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Lionel Robbins Memorial Lectures

Economic Growth, Human Welfare and Inequality

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The capitalist system has gone through a great crisis. And when the crisis dramatically intensified in autumn 2008, there was much discussion about its wide ranging nature, a crisis in economic performance but also in political legitimacy and economic theory.

- The prospects for the economy itself were discussed in apocalyptic terms – a new Great Depression threatened, mass unemployment inevitable.

- But there was also talk of a paradigm shift in political economy: the end of the era of Anglo-Saxon unfettered finance driven capitalism. And an end to the era of greed: a likely shift some believed to left-wing and more redistributive politics. New ideas and policies as radical as those of the New Deal.

- And finally, a belief that what had failed was not just a financial system, and a way of regulating that financial system, but a set of economic theories – so that we should now reject the simplicities of neo liberal and neo classical economics, reject overly mathematical economics, and return indeed to the insights of the past – with Robert Skidelsky, in a book both brilliant and brilliantly timed, writing of "The Return of the Master", John Maynard Keynes.[1]

Two years on, how do those forecasts of apocalyptic results and radical change now look?

- Well the good news is that the recession, though severe, has been nothing remotely like 1929-33, with the warnings of economic apocalypse always overstated, and with very good reasons, even in October 2008, for believing that our economic understanding – deriving indeed from the experience of 1929-33 – gave us the macroeconomic tools to prevent disaster.

- As for political economy, the developments have been complex. In general, left-wing parties have not gained from this crisis of capitalism. In the UK a coalition party of moderate free marketers took over from an incumbent party of the Left that had itself largely embraced market ideology and language. In the US a Democrat victory in 2008 raised expectations of major change, but there has been no clear shift in the balance of American public opinion away from free market capitalism remotely comparable with that which accompanied Roosevelt's changes in the 1930s. Bankers may have been vilified, but there has no been fundamental rejection of free market assumptions either in Europe or in the US.

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[1] Robert Skidelsky, *Keynes, The Return of the Master*, Allen Lane, 2009

As for the discipline of economics, there are major debates about appropriate macro policy. And major theoretical debates are in hand – the inaugural meeting of the Institute for New Economic Thinking in Cambridge this April bringing together numerous opponents of recently dominant conventional wisdoms. But whether there will be any lasting change in the practice of academic economics, that remains unclear.

So it is at least possible that the great crash of 2008-2009, apparently so earth changing at the time, may in the long sweep of history, prove a far less radical turning point than the early 30s crisis of free market capitalism and the shift to the left that that produced, or the 60s and 70s crisis of managed capitalism and the shift to the right which that produced.

The question I will therefore consider in these three lectures is whether the crash of 2008 <u>should</u> prompt a wide set of challenges to economic and political assumptions, and to economic theory. Or whether the correct response is simply careful management of the major macro challenges we face as we seek recovery from recession, and a major reform of financial regulation to prevent a recurrence – a task very large in itself and to which the majority of my waking hours are devoted – but with overall assumptions about the objectives and the means of market economics continuing much as before.

And my answer will be the former – that the crisis should prompt us to challenge fundamental assumptions and to raise issues which go beyond those directly raised by the impact of the crisis itself. For the faults of theory and policy which led to the crisis within the financial system were I believe integral elements within a wider set of simplistic beliefs about the objectives and means of economic activity which dominated policy thinking for several decades running up to 2008 – a set of beliefs which assumed that maximising economic growth was the clear objective, and markets the universally applicable means to achieve it. Beliefs which we need to move beyond if we are not only to build a more stable financial system for the future, but also address more fundamental issues about how rich developed countries achieve progress in human welfare or at least avoid detriment to it.

So my lectures are intended as a rejection of a dominant conventional wisdom. But by no means a rejection of market economics, or of liberal capitalism – indeed I will suggest that we need to return to justifications of economic freedom in some ways more fundamental than those put forward in the recent dominant conventional wisdom, but which because political, necessarily involve us in debates about choices and trade offs. One of my overall purposes indeed will be to argue that economics to be most useful, must be rooted within a wider discipline of political economy, a philosophical, empirical, historical and ethical discipline, as well as a rigorously mathematical one.

A series of three lectures allows the lecturer the opportunity to develop a detailed and extensive argument. But to make it easy to follow, let me signpost the way by giving a brief overview of the story I will tell.

- Before the crisis, there had developed over several decades a dominant political discourse about economic objectives and a conventional wisdom about the means with which to pursue them. There were three key assumptions.

  - First, that the crucial objective of successful policy is more rapid growth in measured prosperity, in GDP per capita. Enhanced national competitiveness was seen as a key measure of government competence. “It’s the economy, stupid” said both Bill Clinton and Tony Blair.

  - Second, that a key way, indeed <u>the</u> primary way, to deliver growth is by creating freer markets – freeing entrepreneurs from red tape, unleashing incentives through lighter income and capital gains taxes, extending markets via privatisation and liberalisation. And that in particular freer and more complete financial markets, financial liberalisation, drives economic growth by enabling a more efficient allocation of capital.

- Third, that a significant degree of inequality is both the inevitable consequence of and necessary to the operation of free markets, and that increased inequality is acceptable <u>because and to the extent that</u> it helps deliver superior growth.

In the 30 years or so before the crisis, this package of ideas – which I will label 'the instrumental conventional wisdom' – became increasingly dominant across the political spectrum. But all three of these assumptions are now to different degrees challenged by facts and by more thoughtful reflection on theory.

- It is not clear that long-term economic growth should be the overriding objective of policy in rich developed countries, since it is not clear that it necessarily delivers increased human welfare, or happiness or utility or whatever it is that should be our ultimate goal. Short-to-medium term growth from today's starting point – from the depths of a recession – is by contrast undoubtedly and very important; and in Lecture III I will seek to explain why that can be true even though long-term growth maximisation should not be the overriding objective.[2]

- And one reason, though there are many others, why economic growth may not deliver increased wellbeing is that inequality probably does matter quite a lot to human happiness and that problems created by inequality cannot be swept away by the attainment of higher growth.

- And third, that while free markets work very well in some areas of economic activity, in the restaurant industry for instance, in others – and in particular in finance – problems of market failure are endemic and cannot be fixed by simply making markets still more free and more transparent.

My purpose in these lectures is therefore to consider each of these three challenges to the dominant political ideology and the underpinning economic theory of the last 30 years. (Exhibit 1)

- In Lecture I, I will consider objectives – why more rapid growth should not be the overriding objective for rich developed countries; and whether and how much inequality should concern us.

- In Lecture II, I will turn to the role of markets, and in particular financial markets, as means by which to pursue objectives, and argue that the pre-crisis confidence in free financial markets was profoundly misplaced.

- In Lecture 3, I will then consider where my conclusions leave the case for economic freedom, and what implications might follow in specific areas of public policy such as financial regulation, climate change, demography, the role of local government and our attitude to income inequality. And finally what implications follow for the discipline of economics.

And in that final section – on the implications for economics – I will relate my conclusions to those reached 78 years ago by Lionel Robbins, who in 1932 in a brilliant essay – *On the*

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[2] The essence of the argument, for those reading Lecture I without Lecture III to hand, is that the avoidance of setbacks to already attained wealth or income (e.g. via job losses, home repossessions or income losses) is very important even if further increments of average income have uncertain capacity to make people happier, and that the avoidance of involuntary unemployment is particularly important given the negative impact of unemployment on people's sense of wellbeing and self-worth. Good macro-economic management to ensure a reasonably stable economy over time, and to achieve recovery from recession, can therefore be immensely important even if long-term growth maximisation (achieving a long-term growth rate of, say, 2.0%, not 1.9%) is not the overriding objective.

