from clear that the state is any better at making investment decisions than the private sector. Indeed, there is a danger that the government simply diverts resources to relatively uneconomic projects, undermining productivity further, the close to £100bn that is being spent on HS2 and Hinkley Point being important examples.

An alternative approach would focus on lowering barriers to investment, whether public or private, including by further reform of corporation tax and investment allowances, reductions in energy costs and liberalisation of planning laws – from fracking to housebuilding.

The second distinguishing feature of the UK is its relatively flexible labour market. This may have allowed the UK to settle into what the National Institute of Economic and Social Research has called a 'low wage – low productivity – high employment equilibrium'.

In a nutshell, it has been more attractive for firms to employ people at relatively low wages (and even keep them on when they might otherwise have been let go) rather than invest in more capital. This is good for jobs, but potentially bad for productivity.

Our benefits system also provides some incentives to work, but does not reward progression to more productive jobs because of the high rate at which benefits are withdrawn.

Nonetheless, it would be perverse to conclude from this that the solution is more regulation, with all the damaging side-effects.

Real wage growth should still pick up of its own accord provided the labour market remains tight and price inflation drops back.

If the government attempts to kick-start this recovery – for example by further large increases in minimum wages – the result is only likely to be a large increase in unemployment, especially among younger people. Achieving higher productivity 'the French way' would be a hollow victory●

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# GDP: An A to Z

## PIERRE LEMIEUX ON WHY THE NUMBERS DON'T ALWAYS ADD UP…

**Gross domestic product (GDP) pops up everywhere in the news.**

In the summer of 2016, for example, the news that Ireland's GDP had increased by 26.3 per cent in 2015 had people scratching their heads.

The 3 September 2016 issue of The Economist raised the perennial question of whether GDP figures released by the Chinese government are reliable.

Then Japan began revamping its GDP calculations after some contradictions appeared in official statistics. This is not counting the routine articles that follow the periodic releases of official estimates.

There is much to be debated in relation to the use and misuse of GDP. But among the many forms of GDP misuse, one is obvious, frequent, and dazzling.

One of the main accounting identities used in national income accounting and basic economics courses states that GDP is equal to the sum of consumption, investment, government expenditures (excluding transfers) and exports.

In other words, it is the sum of domestic production flows to domestic consumers, domestic purchases of investment goods, domestic governments, and foreign importers. In still other words, the production side of GDP is equal to its expenditure side: everything that is produced is purchased.

This is an accounting identity, which means that it is true by definition and cannot be false. It is necessarily true because anything produced that is not purchased by domestic consumers, businesses, governments and foreign importers will pile up in inventories. Inventories are a form of unintentional business investment.

Investment, in GDP numbers, is defined as including such inventories as well as fixed capital investment. This is how accounting identities are necessarily true in the real world: a residual adjusts as a matter of definition.

We could write our accounting identity as:

**GDP = consumer expenditures + business investment + government expenditures + exports**

This is true provided that we take consumer expenditures, business investment, and government expenditures as including only goods and services produced domestically. As its name indicates, gross domestic product is made of domestic production only.

In the statistics that are actually collected, however, consumer expenditures (normally represented by C), business investment (I), and government expenditures (G) include some imported goods and services.

The Chinese-made football you bought at Sports Direct was captured in C; the printing press a newspaper company bought from Germany was part of I; and the salary of the foreign consultant hired by the government was included in G.

Consequently, it would not be correct to write our accounting identity as $GDP = C + I + G + X$ (where X represent exports), because spending on imports is captured in the right hand side of the equation (in C, I and G).

To solve this statistical problem, the accounting identity is written as:

$$GDP = C + I + G + X - M$$

The term –M cancels the imports that are hidden in C, I, and G. It does not mean that imports are a subtraction from national income.

It is easy to be misled. The problem is compounded by the fact that X – M is often grouped inside parentheses so that the accounting identity is remembered as:

$$GDP = C + I + G + (X - M)$$

For the non-expert, the last equation can easily suggest that (X – M) is the balance of trade. This interpretation error is further encouraged by experts who call (X – M) "net exports".

To repeat, it is only "net exports" if you forget that –M is used only to cancel the imports that, in the process of data collection, were included in C, I and G. In other words, the term –M is a statistical trick•

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