Lionel Robbins Memorial Lectures

Economic Freedom and Public Policy: Economics as a Moral Discipline

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I begun Lecture I by describing the dominant political discourse and economic conventional wisdom of the last thirty years, which together presented an instrumental justification of free markets: the idea that free markets and strong market incentives to economic efficiency are good because they would make societies on average richer, and that getting richer is by definition good for human welfare. And the idea that in turn inequality is an essential by-product of a dynamic free market, justified because and to the extent that free markets with substantial inequality generate faster growth.

But in fact, as Lecture I set out, we cannot be confident that economic growth beyond some level of GDP per capita will necessarily deliver significant and sustained increases in welfare; and it seems highly likely that inequality can be a major cause of human anxiety and unhappiness, which no amount of growth will dispel. And as Lecture II set out, some forms of market liberalisation – in particular in financial markets – may not deliver increased economic efficiency, and may result in both increased instability and increased inequality – the net benefit of liberalisation being highly dependent on precise details and precise circumstances. The pre-crisis justification of financial liberalisation as beneficial because it maximised global economic efficiency and thus growth is therefore dangerously simplistic.

The instrumental case advanced for free market capitalism and market liberalisation so dominant for thirty years is therefore unconvincing, both in its specification of objectives and in its prescription of means. For some people the logical implication might seem a sort of radical green egalitarianism: economic growth seen as not only unimportant but positively harmful; radical action to reduce inequality justified by the sort of analysis that Wilkinson and Pickett present; markets of little value and tending to generate high levels of inequality.

But this third lecture is going to disappoint radical green egalitarians. For I believe there is a strong argument for a market economy, which will tend to result in growth, and which will tend to generate non-trivial levels of inequality. But the argument is quite different from that advanced in the last thirty

years, resting primarily not on the instrumental benefits of economic freedom for prosperity, but on a human desire for change and economic freedom as ends in themselves; an end however which need to be balanced against other potentially desirable objectives.

In this lecture I will therefore do three things:

- First, argue that measured economic growth should not be the overriding objective, but the likely and acceptable, though not in itself very important, by-product of two desirable things: economic freedom and the avoidance of involuntary unemployment.
- Second, explore possible policy implications of my conclusions – both those which are clear and those where the issue is clear but the resolution not so.
- Third, consider the implications for the discipline of economics, a subject which Lionel Robbins himself addressed seventy eight years ago in his *Essay on the Nature and Significance of Economic Science*.

1. GROWTH AS THE DECREASINGLY IMPORTANT BY-PRODUCT OF FREEDOM

In Lecture I, I argued that it is unclear that economic growth beyond that already achieved in rich developed countries will deliver further significant and sustained improvements in average or aggregate happiness, or welfare, or utility, or however we define the objective. But there remain at least three reasons why economic growth may in some circumstances be positively desirable; and three further reasons in favour, not of growth per se, but of economic freedom and markets, with growth resulting therefore as the by-product of other desirable objectives.

Three arguments for growth

(i) Growth in low-income countries.

The first is the most obvious, though not directly relevant to the issues that I am seeking to address in these lectures. Economic growth, even if measured via the imperfect devices of National Income Accounting, is very important to welfare in countries still well short of the "satiation level" suggested by Exhibit 1. The same analysis which casts doubts on the importance of income beyond a certain level, suggests that it is likely to be very important up to that income level. Classic economic growth still matters a lot in emerging middle income countries like China; and matters a very great deal in still poor continents like Africa. And to the extent that reasonably free markets with incentives for entrepreneurship, and some significant resulting inequality, are part of the formula which tends to deliver growth in developing countries – an empirical issue which we should approach with an open mind – to that extent the conventional instrumental argument is still valid. But these problems of middle and lower income development are not my focus in this lecture.

(ii) "Good growth" can deliver wellbeing?

In addition, however, while the empirical evidence and a priori logic discussed in Lecture I cast doubt on the assumption that economic growth necessarily and limitlessly delivers increased human contentment, it does not prove that economic growth has no potential to deliver increased wellbeing even in rich countries. The cross-country comparison data in particular is compatible with the assumption that there is some mild benefit of increased growth, though with a weak correlation and with other important factors clearly at work. And since some factors which researchers have identified as strongly associated with self-perceived well being (e.g., good health) are capable of being improved through the innovation and resource allocation made possible by growth, there is also an a priori argument for believing that some permanent increases in human well being <u>could</u> be delivered via economic growth. The crucial issue is therefore whether the actual path of growth followed delivers those products and services most likely to result in sustained increases in well being. I return to this issue in Section 2 (vi) below.

