CENTRE *for* ECONOMIC PERFORMANCE

Lionel Robbins Memorial Lectures

Economic Freedom and Public Policy: Economics as a Moral Discipline

Lord Turner

Chairman of the Financial Services Authority, the Climate Change Committee and the Overseas Development Institute

Howard Davies

Chair, LSE

LSE events

Lionel Robbins Memorial Lectures

Economics after the crisis: Objectives and means

Lecture III

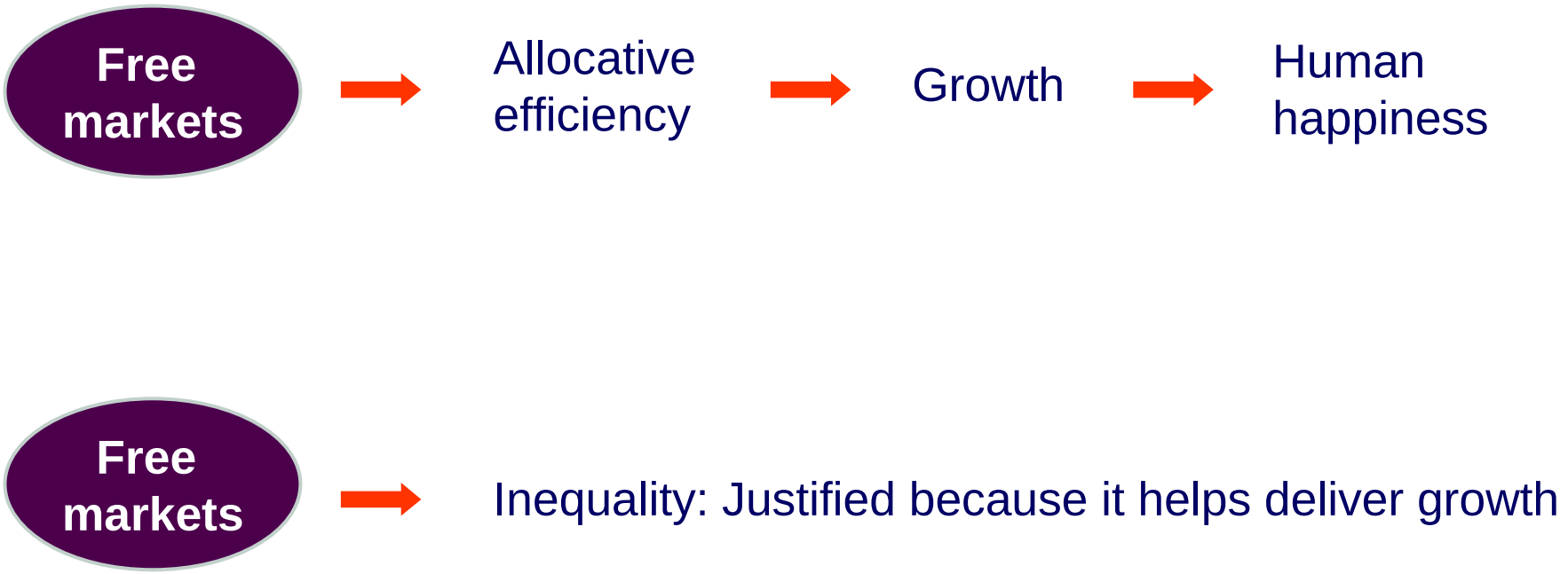
Economic Freedom, Public Policy and the Discipline of Economics