Nature and Significance of Economic Science – set out a very clear point of view on what the subject matter of economics should be, drawing a clear distinction between the ends and means of economic activity, and delineating economics very clearly from other disciplines such as politics, psychology, or philosophy.[3] The thrust of my conclusions may seem different, agreeing with Keynes, who argued that "As against Robbins, economics is essentially a moral science". But a careful reading of Robbins's essay suggests that the difference is less fundamental than first appears, and that if subsequent economists and users of economics had heeded Robbins's warnings about the limitations of economics narrowly defined, they would have been more wary of the simplicities of the instrumental conventional wisdom.

Economic growth, human welfare and inequality

To begin then with the objectives of economic activity and economic policy.

In the second half of the 20th century, the idea that attaining a superior growth rate and thus increased prosperity should be the central objective of public policy became increasingly dominant.

Other issues – culture, morals, religion, national identity – were not entirely absent, but the issue of which political party would best deliver material prosperity was often the key electoral battleground, in a way which was not true in 19th century or early twentieth century politics. Harold Macmillan's claim for votes in 1959 crucially depended on the assertion that "we've never had it so good". Harold Wilson's Labour government was determined to boost the rate of growth to that being achieved in continental Europe; and Thatcher's promise was essentially that, after some tough medicine, prosperity would grow faster than under Labour.

The shared assumption across the political spectrum was that economic growth – growth in GDP and per capita GDP – would feed directly through to rising wellbeing, welfare, happiness, contentment, or whatever word we use and, therefore, to political success for the party best able to deliver it. The debate was essentially about what policies would achieve that end, how free a role markets should play in delivering prosperity, and what level of inequality was required to ensure economic success and acceptable as a by product.

The conservative narrative, asserted with increasing confidence towards the end of the century, was that free markets were the best way to deliver prosperity, and that significant inequality was acceptable and indeed required because it provided the incentives to entrepreneurs, to executives and to ordinary workers, which would ensure innovation, competitive success in global markets, high productivity growth and thus rising prosperity. Unlike in the 19th century, therefore, when conservatives defended inequality and property rights as elements of a natural order, conservative parties tended to advance an instrumental justification of both markets and inequality – flexible markets and low taxes on the rich are good for you because they will make you, the average citizen, richer. Parties of the right, to different degrees in different countries, have therefore tended to be defined less by the classic parameters of conservatism – nation, social order, religion, received morals and culture – becoming instead parties of liberal economic ideology.

Parties of the left in turn had to decide how much of this narrative they accepted and how much was compatible with egalitarian instincts. Reactions differed by country and between those parties with strong Marxists traditions and those more willing to accept the amelioration of working class conditions within capitalism as an acceptable end objective, rather than either a stepping stone or an impediment to revolutionary change. But the direction of change everywhere was towards at least a partial acceptance and in some countries a positive

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[3] Lionel Robbins, *An Essay on the Nature and Significance of Economic Science*, first edition 1932; second edition (revised and extended) MacMillan 1935

embrace of liberal economic ideology. The role of social-democratic parties was to smooth the rough distributional edges of the market economy, but the assumption that markets helped create growth in GDP, that growth in GDP meant social wellbeing and individual welfare, and that significant inequality was acceptable because and to the extent that it helped deliver enterprise, competitive success, productivity growth and rising GDP per capita – those assumptions became increasingly shared across the political spectrum.

But even as that increasing consensus has grown, it has become increasingly unclear whether there is a strong link between average GDP per capita and people's average happiness or welfare, once one has reached the levels of average income already attained in rich developed countries. And that has profound implications for how we should think about the objectives of economic policy and about the validity of what I have labelled the "instrumental" justification of markets and inequality.

Any discussion of the relationship between income and happiness of course raises questions about whether happiness should be the objective, and if so whether we can actually measure happiness.

On both these issues I am somewhat more sceptical about the precision of what we can assert than I think my good friend Richard Layard is.[4] On the first, the problems of aggregation and of possible competing objectives – justice or virtue, or freedom – seem to me significant. Suppose people are 'happy' under a dictatorial regime, would we accept that as a good result? If 99.9% were made ecstatically happy by the human sacrifice of a minute minority, I don't think we could say that was OK. Is happiness the same as welfare, and if not, precisely how does it differ? And when we use surveys of self-perceived happiness across different time periods and different countries, how certain are we that there are not important differences as to how people answer those questions?

These are all non-trivial problems, but also, I believe, not fatal to the limited proposition which I will assert; which is not that we can define a gross national happiness index as the objective and measure our achievement of it, but simply the negative hypothesis:

- that we have no good reason for believing that additional growth in average income, as measured by national income accounts, will necessarily and limitlessly deliver increased happiness, wellbeing, welfare or however precisely we define the objective;[5]

- and that there are fairly strong grounds for believing that rich developed countries have – in terms of their average income – moved past the limit beyond which further increases of average income are of uncertain and in some respects diminishing importance.

With all due caveats about difficulties of definition and measurement, I will argue that the combination of empirical evidence, a priori logic and common sense observation of human nature strongly supports those conclusions.

Empirical evidence: contesting claims

The empirical evidence has recently become contested. Until the last ten years and particularly the last three, it seemed that the axiomatic assumption that increasing income

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[4] Richard Layard, *Happiness,* Penguin, 2005

[5] The question of what meaning can be attached to measures of national income is addressed in Lecture II. It was one on which Robbins commented perceptively in his *Essay.*

necessarily and limitlessly increases human satisfaction had been successfully challenged by empirical evidence that beyond some level of average income per capita no such relationship exists. But this assertion, originally proposed by Richard Easterlin[6], has more recently been itself challenged by the work of, for instance, Justin Wolfers and Angus Deaton.

The empirical case against the value of growth is that surveys of self-assessed 'life satisfaction' or 'happiness' from several different rich developed countries with different cultural characteristics, suggest that over the last 40 to 50 years there has been no improvement, despite very significant increases in GDP per capita; the figures in Exhibit 2 and Exhibit 3 show the results for Japan and the US, taken from Bruno Frey and Alois Stutzer's *Happiness and Economics* (Exhibits 2 and 3).[7] Cross-country comparisons, meanwhile – this chart, for instance, from Richard Layard's book *Happiness* (Exhibit 4) – suggested a pattern in which there was a fairly strong relationship in self-perceived happiness / 'contentment with life' over a range of per capita incomes up to around $15,000 to $20,000, but that beyond that further increments in average income make little difference.[8] In stylised form, the empirical evidence has therefore seemed consistent with the pattern shown on Exhibit 5 – a pattern applicable in a time series as well as a cross-sectional sense – countries experiencing major increases in human welfare and self-perceived contentment as they achieve growth from low income levels to around 20,000 US dollars per year, but thereafter continuing to grow measured income without significant aggregate welfare benefit.

The transition from very low income levels to those seen in rich developed countries today is of course the great and in historic terms unique achievement of the last 200 years (Exhibit 6). For the whole of human history until abut 1000 A.D. average standards of living showed no sustained tendency to increase. While any quantification is highly uncertain, Angus Maddison's estimate that GDP per capita was pretty much flat in most parts of the world at around 400 US dollars per capita, still probably captures the essence of reality.[9] Quality of diet and life expectancy varied with the vagaries of disease, war and climate. Fluctuations in political regimes and culture produced changes in the level of sophistication of elite groups, their art, household possessions and architecture. But the modern assumption and reality that each century, and indeed each decade, would bring new technologies, new products, increased income, and significant changes in lifestyle were entirely absent in the pre-modern world.