(iii) The poor in rich countries.

In addition even in rich countries there are clearly many people who are relatively poor, and indeed still some trailing below the point of inflexion beyond which it is possible that higher absolute income becomes less important to increasing welfare. So, do we not need growth in order to raise the income position of the poor? The classic "rising tide raises all boats" argument. Am I, and other doubters about the limitless and certain value of growth, open to the charge "it's all right for you; you are one of the better-off; you'd still care about maximising Britain's economic growth if you were at the bottom of the income distribution".

But the precise answer to that depends crucially on the relative importance to the welfare of the poor of absolute income versus relative income and relative social position. If what matters is absolute income alone, then an instrumental argument for free market growth could be justified even if it resulted in high inequality, as long as the absolute income of the poorest progressed. But if, as Lecture I suggested, relative income matters as well as absolute, and increasingly so as the general level of income rises, then the argument which says "don't worry about increasing inequality if it helps create wealth", even if empirically correct, is based on an internal contradiction **(Exhibit 2)**.

In these circumstances, economic growth is relevant to the position of the poorest only and to the extent that it could at least in theory help ameliorate relative deprivation.

It may, however, do so because it makes redistribution more acceptable.

Richer and middle income people in rich societies are unlikely to be made significantly and permanently happier by further increases in average national GDP per capita; but the same logic which suggests that, also suggests that people can be made unhappy by set-backs to levels of income and wealth already attained. Any attempt to redistribute income to the less well-off in order to address relative deprivation within a static economy will therefore be strongly resisted. In a growing economy, it may be more feasible.

That therefore creates an instrumental justification for growth, but one which is only valid if it is actually combined with action to address the relative position of the least well-off. If instead the argument is made that we need lower taxes on entrepreneurs, market liberalisation and lower public expenditure in order to spur growth, and that we should be unconcerned by increasing inequality because it is a necessary concomitant to growth, and that growth in turn is essential because it still matters to the still relatively poor, we should recognise that argument as nonsense.

<u>Three arguments for markets and economic freedom</u>

(iv) Markets, economic growth, and economic regression.

The fourth argument, not for growth per se but for reasonably free markets, is the observation that where there is not economic freedom – to innovate, to improve productivity, to set up new businesses, to compete – we sometimes face not just slow or nil growth rates, but absolute regression, falling living standards, declining public infrastructure and health. That was the experience of the Soviet Union in its final years of stagnation. And that reflected the fact that a planned economy without economic freedom falls, not only because economic planning cannot possibly replicate the effectiveness of the price mechanism as a means of processing information – Hayek's key insight – but also because without markets and market incentives, human behaviour changes in two ways:

- First, through a pervasive tendency across society for people to cease to care about the quality of the product or service they are delivering if there is no market incentive or sanction at the firm or the individual level to make them care.

- Second, a strong tendency for elite groups to channel their natural human tendency for relative status competition into positively harmful activities – aggrandisement of organisational units or personal power for its own sake, and outright corruption. As Keynes puts it in The General Theory, **(Exhibit 3)** one of the benefits of the market and of significant inequality is that *"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 man should tyrannise over*

his bank balance than over his fellow citizens".[1] This may seem a very negative justification for markets and resulting inequality, but even this negative justification is, I think, more compelling than the instrumental argument that markets are good and inequality acceptable because they produce growth which in turn delivers happiness.

(v) **The journey matters, not the destination**.

But once we start thinking not of growth as an objective but as the result of the expression of natural human proclivities, that also leads us to a direct and positive justification of economic freedom as an end per se, a point indeed which Keynes himself also made in the same passage: *"there are valuable human activities which require the motive of money- making and the environment of private ownership for their full fruition"*. And those valuable human activities need not in turn be directly linked to any theory that growth is required to deliver happiness. Rather, competition, innovation, a desire to do things better, more efficiently or just differently, need to be recognised as ends in themselves.