Adair Turner

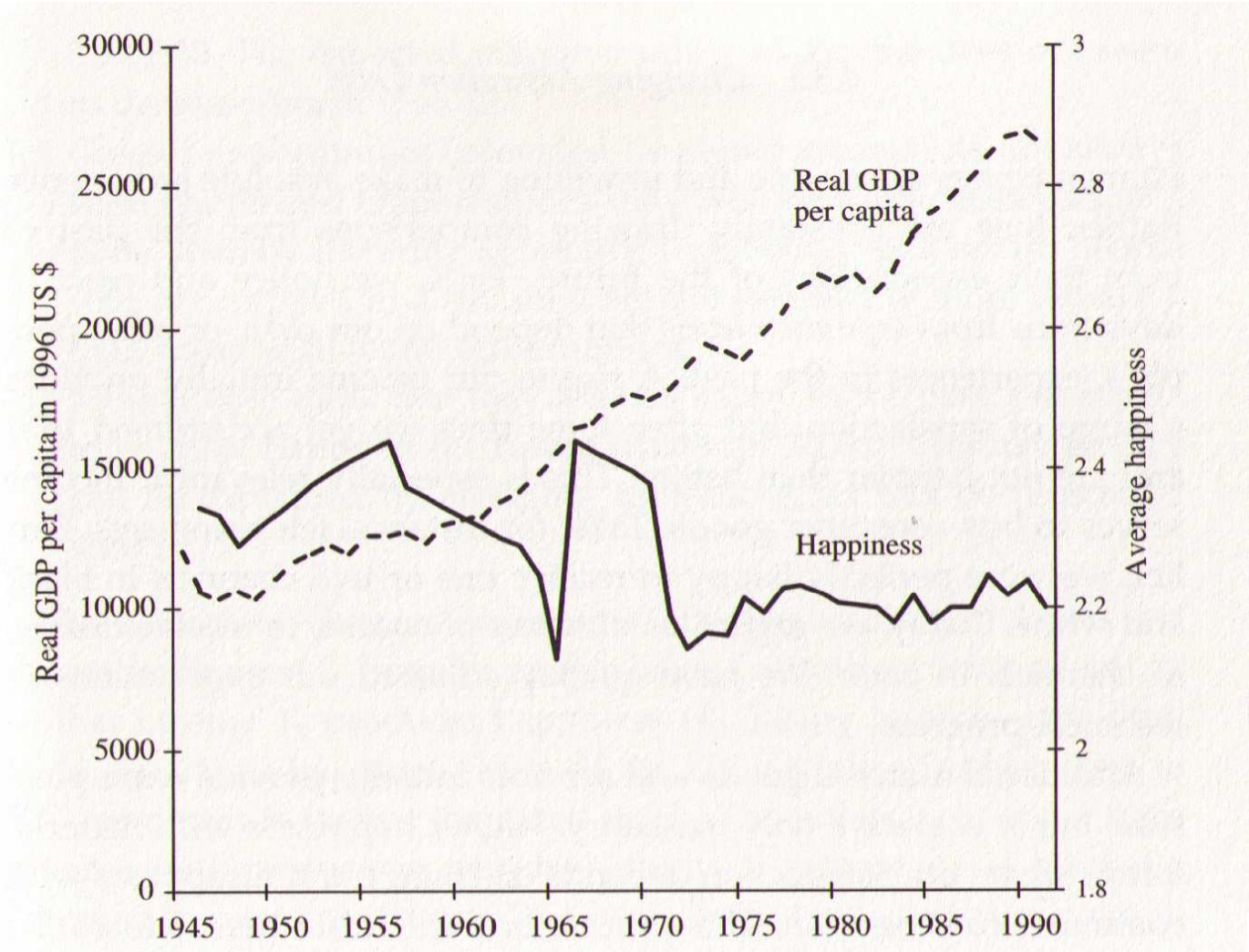
London School of Economics

13 October 2010

Starting Point: The Instrumental Conventional Wisdom

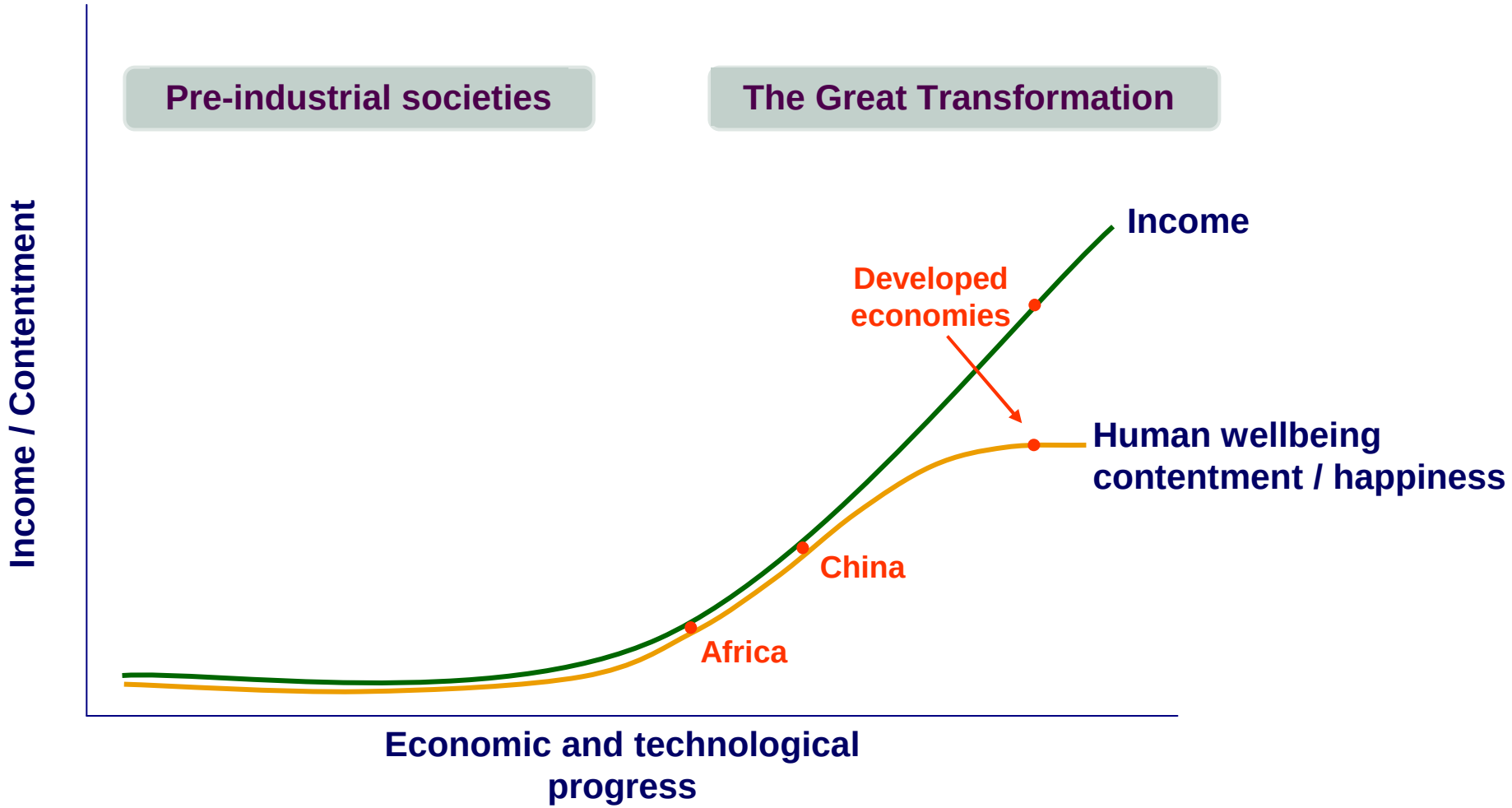


Happiness and income per capita in the USA

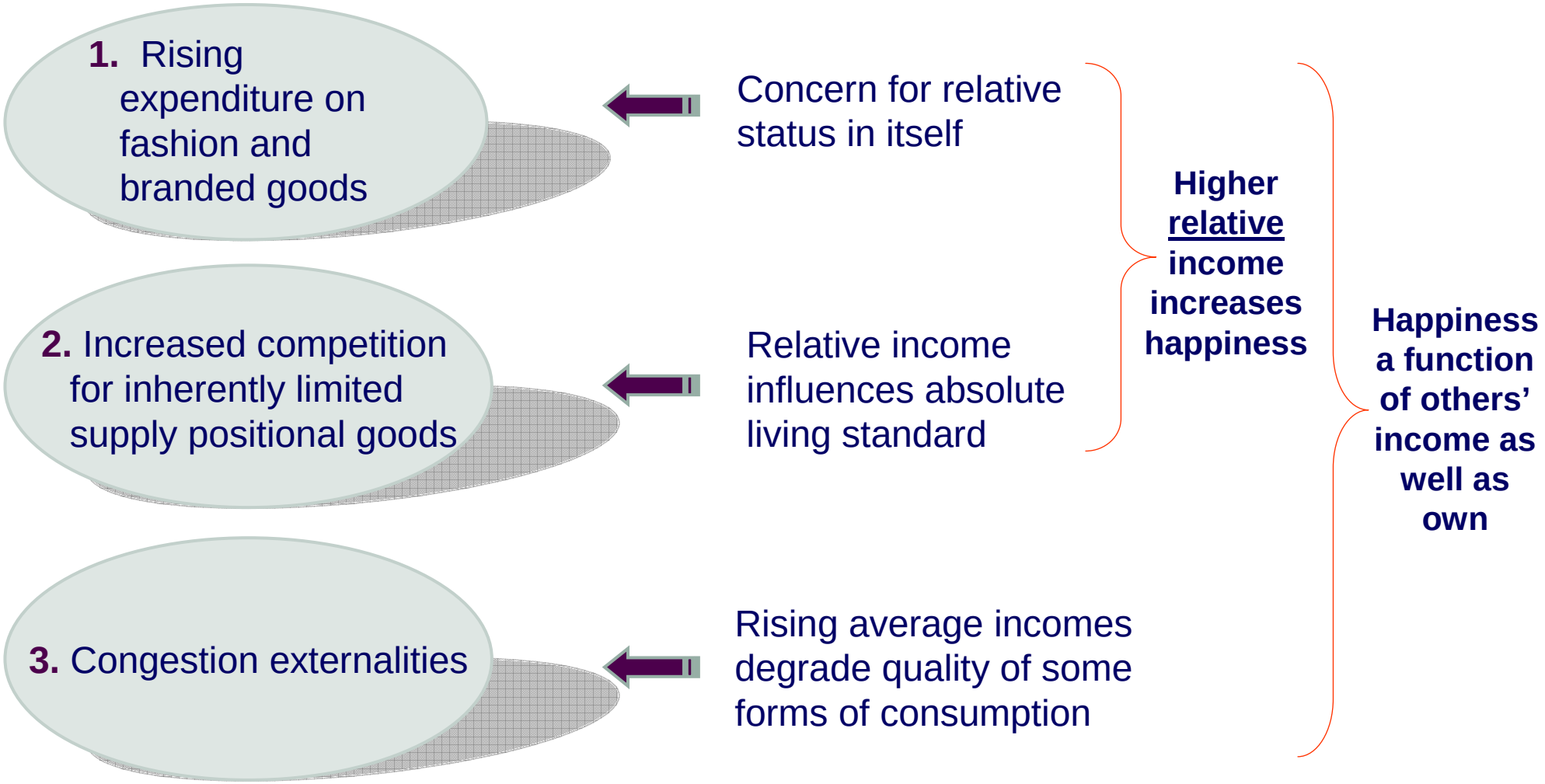


Source: Bruno Frey & Alois Stutzer, *Happiness and Economics*, Princeton University Press, 2002