The change which then occurred, first in Western Europe and then elsewhere, glacially from 1000 to 1500, very gradually from 1500 to 1800, and then explosively over the last two centuries, was the second great transformation in human economic history, equivalent in impact, though far more sudden, than the development of agriculture from the 8th millennium B.C. on.[10]

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[6] Richard Easterlin footnote.

[7] Bruno Frey and Alois Stutzer, *Happiness and Economics,* Princeton University Press, 2002

[8] Richard Layard, *Happiness,* Penguin, 2005. The scatter diagram OF cross-country

[9] Angus Maddison, *The World Economy, A Millennial Perspective,* OECD 2006

[10] Jared Diamond in *Guns Germs and Steel* argues however that the first transformation, the development of agriculture, while enabling the creation of complex states and their elite architecture and art, may well in fact have produced an average standard of living – measured for instance by calorie intake relative to hours of work required to produce food – which was actually lower than that of hunter-gatherer societies.

The empirical evidence presented by Richard Easterlin, Richard Layard and Frey and Stutzer appears to illustrate that the early stages of this transition have been strongly positive for human wellbeing, but that beyond some level of income there is a flattening of the income/wellbeing relationship. **(Exhibit 7)** And it seems intuitively obvious that increasing productivity and income from pre-modern levels to those enjoyed by rich developed countries should have had a major impact on human wellbeing.

This increase has transformed life expectancy, freed people from the drudgery of never ending manual labour, abolished in most societies primary detriments to human happiness such as hunger, inadequate clothing or housing, and has delivered a cornucopia of material goods and services which delight, intrigue and stimulate us. It is an extraordinary achievement. And as best we can tell, it has increased human happiness, self-perceived contentment.

I will in this lecture therefore work on the assumption that further growth is still a priority for human welfare for those many societies which have not yet completed this transition – a high priority for China, still at an early stage in the transformation, and a vitally important priority for what Paul Collier has called "The Bottom Billion"[11], the many, particular in some African countries who are yet to enjoy much economic progress at all. But my subject matter in these lectures is not how to achieve an economic growth transformation in the bottom billion, vitally important though that is, but what we can say about the objectives of economic activity and economic polity once countries have achieved the great transformation of the last two centuries.

And the implications of Exhibits 2 to 4 is that for those countries, increasing average GDP per capita has no ability to produce increases in human wellbeing.

This conclusion is however strongly contested by some other researchers. Daniel W. Sacks, Betsey Stevenson and Justin Wolfers, for instance, argue in a recent paper that both cross-country and time series data do illustrate continuing increases in human satisfaction or happiness even as income rises above what other researchers have identified as possible points of inflection.[12] Plotting life satisfaction versus real GDP per capita with a log scale for GDP per income, **(Exhibit 8)** they argue that the evidence is consistent with the interpretation that doubling average income from $16,000 per year to $32,000 is as important to life satisfaction as increasing it from $1,000 to $2,000: with the difficulty previous researchers have had in observing this fact possibly driven by the fact that differences between the income of rich developed countries are, in proportional terms, extremely slight. Similarly they argue that time series data do suggest a positive upward slope of average life satisfaction as average income rises, at high as well as at low income levels.

This counter-evidence certainly casts some doubt over previous assertions that the average income/average life satisfaction relationship flattens out entirely above a certain income level. And as I will argue below and in Lecture III, the proposal that there might be <u>no</u> net life satisfaction benefit from increasing absolute income beyond some threshold has always seemed counter-intuitive.[13] For instance, since average income growth is capable of

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[11] Paul Collier, *The Bottom Billion,* Oxford University Press 2007

[12] D. Sacks, B. Stevenson and J. Wolfers, *Subjective Wellbeing, Income, Economic Development and Growth,* NBER Working Paper 16441, 2010.

[13] See Lecture III, Section 1(i) and 2(vi). It is also worth noting that any finding of <u>no</u> cross-country correlation between life satisfaction and income when comparing rich countries would be inconsistent with the finding (on which all researches agree) that relative income within a society matters, since the relevant measure of relative income must, to a degree, be international. Thus, for instance, the ability of British people to afford more pleasant hotels in European skiing or beach resorts is determined by income relative to that of other Europeans, and not just relative to other Britons. In addition, advertising and product promotion

delivering improvements in health and life expectancy (and in particular in the avoidance of early death) and since evidence has always suggested that better health is strongly correlated with perceived wellbeing, it would be surprising if this potential positive effect were never actually being achieved.

But the new evidence leaves intact the finding that the relationship between average income and human wellbeing is, at least for rich developed countries, uncertain and complex. It is for instance noticeable in Sacks, Stevenson and Wolfers' analysis that long term changes in average income appear to have much less of an impact than changes over shorter time periods: this is consistent with the hypotheses that individuals adjust to new circumstances and that their aspirations change over time, so that wellbeing gains from increased income eventually dissipate.[14] And the time series findings drawn from the Euro Barometer Survey, which ought to provide some of the best empirical evidence, since based on consistent questions and comparing reasonably culturally similar countries, suggest a complex and uncertain relationship between average income and life satisfaction. The overall correlation of decadal changes in life satisfaction in GDP per capita is weak **(Exhibit 9)**. And the comparisons of the results for different countries are intriguing and not at all consistent with the assumptions of the instrumental conventional wisdom. The correlation suggests, for instance, that France and Italy have been very much more successful of turning GDP per capita growth into increased life satisfaction than has the UK **(Exhibit 10)**. If these figures are truly telling us what they appear to, a British government which wished to ensure increasing life satisfactions for its citizens would devote very little attention to increasing GDP per capita growth, and most of its attention to understanding what it is about the pattern of growth being achieved in France and Italy which appears to be producing more significant increases in life satisfaction.

Thus while we need to be careful of leaping from the assumption that growth necessarily drives happiness to Richard Easterlin's apparent certainty that there is no relationship between average income and average life satisfaction about a certain turning point, the evidence is certainly compatible with the conclusion that there are many other drivers of life satisfaction other than measured income growth, and that the precise pattern of growth matters as much if not more than its absolute level. We certainly do not have good reason for believing that further growth in measured GDP per capita will <u>necessarily</u> deliver further significant increases in human contentment.

<u>Explanations for an average income / happiness disconnect</u>

Why might a breakdown occur in the relationship between average income growth and human contentment? There are several easy identifiable reasons. Indeed given the factors which could support Richard Easterlin and Richard Layard's assertions, it is difficult to see how economic growth could be expected limitlessly to deliver increments in human contentment. For the very process of becoming rich, and the changing nature of what a rich economy produces and consumes, themselves are likely to undermine the logical linkages between average income and average utility.

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stimulates aspirations for a standard of living which is, to a significant degree, internationally defined. If the hypothesis is that both absolute and relative income are important, but relative income the more important driver of happiness, then empirical evidence compatible with this hypothesis would combine: (i) strongest correlations for income variations within countries; (ii) somewhat weaker correlations for cross-country comparisons; (iii) weakest and most uncertain correlations and lowest gradients, for long period time series. The evidence presented by Sacks, Stevenson and Wolfers is compatible with this hypothesis.

[14] See D. Sacks, B. Stevenson and J. Wolfers, Figure 7 and discussion on page 21, *Subjective Wellbeing, Income, Economic Development and Growth,* NBER Working Paper 16441, 2010.

One major change that occurred as we got richer, of course, was the transition from a significantly industrial to a largely post industrial or service economy in which a greater proportion of total consumption is devoted to services rather than goods. But I want to stress immediately that that transition in itself, and the distinction between material goods and immaterial services, is not fundamental to the issues that I will discuss today. That indeed was a point that Lionel Robbins himself made, in his 1932 lecture.[15] If we have a theory that increments to happiness are produced by increased measured prosperity, it is as likely to be produced by more restaurant meals as by more washing machines, by more gardeners as by more cars.