Income and Human Contentment: Possible stylised pattern over time



Three distinct reasons why relative income matters



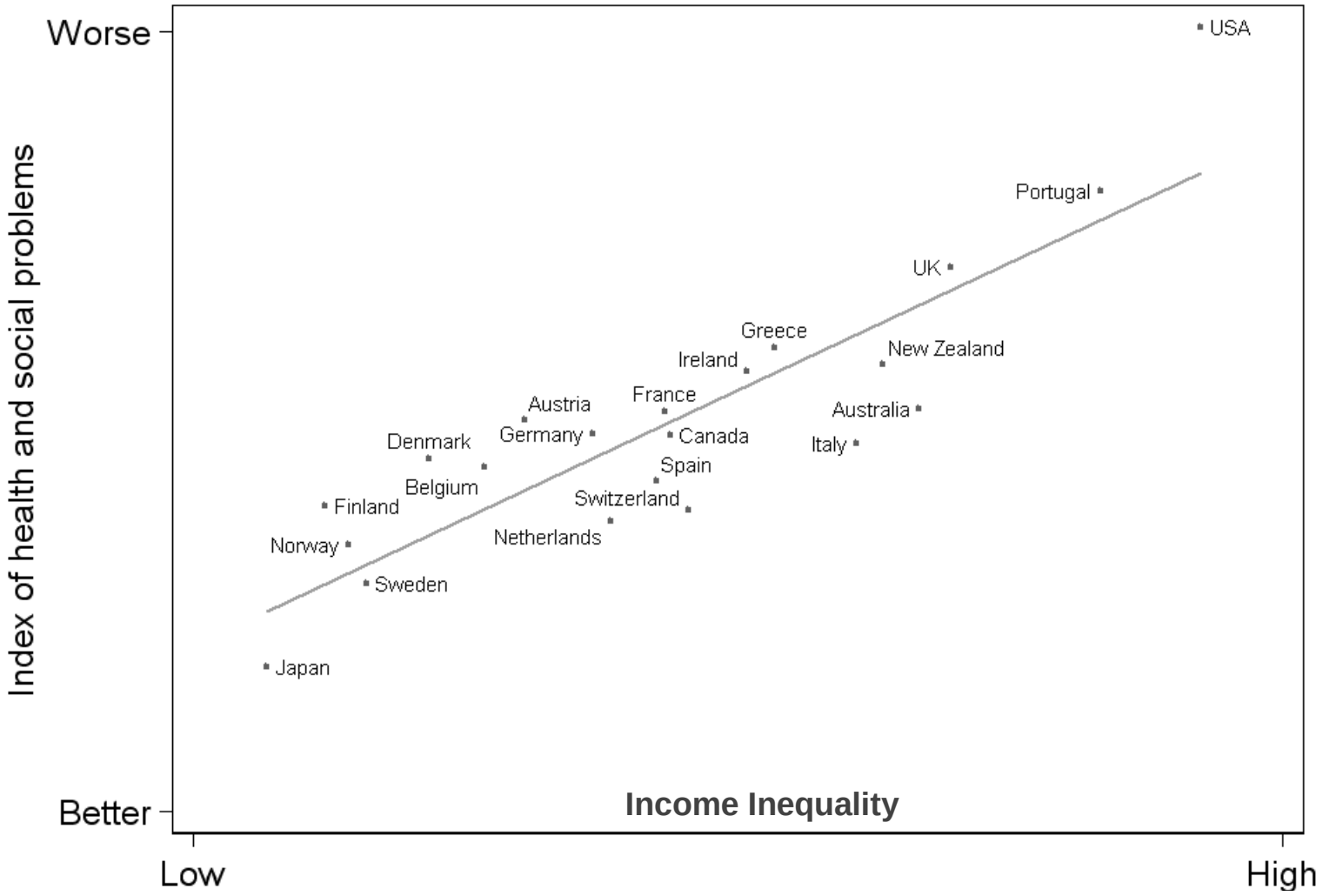
“Distributive” versus “creative” activities

- **“Creative”** — Increasing the net real income available for consumption

- “**Distributive”** — Winning increasing income at expense of others

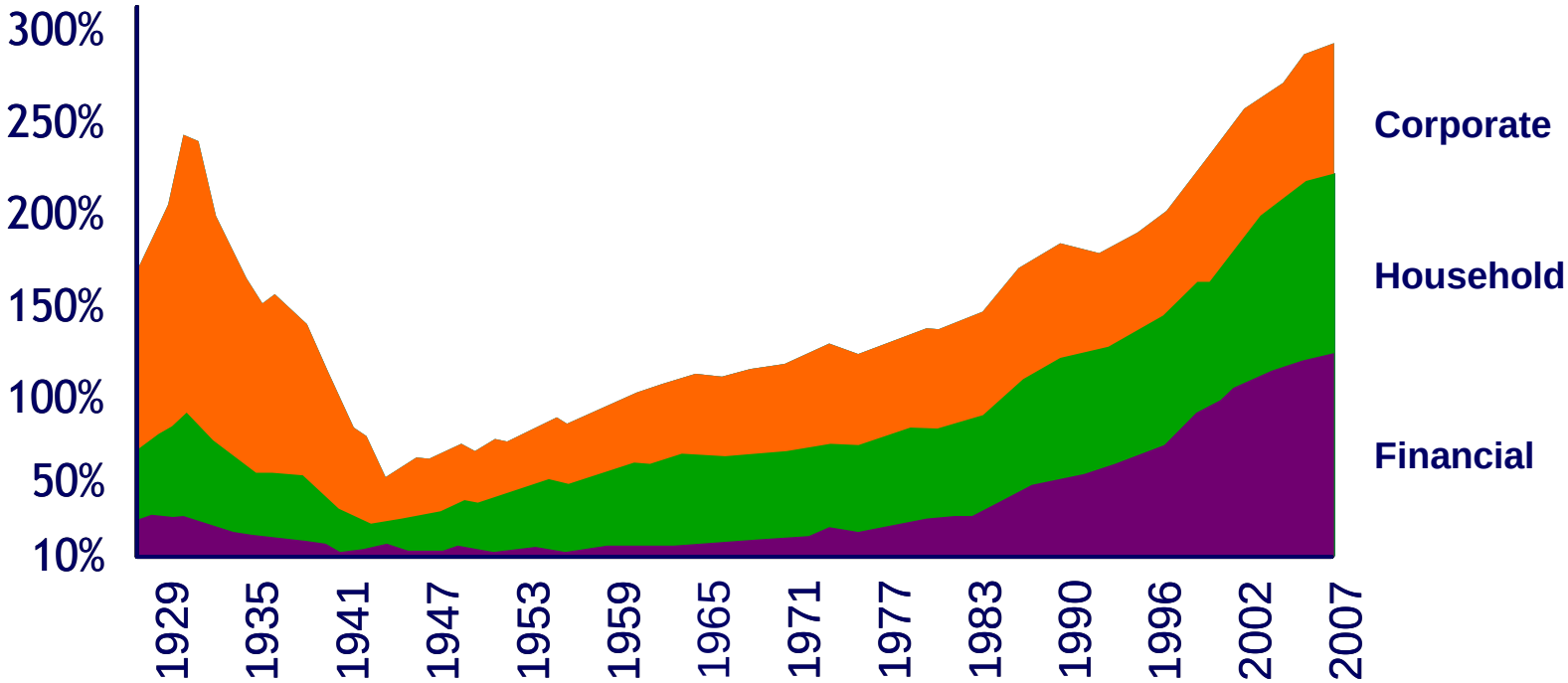
Source: See Roger Bootle, *The Trouble with Markets,* chapters 4 and 5

Health and social problems



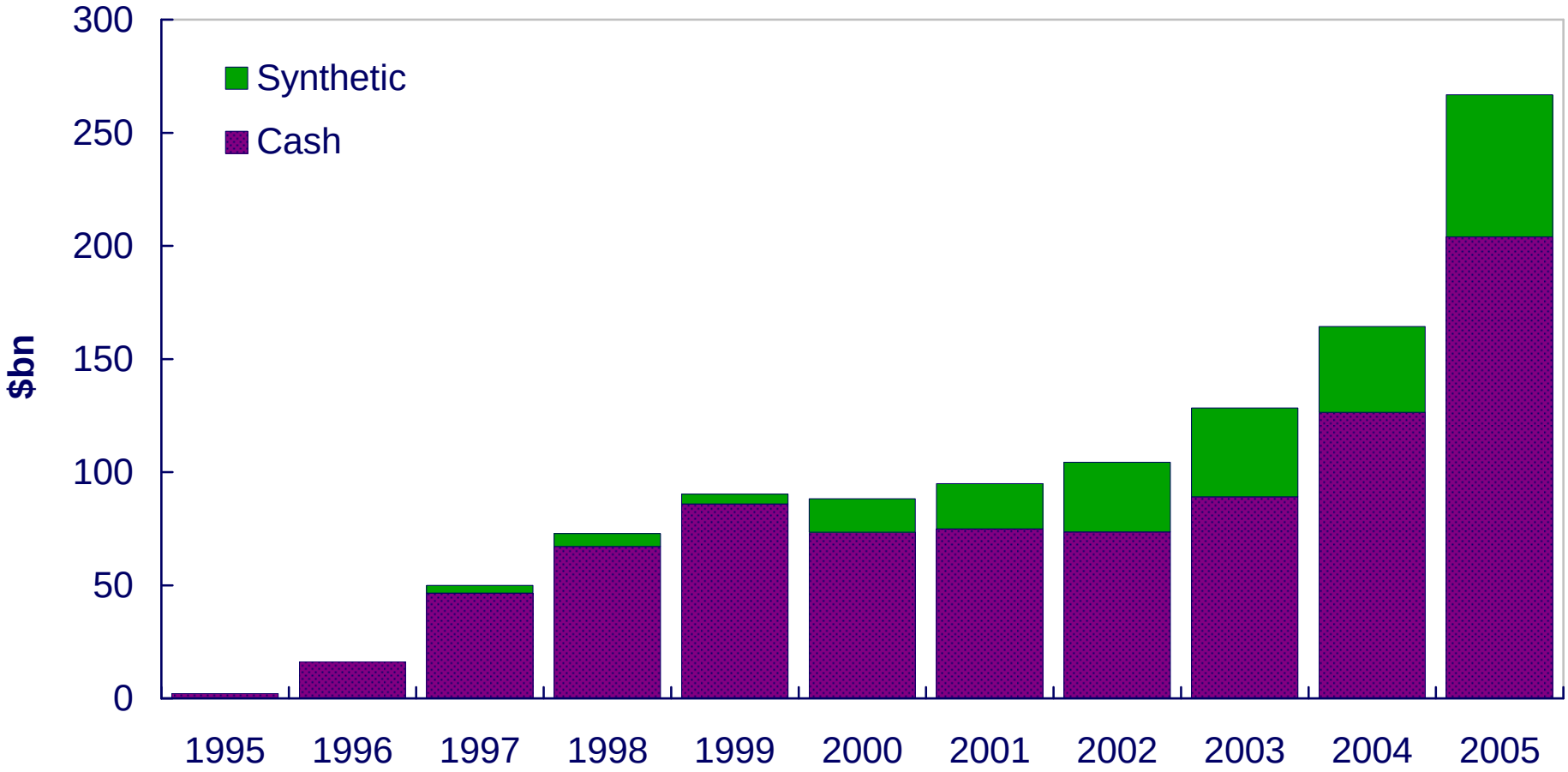
Source: Wilkinson & Pickett, *The Spirit Level* , Penguin 2009