The most obvious reason why increasing income may not deliver significant increases in contentment is of course the simple theory of satiation, of declining marginal benefits. One winter coat keeps you warm; two winter coats don't keep you warmer, but give you a second order benefit of fashion and style. A common sense assumption about human preferences expressed in the formal economic concept of diminishing marginal utility (Exhibit 8). But while this concept might help explain a steadily weaker relationship between income and increased contentment, it could not explain its complete disappearance.

Indeed it can be argued that it does not even necessarily explain declining <u>aggregate</u> marginal utility with respect to all income and all consumption. Strictly applied, the concept of declining marginal utility relates to the consumption of a particular good, and determines the price of that particular good, given the alternative of consuming other goods.[16] In a continually creative economy, there could be many products on which consumption is approaching satiation, but a continual flow of new products and services where each individual's consumption is still on the steep early section of the curve (Exhibit 9). An assumption of potential aggregate declining utility can still be reasonable, given a hierarchy of human needs – an ipad must be less important to human contentment than freedom from hunger. But declining marginal utility as a result of increasing satiation would still be an inadequate explanation of a <u>complete</u> disappearance of any link between income and contentment.

The flattening of the aggregate curve suggested by some empirical evidence, however, becomes more understandable if we consider three ways in which the nature of consumption and its relationship to human wellbeing is in itself changed by the very fact of rising income.

- The first is that the richer people become, the more they choose to devote their income to buying goods – delineated by style, fashion and brand, which prove that they are in with or ahead of the crowd. (Exhibit 10) But the higher other people's income, the wider the range of goods and services over which this relative status competition occurs. There has, for instance, been a significant growth of family expenditures on children, driven in part by the desire to ensure that one's child does not feel deprived of relative status by the lack of the latest fashionable toy, or electronic gadget, or branded clothes. There is no evidence that this has made childhood a more pleasant, happier experience: some would indeed argue the inverse. But whether or not that is the case, we have increased expenditure

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[15] See Robbins, *Essay on the Nature* and Significance of Economic Science, Chapter 1: "The subject matter of economics". Second edition (revised and extended) MacMillan 1935.

[16] The need therefore to be very careful in applying marginal utility concepts to issues of overall welfare, rather than simply to the determination of relative prices, was one which Lionel Robbins stresses, arguing indeed that the application of marginal concepts to issues of human welfare maximisation was simple the accidental result of the historical association of English economics with Benthamite utilitarianism (see Essay page 141). While this rigorous delineation of the limits of what economic science can contribute can be used to argue against the attempt to address the issue of objectives discussed in this lecture, it also, as I will suggest in lecture III, helps guard against the simplistic assumption that growth and income necessarily deliver increasing aggregate happiness.

enabled by higher income, which is very unlikely to drive a sustained increase in contentment. And that must be true also of the large slice of income devoted to expenditures on adult branded and fashion goods.

- The second factor at work is that as people get richer they devote a higher percentage of income to competing for the enjoyment of amenities which are locationally specific and inherently in short supply, and where each person's ability to afford them is determined by relative income, not absolute income. To be able to stay at the hotel on the beach, rather than a mile away, or at the hotel on the skiing piste, rather than down the valley, what matters is not your absolute income, but your income relative to everyone else – and to that an increase in average GDP per capita can make no difference. And while skiing and beach hotels might seem a minor issue – though not necessarily as people devote increasing shares of their income to leisure activities – the competition for housing amenity is clearly not minor. And as we get richer we devote an increasing percentage of our income to competing to buy houses in the pleasanter parts of the city, town or countryside, and our ability to win in that competition is driven entirely by relative not absolute income.

- Third, of course, is the problem that increases in aggregate income can produce environmental externalities which are themselves detrimental to human nature. Some of these effects can be overcome through the achievements of growth itself – through improvements in technology. London no longer has the smog which it used to suffer; local air-quality has improved steadily in most rich countries over the last 30 years. But some externality effects are inherently difficult to deal with – I will address the issue of climate change in Lecture III. And important congestion effects are almost inherent to the very process of getting richer. As we get richer, more people can afford the skiing, beach or countryside holiday, and the piste, beach and countryside get more crowded, degrading the experience people seek to enjoy. Driving a car along country roads in 1950s Britain – for the minority that could then afford it – was a more pleasant experience than doing so today, simply because you were much less likely to be driving bumper to bumper behind the car in front. And a large proportion of our car advertisements on television today – apparently shot along rural roads in Scotland or Scandinavia at 4 a.m. on a summer morning – are almost bound to produce frustration, since they entice you to buy a product – driving along an open road – that you will almost never actually enjoy. In many ways, therefore, as we get richer, and if we do not very carefully manage the process, increasing wealth degrades the very benefits it seems to make more generally available.

Each of these three factors helps explain why, beyond some income level, further average income growth is not certain to deliver significant sustained increases in contentment. The three effects are distinct (Exhibit 11).

- The first is rooted in concern about relative status as an end per se, status evidenced by fashion or branded goods or by being an early adopter of the latest gadget. And it is therefore a factor from which some people could escape: if you don't care what label your clothes bear, this effect does not apply. But for many, it does.

- The second, however, makes relative income a crucial driver of absolute standard of living, even for those who are not fixated with relative status. Even if you are unmoved by relative status per se, and perfectly happy for everybody else to have as nice a house as you, if the supply of pleasant houses is restricted, you have to seek to win in the relative income competition. And the more we have reached satiation in basic needs, the higher the percentage of our income we devote to such competition.

- The third, meanwhile, means that in some ways the total available utility for which we compete is itself diminished by the very fact of increased aggregate income.

So these are three distinctive factors but with a common implication – that the implicit assumption of any simply presented marginal utility schedule – that my utility is a function of my income alone – is clearly wrong. My utility is clearly also a function of other people's income and of my income relative to others. The first two effects together, moreover, mean that the empirical finding that richer people within any one country are on average happier than poorer (Exhibit 12) is both what we would expect and entirely compatible with a finding that increases in <u>average</u> income do not certainly and strongly translate into increases in <u>average</u> contentment, when considered on a time series basis.[17]

<u>Distributive and creative activities</u>

So the changing pattern of consumption, which directly results from increasing income, in itself changes the logically expected relationship between income and human contentment. It seems likely, in addition, that important and subtle changes in the pattern of production activity – of how people earn income – are also at work.

A crucial distinction here is between what Roger Bootle in his recent book *The Trouble with Markets* labels 'creative' and purely 'distributive activities' a distinction close to that which William Baumol highlighted in his delineation of "Entrepreneurship: productive, unproductive and destructive".[18] [19] (Exhibit 13)

That distinction has always been present in market economies, and indeed in all human societies. The clever lawyer whose client wins redistributes money from the opposing client, she does not create greater social value; the financial trader who bets well makes money at the expense of the one who bets badly. Indeed while it may be possible to describe some jobs as, in Bootle's terms, almost entirely and directly 'creative' (e.g., a doctor directly providing the value of better health) the majority of jobs in a developed market economy are part distributive and part creative, though often creative in indirect ways. The salesman who gains an order for company A against company B is involved in an activity whose first order effect is distributive, but which might be indirectly creative to the extent that company A is a more efficient company whose growth relative to company B will ensure a more productive overall economy.[20] [21] The market economy creates growth not because every person is

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[17] See footnote 13 above for discussion of why relative income concerns should logically imply some correlation between satisfaction and average income when analysed on a cross-country basis.

[18] Roger Bootle, *The Trouble with Markets: Saving Capitalism from Itself* (2009).

[19] William Baumol, *Entrepreneurship: Productive, Unproductive and Destructive*, Journal of Business Venturing (1990)

[20] To illustrate the complexity of the distinction, Bootle points out that even the activities of teachers, which we might assume to be entirely creative (since they either impart a direct consumption benefit of enjoyable knowledge or provide skills which are in turn used to underpin 'creative' activity), might in some circumstances be distributive. Thus if one of the functions that better education plays is to signal superior skills, enabling individual A to beat individual B in job market competition, but without the skills imparted being relevant to any subsequent 'creative' economic activity, teaching such skills to ensure success in assessments and examinations is an essentially distributive activity. The extent to which job market success is driven by perceived relative skill rather than absolute skill is important to the issue of whether increasing inequality can be countered by 'increasing skills': this is considered in Lecture III.

continually involved in activities which, even in classic income accounting terms, 'create value', but because on average competition between individuals and firms, many of whose day-to-day activities are in their direct impact purely distributive, tends over time to deliver improvements in productive efficiency and new products which consumers value.

So the existence of 'distributive' activity is not new. Roger Bootle, however, suggests that "the more developed a society becomes… the more it is at risk of behaviour that merely redistributes rather than creates". And there are certainly many ways in which we could expect purely distributive activities to become more prevalent as average income increases.

- Financial services – and in particular wholesale trading activities – include a large share of activities which are in their indirect effects purely distributive and which are very highly remunerated: and the share of financial services in our economy has grown. An issue to which I will return in Lecture II.

- Richer societies tend to different degrees to be more litigious societies; litigation is essentially a zero sum distributive activity, and lawyers are highly paid.

- And in rich societies consumers are able to devote a significant slice of income to buying goods solely because they bear a brand – celebrity A's perfume versus celebrity B's. But brand competition of this sort is essentially distributive rather than value-added, distinct in its economic function from the early development of branding which performed a vitally important function in enabling consistent quality products to dominate over the multiplicity of lower quality and sometimes dangerous products.

How far such distributive activities – in advertising and PR, in much of financial services, in legal services – have increased as a percentage of the total economy, I do not know: it would be an interesting subject for research. But Bootle's hypothesis that they will tend to become more extensive as society gets richer is, I think, a reasonable one. It has two important implications.

- The first is that as we get richer, as measured by GDP per capita, the more arbitrary and uncertain becomes some of the conventions required to calculate GDP.[22] For while in principle GDP per capita measures exclude purely distributive activities (the gains of one poker player at the casino at the expense of others are not included in the calculation) their ability to do so in practice is highly imperfect. In particular, the ability of national income accounts to distinguish within financial services between those activities which are meaningfully value creative and those which are essentially distributive rent extraction, is far from perfect, an issue

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[21] The implication of the fact that activities (and in particular financial market activities) might entail a mix of the 'indirectly creative' and the 'distributive' has important implications for our ability to determine whether the expansion of a particular category of activity is 'socially useful', and for the ability for those involved in that activity to place the pursuit of private gain within appropriate ethical bounds. This issue, perceptively considered in Raghuram Rajan's "Fault Lines" (Chapter 6: When money is the measure of all wealth), is considered in Lecture II, Section 4: Financial Intensity and Income Distribution.

[22] The importance of understanding that national income accounting is the product of a set of somewhat arbitrary conventions, and the implications of this for the limited range of economic policy questions to which measures of GDP are directly relevant, was a point stressed by Lionel Robbins, writing at a time when national income accounting was in its infancy (See Essay Page 57). The importance of this insight is one to which I will return in Lecture III.

explored by Andrew Haldane and others in their chapter within the recent LSE report on *The Future of Finance.*[23]

- The second is that, for reasons I will explore below, it is noticeable that many of the highest paid and presumably most skilled people, earn their living from essentially distributive activities where a devotion of still higher skills must simply increase the intensity of distributional competition rather than deliver benefits at all likely to deliver sustained improvements in average contentment. If over a period of time the intensity of divorce litigation increases, and divorce lawyer pay increases, and if as a result more highly skilled people are attracted to be divorce lawyers, then we would not expect society to gain from this reallocation of skilled human resource, even though divorce lawyer output shows up in GDP calculations as much as, for instance, more highly skilled doctors. The implications of this principle for the debate about the size of the financial sector and the high levels of remuneration within it, is one to which I will return in Lecture II.

Increasing inequality and its implications

In a number of different ways, therefore, an increasingly rich economy is likely to be one in which both more of consumption and more of productive activities are devoted to zero sum and distributive competition, in which relative income and status is crucial to the individual sense of wellbeing and relative skill crucial to success in the competition for higher income. Given these changes it should not surprise us that the relationship between income growth and self-perceived wellbeing is uncertain in rich developed societies.

Particularly since, in this environment where relative income is becoming logically more important, inequality has tended to increase in rich developed countries, along two dimensions. (Exhibit 14)

- First, a tendency, most prominent in Anglo-Saxon countries and in particular in the US, for the bottom of the income distribution to fall further behind the median.

- Second, a very strong tendency, most extreme in the US but also pronounced in the UK and significant throughout the developed world, for the top to pull away from the middle and the very rich from the moderately rich. With increases in the income of the top decile over the last 30 years far exceeding those of the median, the top percentile doing better than the rest of the top decile, and the top 0.1% of the population pulling far away from the rest of the top 1%.

The first phenomenon – the poorer relative position of the poorest – has been extensively analysed. The explanation probably combines a number of interlocking primary and secondary factors. The primary factors include technology which, by reducing the need for unskilled or semi-skilled manual labour, has reduced the relative marginal product of relatively less skilled people. They also include the impact of globalisation and more mobile factors of production – more open trade, freer movement of capital and freer movement of people – the end for instance in the 1960s-70s of the restrictions on immigration into the US put in place in the 1920s. Each of these forms of easier factor movement would be predicted by economic theory to produce aggregate income benefits but distributional effects – an increase in the average income level of people in richer countries but a decline in the relative income of the less skilled. In addition to these primary effects, however, the erosion of trade union power and collective bargaining structures, itself partly an endogenous consequence of greater openness to trade and capital movements, has certainly also played a role.

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[23] See "What is the Contribution of the Financial Sector: Miracle or Mirage", Andrew Haldane, Simon Brennan and Vasileios Madouros in *The Future of Finance,* LSE Report , 2010

The second, the richer relative position of the richest, has been less extensively analysed. But it seems likely that among the reasons for it are factors inherent to the changing nature of consumption and production which naturally occur as we become on average increasingly rich. Even while increasing average income makes relative income more important to human contentment, it may also unleash tendencies which, unless counteracted, will automatically tend towards increasing income dispersion.

At least four interlocking forces combine, I suspect, to make increasing inequality at the top an almost inevitable consequence of rising average prosperity (Exhibit 15). Three are in some sense inherent – driven by changes in the underlying equilibrium value of private marginal product: the fourth is a sociological phenomenon which is part exogenous but part also an endogenous consequence of the first three.