USA debt as a % of GDP by borrower type



Source: *Oliver Wyman*

Global issuance of Collateralised Debt Obligations: Cash and synthetic



Source: *IMF Global Financial Stability Report, 2006*

Complete markets as a route to…

… efficiency

Credit derivatives *"enhance the transparency of the markets' collective view of credit risks.. [and thus]… provide valuable information about broad credit conditions and increasingly set the marginal rice of credit. Therefore, such activity improves market discipline"*

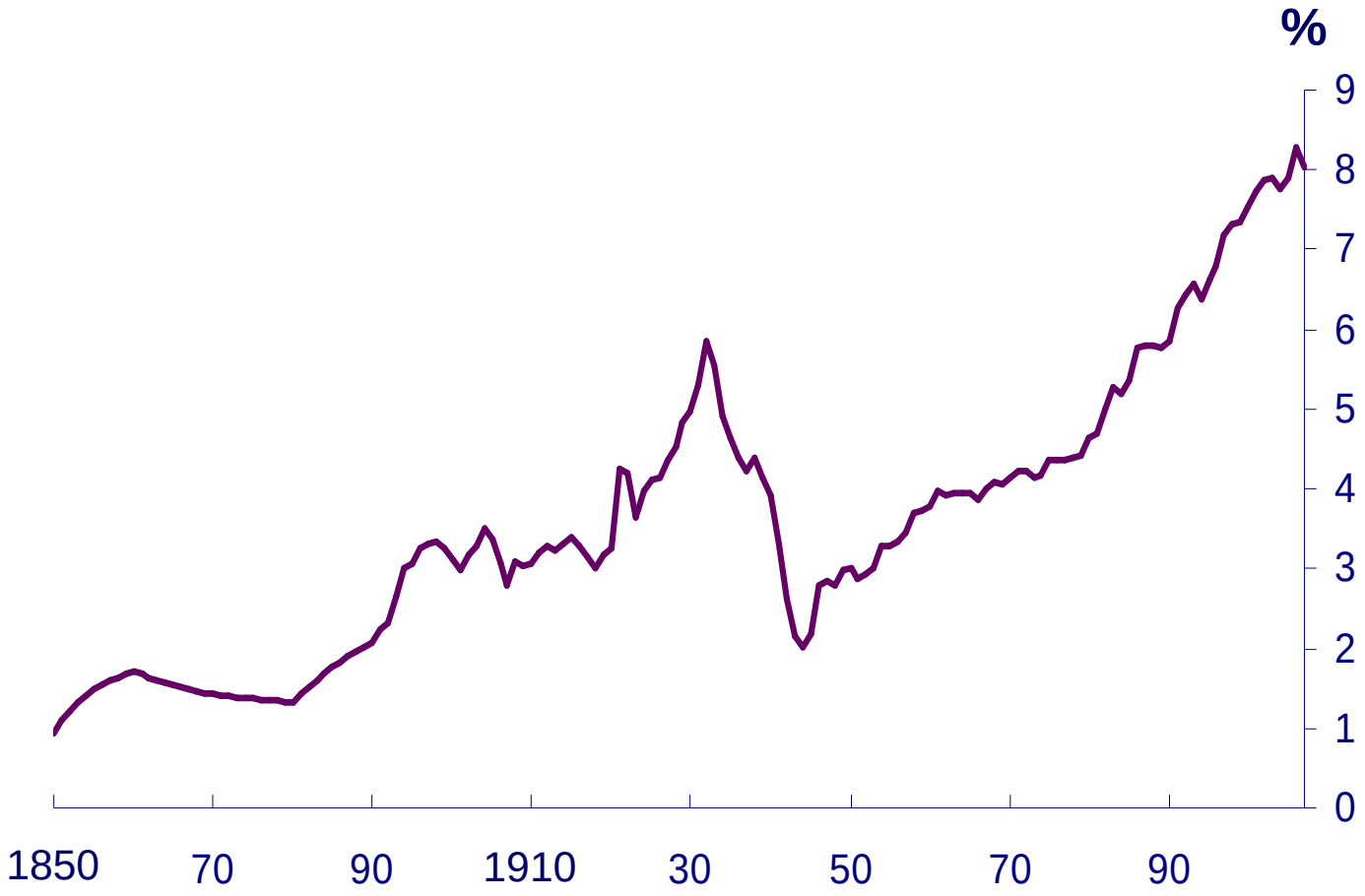
… and stability

"There is a growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors has helped make the banking and overall financial system more resilient …

The improved resilience may be seen in fewer bank failures and more consistent credit provision".

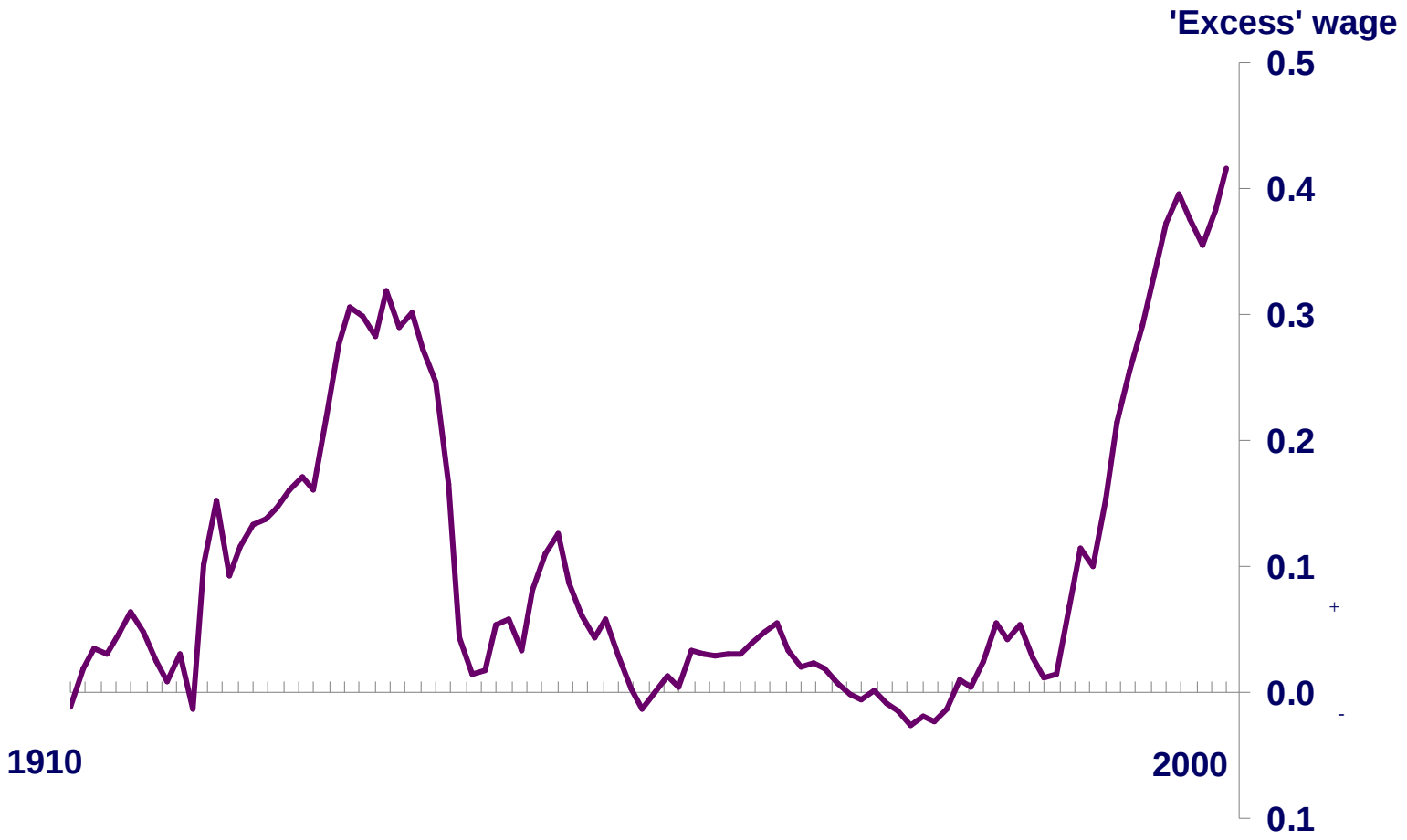
IMF, *Global Financial Stability Review*, April 2006

Share of the financial industry in US GDP



Source: Philippon, T (2008), *The Evolution of the US Financial Industry from 1860 to 2007: Theory and Evidence.* (As referenced by Andrew Haldane in *The Future of Finance,* LSE Report, 2010)

Historical 'excess' wage in the US financial sector



Source: Philippon, T and Reshef A (2009). *Wages and Humal Capital in the US Financial Industry: 1909-2006*, NBER Working Paper No 14644.A. Resh (As referenced by Andrew Haldane in *The Future of Finance,* LSE Report, 2010)

- Growth not the objective but by-product of other desirable objectives
- Policy implications
- Implications for the discipline of economics

The case for growth

- Growth in low and middle income countries
- The poor in rich countries
- Economic regression in absence of markets
- The journey, not the destination
- Economic freedom as an end per se

+

Avoidance of involuntary unemployment

The internally contradicted argument

- Economic growth in rich countries still matters because it matters to poorer citizens
- Economic growth is maximised by significant inequalities / incentives
- Therefore don’t worry if economic growth is combined with increasing inequality

The case for growth

- Growth in low and middle income countries
- The poor in rich countries
- Economic regression in absence of markets
- The journey, not the destination
- Economic freedom as an end per se and avoidance of involuntary unemployment

Keynes, *The General Theory*

"There is social and psychological justification for significant inequalities of incomes and wealth…

… dangerous human proclivities can be canalised into comparatively harmless channels by the existence of opportunities for money-making and private wealth which, if they cannot be satisfied in this way, may find their outlet in cruelty, the reckless pursuit of personal power and authority, and other forms of self-aggrandisement. It is better that a man should tyrannise over his bank balance than over his fellow citizens."

(Chapter 24)

The case for growth

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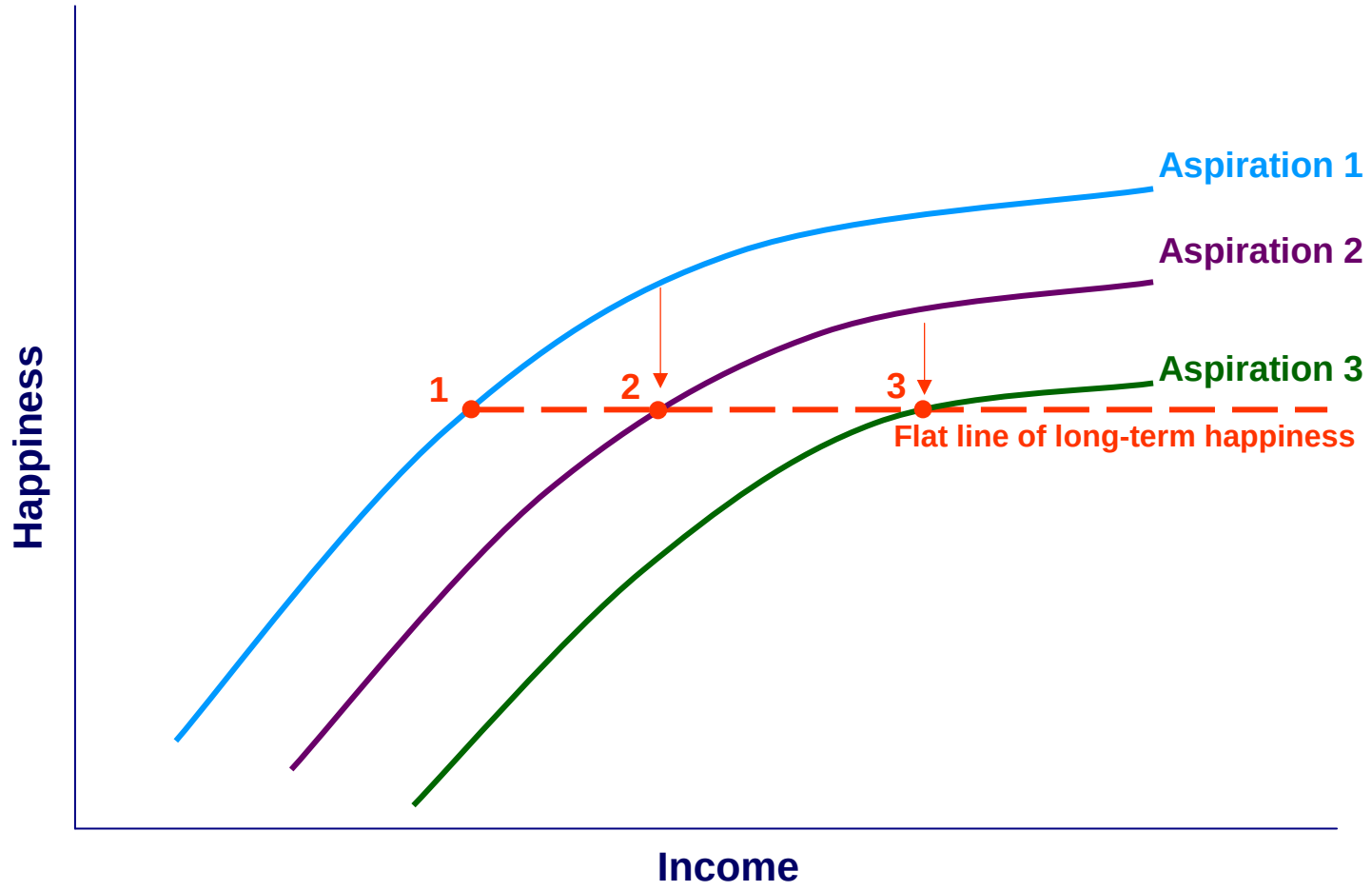
Happiness, income and changing aspirations



The case for growth

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Amartya Sen, *"Development as Freedom"*

"… the freedom of people to act as they choose in deciding where to work, what to produce, what to consume…"

"The merit of the market system does not lie only in its capacity to generate more efficient culmination outcomes but also in the processes by which those outcomes are achieved"