- One striking development at the top of the distribution is increasing returns to stardom and celebrity, to high sporting and artistic skill. Stanley Matthews, one of the football greats of 1950s Britain, earned from his football genius an adequate middle class standard of living; David Beckham is in the super rich. The novelist CS Lewis made adequate money; JK Rowling is a billionaire. Technology and globalisation are among the factors at work here: the ability of TV and internet to make David Beckham and Harry Potter global brands.[24] But rising average income level is also important. As people's income rises, they devote more of that rising income to providing themselves or their children with the latest branded merchandise, without which relative status is lost, and buying that merchandise puts money in the hands of celebrities. David Beckham is far richer than Stanley Matthews <u>because</u> the average income of his fans is high enough to allow significant discretionary expenditure both on more expensive tickets and on goods which bear his brand, or which he endorses. And while the super stars are few, once the minor stars and passing celebrities, the agents and the lawyers and PR firms and the executives of the media channels are included, and the party organisers and luxury good providers, and up-market hoteliers and restaurateurs, we have a phenomenon helping to accelerate income growth throughout the top income decile, as well as at the pinnacle of enormous wealth. As Lionel Robbins perceptively identified in 1932 "a substantial proportion of the high incomes of the rich are due to existence of other rich people".[25]

- In parallel meanwhile the changing nature of consumption, and its increasing devotion to goods or services which in the hierarchy of human needs are not essential but nice to have, and driven by fashion or caprice, means that in some areas of economic activity, highly talented individuals can make their companies greatly more successful, rapidly and in a highly measurable way. A talented retailer with a flair for store design and ambience, for range selection and marketing can make a huge difference to a retail chain's success quite quickly, whereas a talented manufacturing manager can only do so over many years, as research and development investment or manufacturing efficiency improvements slowly reach fruition. And the shorter the time period over which results are achieved and the more easily they seem identifiable with the individual rather than the team, the more they are likely to be reflected in individual remuneration. The higher the percentage of our consumption devoted to goods and services where soft factors like style,

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[24] Sherwin Rosen, in *The Economics of Superstars*, American Economics Review (1981) explained the process by which mass communications media tended to increase the inequality of distribution of incomes of performance artists. Since then the forces identified by Rosen have intensified.

[25] Lionel Robbins, *Essay,* page 58.

ambience and brand matter, the higher may be the naturally arising inequality at the top of the distribution.

- This phenomenon of highly measurable and immediately measurable economic impact, moreover, is particularly present in some of those activities which are most clearly – in Roger Bootle's terms – 'distributive' rather than 'creative'. The successful divorce lawyer redistributes income in favour of his or her client and away from the other lawyer's client, and his or her success in doing so is immediately apparent, in a way which is not true of the research scientist working alongside many others on a new drug which will reach patients many years hence. Top lawyers are therefore paid more than top scientists, and the more litigious the society, in either personal or commercial cases, the larger the number of high paid lawyers. The reason why financial traders are paid so much is that their distributive economic impact – the extent to which they have made their firm richer at the expense of others – appears to be immediately measurable. Sometimes of course that is because success this year is at the expense of a trail of toxic liabilities for the future, and financial regulators are trying to fix that problem by demanding bonus deferral and claw back arrangements. But even when we have done that, I still suspect that we will see financial traders paid highly for what at least in part are distributive rather than creative activities. As a result, the larger the share of financial services within the economy, the wider may tend to be income disparities between the top few percentiles and the median of the distribution.

- Finally, the factors already mentioned help change attitudes and that in itself unleashes further change. If the world of celebrity and fashion and media generates very high pay, and if there are more highly paid corporate lawyers and investment bankers than in the past, and if there are some businesses, such as fashion retailing, where the star CEO can make a big difference and get highly rewarded, then the sense among the generality of the income elite of what is normal and justifiable shifts.[26] In addition, the income which they need in order to afford houses in the best part of town increases because the price of those houses is set by the average income of the rest of the income elite. Then add the impact of a partly global market in executive talent, and the role of remuneration consultants with their comparisons between this CEO and that, and the central role which relative status competition plays in the motivations of high talent people – and you have the ingredients for the relentless rise in the relative income of not just the few top stars, but of the top 1% of the population, which we have seen over the last 30 years.

As for what the balance is between these four and other factors, and in particular between those that are in a sense inherent and those which reflect changing attitudes and practices – I frankly do not know. But I think it is clear that a complex combination of narrowly economic and wider sociological factors, with the latter somewhat driven by the former, has produced a significant increase in inequality at the top. An increase which in the dominant narrative of the last 30 years tended to be justified because and to the extent that it had made the economy more efficient, competitive, and thus faster growing. But with, as Lecture II will suggest, no clear evidence that it had that supposedly beneficial effect: and with it also unclear whether higher measured growth, if achieved, implies rising average wellbeing.

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[26] See Polly Toynbee and David Walker, *"Unjust Rewards"*, Granta 2008, for a description of how many of the highest paid gain reassurance from the belief that they <u>deserve</u> their high rewards, rather than seeing them simply as the rewards which the market happens to allocate today because of today's specific balance of supply and demand for different skills and because of today's specific institutional structure. There really were investment bankers who felt "insulted" to be paid "only" £2m when the trader next door was paid £4m.

So we have increases in inequality which seem likely in part to be inherent consequences of the very fact that we are getting richer, rather than themselves drivers of increased prosperity. The question then becomes: does this matter? And if it does, can we do anything about it? I will return to the second question in Lecture III (though without – I'm afraid – reaching any definitive conclusions). For now I will concentrate on the important and highly contentious debate of whether and how much inequality and rising inequality matters to human wellbeing. Is one of the reasons why the relationship between increasing average income and increasing average contentment is complex and uncertain that rich societies have become more unequal?

Does inequality matter?

Well the easy bit of the answer is surely that when inequality takes the form of the bottom of the income distribution falling far away from the median, and when this fall away is so extreme that the bottom not only falls in relative terms but receives either no or very little increase in absolute income, then it must matter a lot to the people at the bottom of the distribution. And that is not just a theoretical case, but pretty much what has happened in the US over the last 30 years, with the bottom 20% or so of the income distribution participating hardly at all in rising average prosperity. With the implication that even if we ignore any issues relating to relative status anxiety as a concern in itself, or competition for positional goods or congestion externalities, but simply allow for the fact that marginal units of income must be less important to the already rich than they would have been to the poorest, then, as Tony Atkinson has pointed out (Exhibit 16) the increase in the geometric mean of income is a better measure of increased welfare than the increase in the arithmetic mean.[27] And on that measure the US economy has delivered no improvement at all over the last 20 years.

Increasing US inequality at the lower end of the distribution, moreover, has in turn had consequences which undoubtedly contributed to a major set back to human welfare for many people across the world. As Raghuram Rajan points out in his recent book *Fault Lines,*[28] rising American inequality, which in the US political culture could not be offset by a distributional response, led instead to the deliberately encouraged palliative of risky credit extension to lower income groups, the explosion of sub-prime lending which contributed to the financial crisis. Increasing inequality at the lower end of the income distribution as severe as experienced in the US over the last 30 years must matter a lot.

But rising inequality could matter more generally, and could do so even if the poorest groups participate, at least to some significant degree, in rising absolute income. That is the proposition put forward by Kate Pickett and Richard Wilkinson in their recent book *The Spirit Level: Why More Equal Societies Almost Always Do Better*.[29] Across a whole range of indicators – from life expectancy to obesity, levels of community trust to violent crime, teenage pregnancy to environmental sustainability, they find and illustrate with scatter diagrams (Exhibits 17-20) an adverse impact of income and wealth inequality. That adverse impact in turn is explained both by the direct consequences for individual health, wellbeing and social trust of intense relative status competition, and by the diminished ability of unequal societies to coalesce around the achievement of those elements of increased welfare which can only be delivered through collective action. Adverse consequences of inequality which,

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[27] Tony Atkinson, *Economics as a Moral Science,* Inaugural Joseph Rowntree Foundation Lecture, University of York, January 2008

[28] Raghuram Rajan, Chapter 1 "Let them eat credit", *Fault Lines*, Princeton University Press 2010

[29] Kate Pickett and Richard Wilkinson, *The Spirit Level: why more equal societies almost always do better,* Allen Lane, 2009

Pickett and Wilkinson argue, are so fundamental as to make unequal societies less attractive even for the winners at the top of the unequal pile.