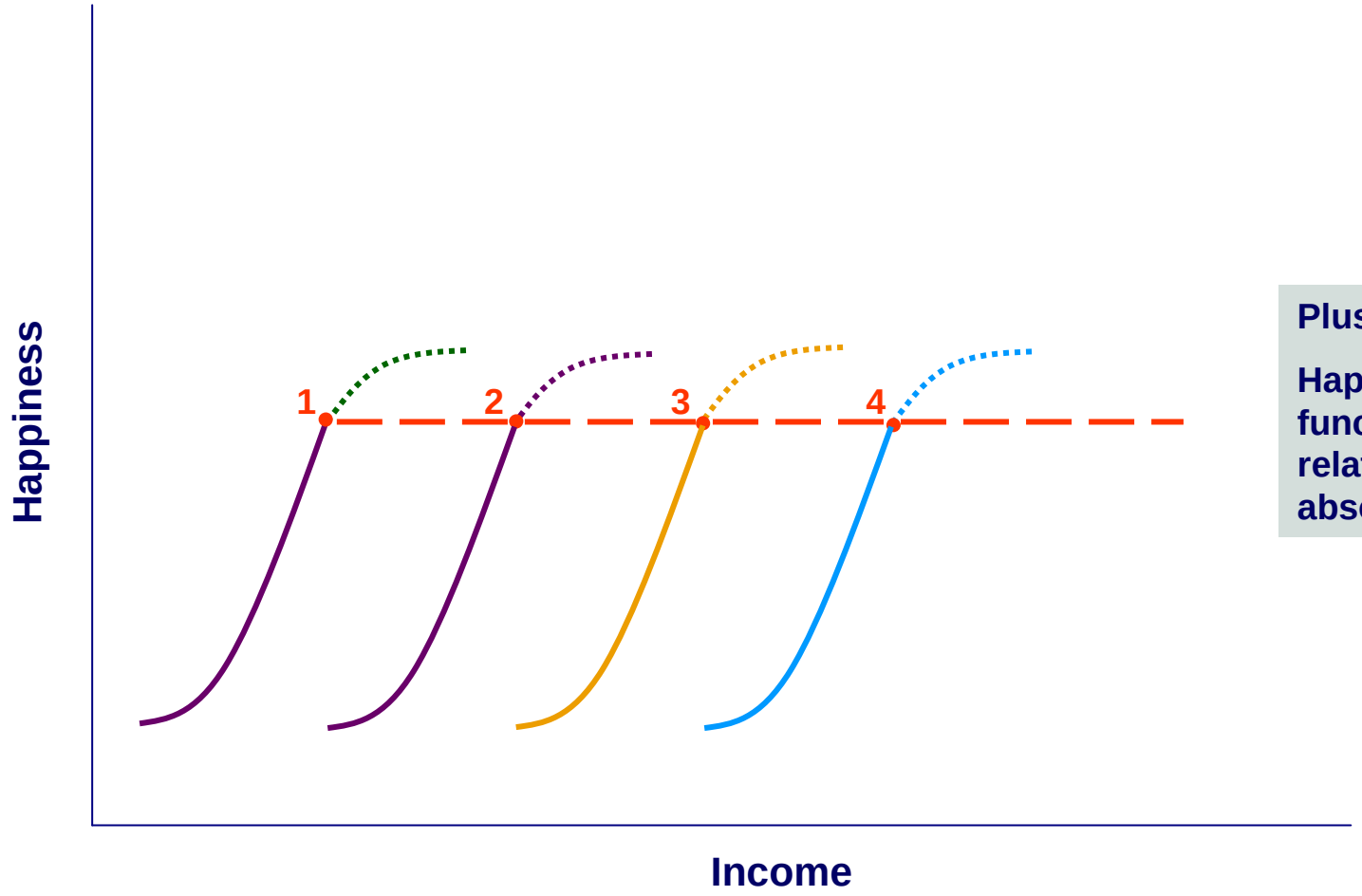
(Chapter 1, *The Perspective of Freedom*)

- Growth not the objective but by-product of other desirable objectives
- Policy implications
- Implications for the discipline of economics

Four clear policy implications

- Maximise stability and minimise downsides
  - Financial regulation and macro-economic management
  - Climate change mitigation
- Maximise public choice: especially at local level
- Minimise positional goods competition
  - Welcome population stabilisation

Happiness, already achieved income, and changing aspirations



Plus:

Happiness as function of relative as well as absolute income

Do we “need to grow” to afford public expenditure?

- Health
- Education

In general no, if main cost is salaries which rise proportionally with average GDP per capita

- Debt servicing

Yes, if macro-instability or fiscal profligacy generate high stock of debt relative to GDP

Costs and benefits of higher capital and liquidity standards

Possible costs to GDP growth

- Long-term?
- Transitional

Vs

Benefits of reduced probability of negative setbacks

- Standard evaluation techniques
  - Compare costs & benefits using a discount rate which accords equal weight (in any given year) to costs and benefits

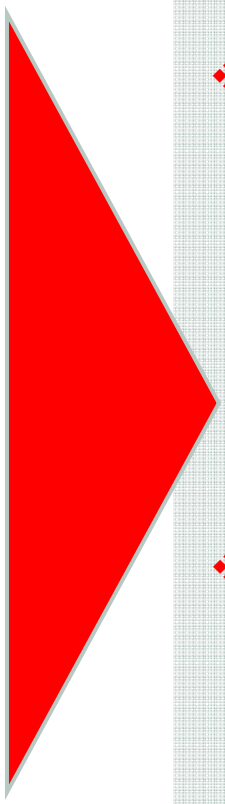
- Consequence: will undervalue stability and over-value minor increments to growth, if people highly value already achieved wealth/income and avoided unemployment, and deeply dislike setbacks

Estimating GDP

Measured value of financial services?

Distributive rent extracting versus "creative" activities

Increasing % of income devoted to housing → house prices increase: inflation or real income?



- Long-term trends and cross-country comparisons between rich countries have uncertain meaning
- Annual or quarterly changes are crucial guide to inflation targeting and economic stabilisation

Lionel Robbins:
"both the concept of world money income and of national money income have strict significance only for monetary theory"

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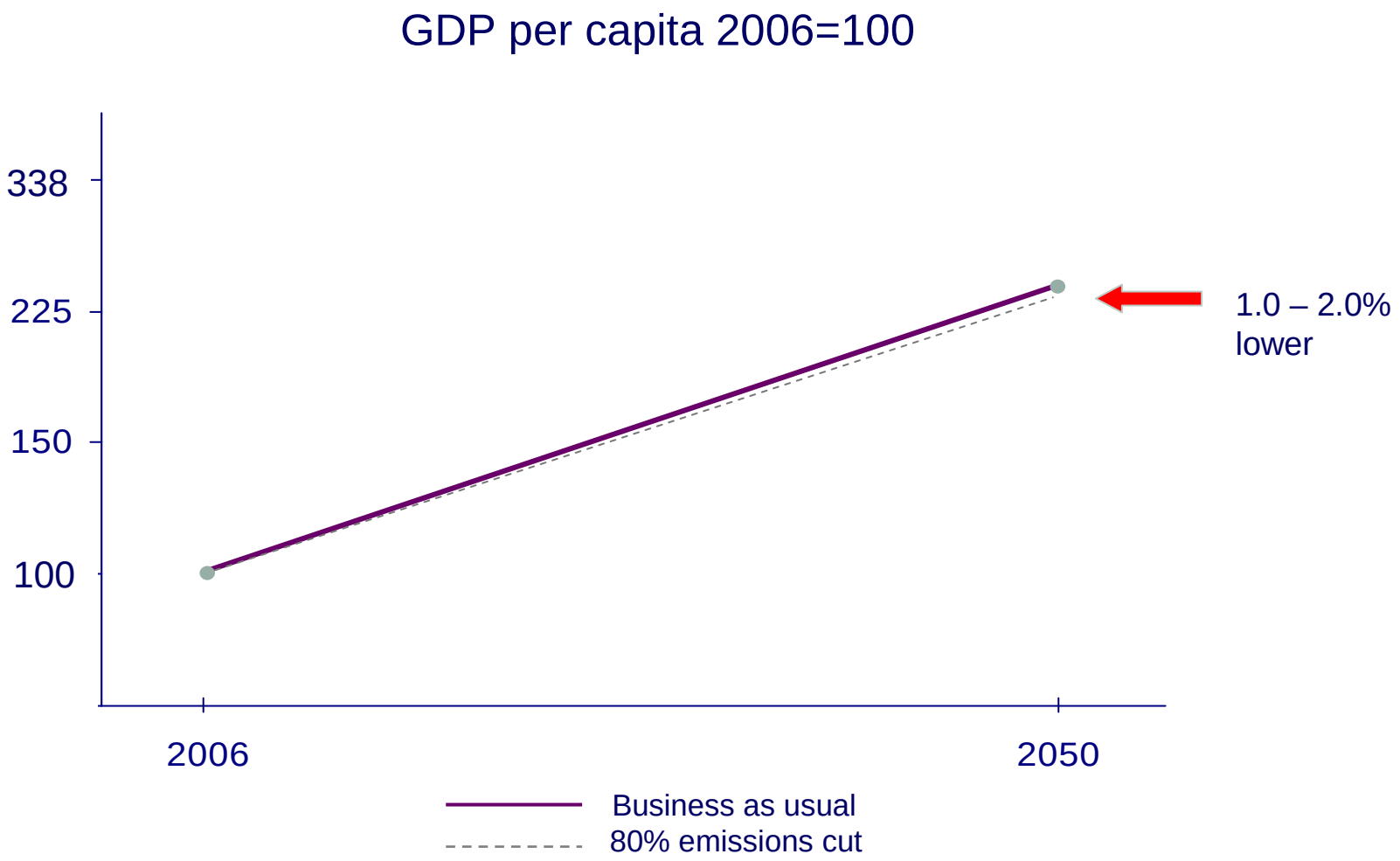
Growth in UK living standards: with 80% emissions cut



Costs of climate change

- Conceptually clear – but difficult to quantify, e.g. changes in agricultural yields
- Inherently uncertain
  - Contingent social and political responses
- Small probability catastrophic losses

The impact of discount rates

Discounted	£1000 in 2150 is worth	Assuming 2% per annum growth: 100 % of GDP in 2150 is worth
➢ at 4% real	£3.67 today	6% of GDP today
➢ at 2% real	£59 today	100% of GDP today

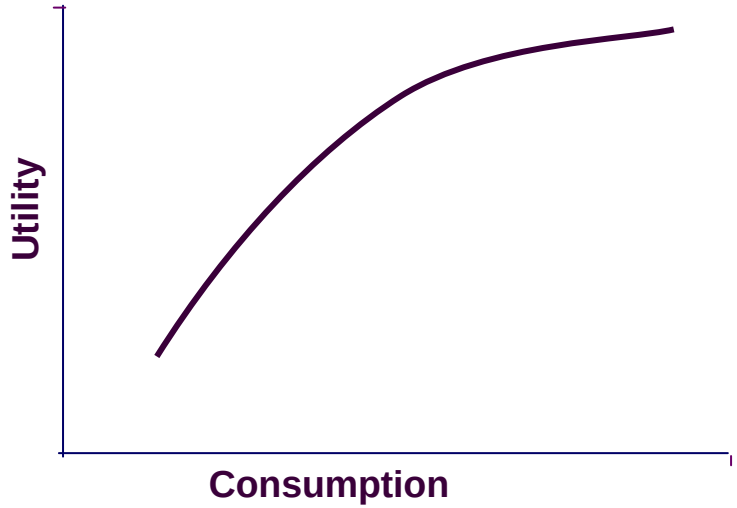
Discount rate and declining marginal utility

$r = \eta\,(g) + \delta$

η = the elasticity of the marginal utility of consumption

g = growth rate

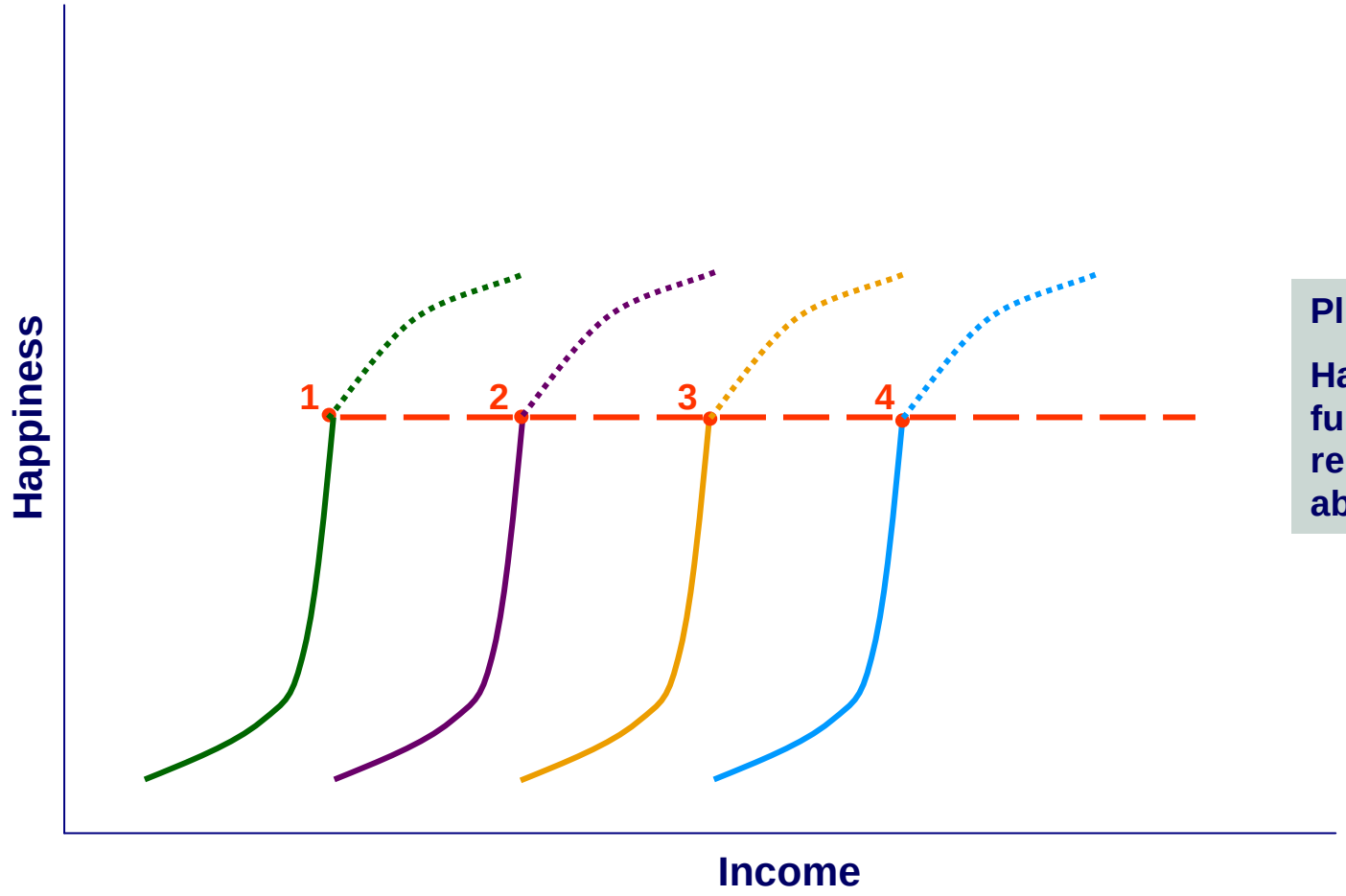
δ = the rate of pure time preference



Stern's base case $\eta = 1$ $g = 1.9$ $\delta = 0.1$ $r = 2.0\%$

The flatter the curve becomes, the higher *η, and the higher the discount rate*

Happiness already Achieved Income and Changing Aspirations



Plus:

Happiness as function of relative as well as absolute income

Three problems with the standard discount rate approach

- Losers in future may be poorer than rich big emitters today → Discount rate should be negative
- Small probability of catastrophic losses → Discount rate applied to those losses should be negative
- Losses of environmental goods – species, beauty, diversity – valued in themselves → Gains of economic income cannot offset environmental losses

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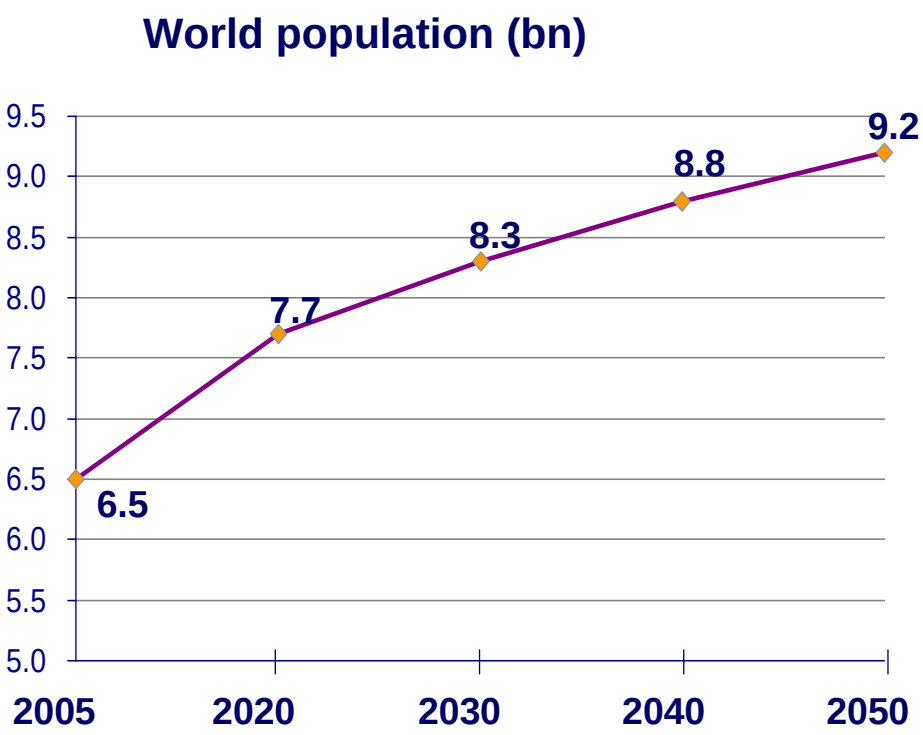
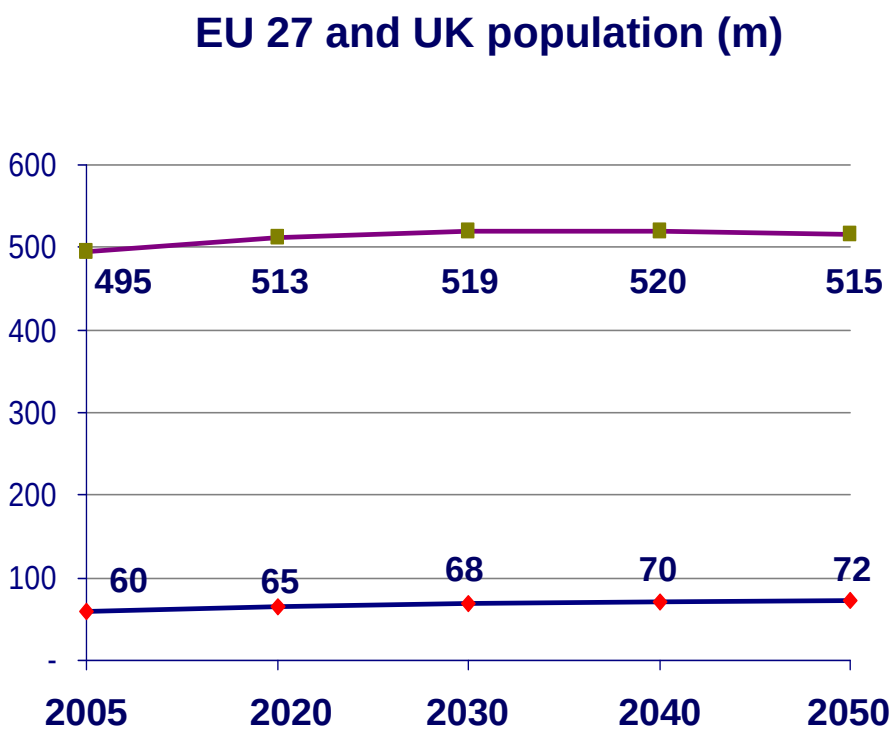
Population growth and stabilisation: UN medium projections