The Spirit Level has been both hailed by commentators across the political spectrum but also roundly criticized. David Cameron, in his Hugo Young lecture, endorsed its findings and himself asserted that "the best indicator of a country's rank on these measures of general wellbeing is not the difference in wealth between them, but the difference in wealth within them" (Exhibit 21). But to the conservative (and Conservative) commentator Charles Moore, it is "more a socialist tract rather than an objective analysis of poverty". My own assessment is that the more thoughtful critics have made some valid points, but not by any means illustrated the converse case that inequality does not matter. Like John Kay, writing in the Financial Times, I think four reservations are appropriate.[30]

- First, that it is clear from the scatter diagrams that the strength of the observed correlations varies greatly.

- Second, that we can often debate which way the causation flows: do the Southern states of the US have high drop out rates from high school because there is high income inequality, or high inequality because the drop out rates are so high?

- Third, we must always be cautious of believing that we have found <u>the</u> explanatory variable. Simply looking at many of the scatter diagrams makes one immediately aware of other possible factors. The Scandinavian countries, for instance, score far higher on many of the community and social relations factors even than Pickett and Wilkinson's equality driven model would suggest – raising, when we make comparisons with the US, the troubling issue of whether relative ethnic homogeneity is a powerful driver of trust.[31]

- Fourth, I cannot see that Pickett and Wilkinson have managed to prove that unequal societies are bad for everyone's happiness, including that of the winners. Like John Kay, I feel that while it would be satisfying to believe that excessive bank bonuses could, through their adverse impact on society's cohesion, make even the recipients unhappy, I really doubt that that is the case. Particularly at the top of the income distribution – and not just at the very top of the super rich, but among the top few percent of the very well off – money gives people the ability to isolate themselves and their families from many of the disadvantages which an unequal society may bring.[32]

But with all these reservations noted, I still feel that *The Spirit Level,* together with the huge body of evidence to which it makes reference, for instance the work by Professor Michael Marmot on the links between relative status and health, makes a powerful case that the degree of inequality within a society must have non-trivial consequences for many important aspects of human welfare.

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[30] John Kay, Financial Times, 10th August 2010.

[31] The ethnic homogeneity of Scandinavian countries has significantly reduced over the last few decades. But so too has support for the broad social democratic consensus which delivered the levels of social provision and cohesion which Pickett and Wilkinson applaud.

[32] This "ability to isolate" may in part be a function of population density and the potential for spatial separation. It is striking the extent to which higher income Americans living in outer suburbs, exurbs, or gated communities, can inhabit a world almost entirely disconnected from less fortunate parts of the US. This raises complex issues relating to the definition of the "community" within which people effectively live.

And more generally, it is simply intuitively obvious that one's relative position in the income and status hierarchy matters a lot to one's sense of wellbeing. We know that people care about relative status: I certainly do to a significant extent, and I think almost everybody I have ever met does so to some degree. So if I ask myself would I rather live in Britain today on the average income of around £25,000, or in 1950 on an income of £20,000 per annum in today's real terms, a figure which would then have put me towards the top of the income distribution, I have no difficulty in imagining that I might prefer the latter even though it entails a lower absolute income. Or conversely, that someone might prefer to live on £10,000 a year in a land where the average was £10,000 rather than £11,000 a year in a land where the average was £20,000. Beyond some level of income which assures the basic requirements of a good life – an adequate home, clothing, good food and good health care and working hours which still leave significant opportunities for leisure – one's relative income is a key driver of one's contentment and concern about relative status a key driver of many people's anxiety. Inequality must matter, even if we conclude that that are no straight forward policies which will reduce it.

What that leaves of course is the issue of whether it <u>should</u> matter, whether relative status anxiety should be treated as an understandable concern, or dismissed as undesirable envy. After all, if the person imagined above prefers £10,000 per year when others have £10,000 rather than £11,000 when others have £20,000, then what is going on is that the additional £10,000 of everybody else's income is entering as a <u>negative</u> factor in the poorer person's utility schedule. A phenomenon which Martin Feldstein in his 2005 presidential address to the American Economic Association labelled "spiteful egalitarianism".[33]

That dismissal of the egalitarian case is of course debatable in philosophical terms. And particularly debatable if the less well off believe, at times with justification, that some of the highest incomes derive from activities which are more 'distributive' than 'creative': people's attitudes towards inequality often seeming to depend crucially on whether they intuitively understand and respect as worthwhile the 'value' which the highly skilled or the highly entrepreneurial have delivered. But even if we accept with Feldstein that envy is undesirable; and even if people feel relative status anxiety in the face of <u>all</u> inequality, not differentiating between justified and unjustified, it would still be important for us to understand that this was the case. And this reality would carry consequences for whether economic growth, accompanied by increased inequality, is likely to deliver increased contentment. If people care a lot about relative status, that is a highly relevant fact for economists to understand, whatever our attitude to whether they should care.

Economists need to understand human behaviours and preferences as they are, not as we assume or wish them.

And that indeed is the general conclusion I reach in this first lecture. Economics must address the world as it is, not the world as we have assumed it to make our mathematics easy. It must ask questions about the end objectives of economic activity, even if answering these questions requires us to make judgements on the basis of imperfect empirical data, and even if the questions are only susceptible to incomplete and uncertain answers. Yes, the measurements of self-perceived happiness reported in Richard Layard's *Happiness,* or in Frey and Stutzer's *Happiness and Economics,* are subject to significant methodological uncertainties: but at least they are asking the right questions, rather than simply assuming that we know the answer and that the answer is that growth is necessarily desirable.

In defining the objectives of economic activity the instrumental conventional wisdom, which has dominated the policy application of economics for several decades, has simply assumed that maximising growth in GDP per capita is an axiomatically desirable objective and that inequality is justified by and to the extent that it helps maximise growth. But those assumptions are not clearly valid for already rich developed countries.

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[33] Martin Feldstein, *Rethinking Social Insurance,* The 2005 Presidential Address to the American Economic Association

Deep enquiry into the objectives of economic activity and into the links between economic variables such as income and fundamental objectives such as human wellbeing or welfare is, therefore, however difficult, essential to good economics. And once we pursue such enquiry, we may need to completely revise our assumptions about a key analytical framework, the framework of the marginal utility schedule.

- We begin with the standard assumption that, for any given product or service, increasing value consumed delivers increasing utility, but subject to declining marginal returns (Exhibit 22).

- This tendency to declining marginal utility may however be partially offset by the fact that entirely new products and services can create new demands to be satisfied, new utility to be delivered by their consumption (Exhibit 23). But if we introduce behavioural assumptions relating to satiation, and to a hierarchy of human needs of changing nature and decreasing importance, we may still end up with an aggregate marginal utility curve which is increasing but at a declining pace (Exhibit 24).

- But a number of mutually reinforcing factors then flatten, complicate and kink the curve.

  - First, it is highly likely, as Frey and Stutzer argue, that people adapt to levels of consumption already achieved, and that once they have enjoyed a higher consumption level for a time, they need that higher consumption to deliver the same satisfaction as before. Aspiration levels increase, so that while in the short term we are on a rising curve, in the long run we may be stuck on a horizontal line, as the curve itself adjusts (Exhibit 25).

  - Second, it is clear that the idea that one person's utility is a function of their consumption alone is invalid. Our utility is also a function of other's income and consumption, both in some ways which even Feldstein would have to accept as relevant (competition for positional goods and congestion effects) as well as through the direct impact of relative status competition which Feldstein dismisses as "spiteful egalitarianism" but which may be a simple fact of life.

  - Third, the tendency to adjust aspiration to achieved wealth and income may be so strong, that at any one time any reduction in income or wealth is very strongly negative for welfare, even if increases are only slightly valued (Exhibit 26).

- So that combining the first and third factor, the long term curve could become closer to the shape shown on Exhibit 27 with further increments in income delivering no necessarily permanent improvement in self-perceived wellbeing, but with any setback strongly negative, and with a factor which for me at least defies two dimensional representation – my wellbeing dependent on my position relative to others as well as on my absolute income.

- But even this more complex shape may still seriously understate the complexity which we face, since it still assumes that it is possible to plot a relationship between rising income and well being without specifying the mix of consumption on which income is spent. Implicitly it therefore assumes that the marginal benefit of each different unit of additional consumption (whether spent on better healthcare, more branded fashion goods or more road travel) is equal, an assumption apparently justified by the logic that if there were any difference between the marginal benefit of different categories of consumption, rational satisfaction maximising consumers would adjust their mix of consumption to bring marginal benefits into line. But as discussed in Lecture III, Section 2 (vi), this assumption may well not be valid, and it is possible that the relationship between life satisfaction and income is different for different categories of consumption (see Lecture 3, Exhibit 39). If this were the case we might expect to see different relationships between income and recorded life satisfaction in different countries which had (whether through private or public choice) made different decisions on how to spend the income benefits of economic growth. In these circumstances economic growth would have the potential to deliver increases in life satisfaction: but there would be no certainty that it would do so.[34]

- Finally, moreover, we need to recognise that income alone is not the sole or indeed anything like the main determinant of human self-perceived wellbeing. Even if we leave aside the many essentially non-economic factors which are clearly important – the vagaries of luck in family life, success in love and friendship, genetic predisposition – it is clear that access to employment should enter our framework as a crucial driver of happiness in itself, independent above and beyond the fact that employment helps deliver income.[35] Contrary to any free market concept that unemployment imposes no utility loss because resulting from a voluntary trade off between reduced income and increased leisure hours, all studies find that unemployment causes major unhappiness for the persons affected, because work is for most people crucial to a sense of status and social relationships, and unemployment is a driver of low esteem and isolation. A finding which, as I will argue in Lecture III, has important consequences for many trade-offs in public policy: for instance, in financial regulation, between policies which might maximise long term growth versus those which maximise economic stability.

In sum therefore many of the assumptions and analytical frameworks which underpin the instrumental argument for free markets and inequality are either invalid or much weaker than commonly supposed. In Lecture II I will question whether free markets, and in particular free financial markets always or in general drive maximum allocative efficiency and/or economic growth – but even if they did, the instrumental conventional wisdom has lost validity because the relationship between average income growth and human wellbeing, important at low and middle levels of GDP per capita, is likely to weaken and become more complex as income rises, and does so because rising average income itself changes the pattern of consumption and production in ways which undermine and change the relationship.

If that conclusion is correct, where then does it leave the case for the market economy, for capitalism? Does it destroy it, leaving instead a justification for a sort of radical green egalitarianism – anti-growth and very strongly redistributive? Well I fear I am going to disappoint the radical green egalitarianisms, because I believe there remains a powerful case for liberal capitalism and as a result for accepting the result of economic growth, but that it is a quite different justification from the instrumental one so dominant over the past several decades. I will consider that case in Lecture III but for completeness this evening and as a sneak preview, the essence of it is two-fold. (Exhibit 29)

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[34] This could, for instance, be among the explanations for the apparent startling difference in the relationship between economic growth and life satisfaction between the UK, Italy and France, seen in Exhibit 10. Several other explanations are however possible; and considerable further analyses would be required to confirm that the apparent difference is a real phenomenon before seeking detailed explanations for it. If it is not a real phenomenon, however, this would also cast doubt over the conclusion that the Euro Barometer results establish any overall relationship between income growth and life satisfaction.

[35] Bruno Frey and Alois Stutzer, Chapter 5, *Happiness and Economics,* Princeton University Press, 2002

The journey not the destination

First, economic growth may not make us happier (or at least not in all its possible forms), but the expectation of growth may be important to our happiness. No rational person can believe that spending money on next year's clothing fashions is going to make them permanently happier, since they know from their own experience that next year's fashions may be so out of fashion a few year's later that they won't be seen dead in them: fashion and style don't in any meaningful sense get better, they simply change, they go round in circles. But the fact that they change, that there is an endless exploration of new styles and fashions to satisfy peoples' fascination and caprice, may itself be important to happiness.

And perhaps more fundamental, the expectation of technological progress, of innovation, of improved productivity and production possibilities may also be important to my sense of wellbeing, even if once the expectation is satisfied no permanent increase in my happiness may result. My marginal utility schedule may continually adjust downwards, so that no permanent increase in happiness ever occurs, but at any one time looking forward it is upward sloping. Given that I know that the electronic gadgetry I own today has not made me permanently happier than I was with a much smaller array 20 years ago, I suspect that the latest generation of computer tablets and high definition TV's will not make me permanently happier in future. But I would be made unhappy if the economy suddenly became static, if products and services didn't in some sense get better or simply get different. The journey matters not the destination.

Which of course may well be a culturally relative statement: for it may be that there have existed in the past societies in which people have been happy to continue with a permanently unchanging lifestyle. But while culturally relative, it is not a mindset from which modern societies have any capacity to escape. For the great transformation of the last two centuries (Exhibit 30) rested crucially on, and itself generated, institutions and cultural assumptions which commit us to perpetual change. When Alfred Tennyson in his great poem Ulysses wrote:

"Yet all experience is an arch where-through,
Gleams that untraveled world, whose margin fades
For ever and for ever when I move",

… I am pretty sure that he did not have clearly in his mind a flattened marginal utility schedule in which aspiration always adjusts to experiences already achieved. But his poem was reflective of a Victorian sense of progress, of life as a continual attempt to discover new frontiers whether in geography or in technology. That is the culture of a modern world, the world of the great transformation, and I don't think we are going to put that genie back in the bottle; nor would I want to: rather we have to manage its consequences.

So the possibility of change and a sense of progress and of growth matter, even if economic growth has no necessary capacity to deliver permanently increased happiness.

Economic freedom as an end per se

And second, even more fundamentally, economic freedom, the freedom to decide "where to work, what to produce, and what to consume" is, as Amartya Sen has put it, a merit of the market system, desirable independent of whether markets produce the "culmination outcome" of higher income, and independent of whether higher income still matters to human wellbeing.[36] And where we have economic freedom we will tend to have economic growth.

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[36] Amartya Sen, *Development as Freedom,* Oxford University Press, 1999

The essence of my argument in Lecture III is therefore going to be that growth in GDP per capita should not be considered as the overriding objective of economic policy, but rather the highly likely outcome, in some ways beneficial, in some ways harmful, of two things desirable in themselves – economic freedom to make choices, and a spirit of continual enquiry and desire for change, which together will tend to produce those changes in technology, productive efficiencies and product innovation which produce measured economic growth. But I will also argue that once you express the objectives in these terms, rather than as an aim always to maximise growth per se, optimal policy choices change, sometimes quite significantly.

Before that however, I will in Lecture II consider the means of economic policy – whether and to what extent free markets, in particular in finance, tend to produce either increased growth or other desirable objectives.

To end this evening's lecture, however, let me reiterate the key message. There is much that is uncertain about what the objectives of economic activity should be and how to pursue them: about whether it is most useful to define the objective as happiness, and if it is, how precisely we measure and achieve happiness or wellbeing. And there are uncertainties about the implications of the empirical evidence of relationships between income and self-perceived wellbeing. But one thing we know with reasonable certainty is that increasing average GDP per capita beyond the levels achieved in rich developed countries does not by itself ensure significant increases in human self-perceived wellbeing, and is not therefore a useful definition of the overriding objective of economic activity. As a result, the instrumental justification of free markets and inequality, which has played a major role in the political discourse of both right and left for the last 30 years, has largely lost its validity.

END