Source: UN Medium Projections

Four clear policy implications

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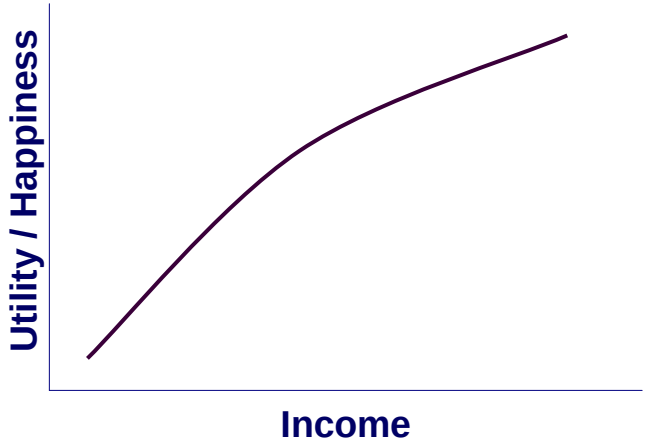
Overall Objective: Creating a stable environment in which freedom to choose can be allowed expression while minimising downside consequences and setbacks

Two unclear issues

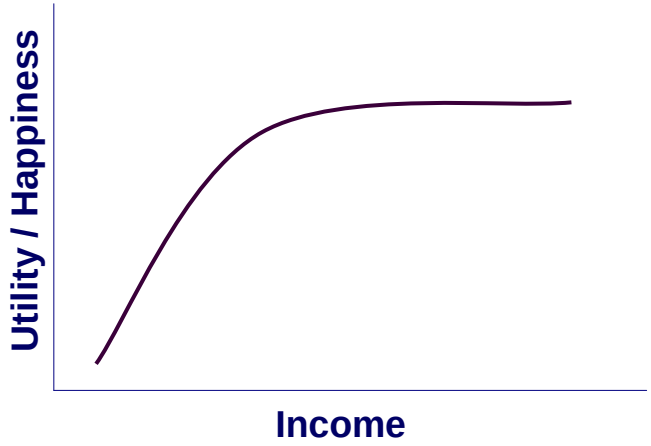
1. Are some goods / services more important to human wellbeing / happiness than others – even when counted equally in GDP?

2. How much inequality is fair / optimal / unavoidable?

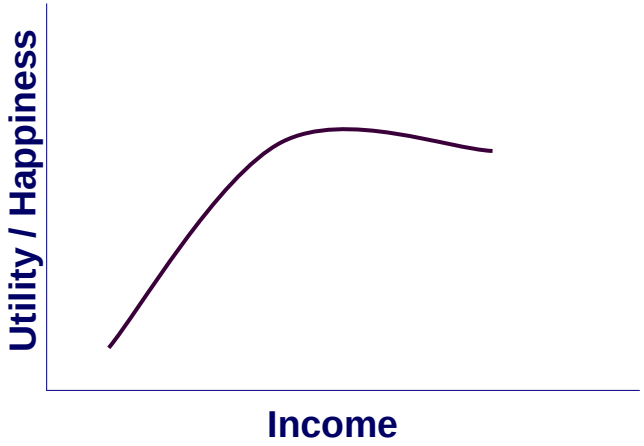
Different marginal utility of different “goods”



Good health?



Branded fashion goods?



Congestion and environmental damage?

REALLY OSTENTATIOUS BIG BAG
I OBVIOUSLY SHOP SOMEWHERE REALLY EXPENSIVE!
BET YOU WISH YOU COULD AFFORD THIS STUFF!
GODDARD

Sub-optimal consumption choices

- Goods consumed as a result of public choice
- Social mores, herd-like fashion, and advertising
- Congestion and environmental externalities

Two unclear issues

1. Are some goods / services more important to human wellbeing / happiness than others – even when counted equally in GDP?

2. How much inequality is fair / optimal / unavoidable?

How much inequality?

The instrumental justification

Inequality is justified because and to the extent that it delivers growth which delivers wellbeing; low taxation rates incentivise effort and entrepreneurship

The reality

- **Relative income matters**
- **Standard responses inadequate**
  - **Growth**
  - **Skills**
  - **Opportunity**
- **Relative status competition invalidates standard incentive theory**
- **Economic freedom, and even perceived fairness, imply significant inequality**

- Growth not the objective but by-product of other desirable objectives
- Policy implications
- Implications for the discipline of economics

Economics in the dock

Prosecution

- Assumption of rationality
- Mathematicisation: “physics envy”
- Focus on market completion and equilibrium
- Lack of enquiry about end objectives

Defence

- Always recognised imperfections
- Never monolithic
  - Mirrlees, Stiglitz, Akerlof
  - Kahneman
  - Sen
- Never said growth (rather than welfare) was objective

Prosecutors:

Robert Skidelsky, *Keynes: “The Return of the Master”*

John Cassidy: “How Markets Fail”

From Arrow-Debreu to the Washington Consensus: Three simplifications

- Downplay of severity of market imperfections
- From Pareto equilibrium to good outcome – even without redistribution
- From equilibrium to growth as the objective

Economics for the real world, not for ease of modelling

Objectives

- Is happiness the objective? Or welfare? Or freedom?
- How are they related to each other, and to income?
- Can we measure happiness or welfare?

Means

- Inherent failures of complex markets
- Consequences of human mental processes – part rational, part instinctive
- Inherent irreducible uncertainty, not mathematically modellable probability distributions

Keynes on economics

“economics is a moral and not a natural science”

* * *

“no part of man’s nature or his institutions must be entirely outside [the economist’s] *regard”*

* * *

The economist should be *“mathematician, historian, statesman and philosopher in some degree”*

"Economics deals with ascertainable facts: ethics with valuations and obligations. The two field of enquiring are not on the same plane of discourse"

(Lionel Robbins, *On the Nature and Significance of Economic Science*, 1932, P.132)

"As against Robbins, Economics is essentially a moral science. That is to say, it employs introspection and judgement of value"

(John Maynard Keynes, Letter to Roy Harrod)

Lionel Robbins: *Essay on the Nature and Significance of Economic Science*

"Both the concept of world money income and of national income money have strict significance only for monetary theory"

* * *

"There is no penumbra of approbation around the theory of equilibrium. Equilibrium is just equilibrium"

* * *

"It is highly desirable that the economist who wishes that the application of his science should be fruitful should be fully qualified in cognate disciplines and should be prepared to invoke their assistance"

* * *

"There is nothing in economics which absolves us of the obligation to choose"