As I suggested at the end of Lecture I, there is no sound basis for believing that devotion of additional resources to ever more intense competition in fashion and design intensive goods, or to their expensive branding, will make people permanently happier. But the possibility of change, the fact that fashions do change every year, that there are new ideas, that there is competition for people's attention, may well be essential to contentment in a rich liberal open society

And more fundamentally the expectation that there will be technological progress, innovation, improved productivity and new production possibilities, can be important to our sense of well being, even if once the expectation is satisfied, no permanent increase in happiness results. My marginal utility schedule may continually adjust downwards, so that no permanent increase in happiness ever occurs, but at any one time it is upward sloping. We are unlikely to be made permanently happier by ever more electronic gadgetry, but we would become less happy if the economy became static, if products and services did not in some sense get better or simply get different. And not just because of the temporary buzz we might expect to get from new products, but because product innovation is in itself an expression of that spirit of enquiry which is a defining characteristic of the modern world, inherent to the great transformation and to the world which it created.

The journey matters not just the destination.

(vi) **Economic freedom as an end in itself**

[1] Keynes, *The General Theory*, Chapter 24, Palgrave MacMillan, 1936.

Finally economic freedom on both the consumption and production side – the right to chose what to consume but also the right to set up a new company, to work for oneself, to compete with new ideas, needs to be recognised as a desirable objective in and of itself, not because of any prosperity dividend it delivers.

The Soviet Union was ultimately a failure in terms of human welfare not just, and perhaps not even primarily, because of its failure to deliver increased GDP growth, but because it stymied the natural human desire to be allowed to make one's own choices. The point is one which Amartya Sen makes in the first chapter of his book *Development as Freedom*.[2] Let us suppose, he asks, that contrary to Hayek's proposition, a centralised Soviet economy of directed labour and no entrepreneurial freedom, had been as effective as a market economy at delivering GDP growth, would that have been an equally desirable outcome? The answer is surely no, because as Sen puts it, *"the freedom of people to act as they like in deciding on where to work, what to produce, what to consume"* is in and of itself an important aspect of freedom. As he puts it, *"the merit of the market does not lie only in its capacity to generate more efficient culmination outcomes, but in the processes by which those outcomes are achieved".*

The crucial justifications for economic freedom and for markets are therefore ones which exist independent of the allocative efficiency benefits of markets, and which are still valid even if in rich developed countries we have reached the point where further growth in aggregate GDP has reduced potential to increase aggregate human welfare or happiness.

But if economic freedom, a spirit of enquiry and a desire for change are combined with the attainment of one other undoubtedly desirable objective – the absence of involuntary unemployment – measured GDP growth is likely to result as a by-product.

Growing income may not make people happier, but involuntary unemployment tends to make them unhappy, both because it involves a set-back to already attained levels on income and wealth, and because it involves loss of social contact within the workplace, and loss of status. But the exercise of economic freedom will tend to generate improvements in productive efficiency, as more efficient firms replace less efficient; and that will lead to involuntary unemployment unless there is aggregate growth.

Growth in rich societies, as measured by standard National Income Accounting, should not therefore be an overt objective of economic policy, but rather seen as the acceptable, sometimes mildly beneficial but sometimes harmful, consequence of the underlying desirable objectives, which are economic freedom and a wide set of employment opportunities. And inequality, rather than being

[2] Amartya Sen, *Development as Freedom*, Chapter I: *The Perspective of Freedom*, Oxford University Press, 1999.

instrumentally justifiable because and to the extent that it delivers growth, is justifiable because and to the extent that it is the unavoidable concomitant of economic freedom.

So as I said in the beginning of this evening's lecture, my position is one which will disappoint some radical green egalitarians – it is neutral towards growth rather than opposed to it, and it accepts some significant inequality as unavoidable. There is, I believe, a compelling liberal argument for economic freedom, for markets. And from economic freedom will follow both economic growth and significant inequality.

But if this is the real justification for the market economy, an essentially moral and political rather than narrowly economic one, then we cannot avoid debating political choices which the instrumental conventional wisdom sought to sweep away; political choices, for instance, relating to the degree of inequality.

And across a wide range of policy issues, the conclusions I have reached in Lectures I and II on the objectives and means of economic activity carry policy implications significantly different from those which appeared to follow from the instrumental justification of markets as a means to maximise growth.

So let me first suggest four key areas of policy where there are clear implications – and then two areas where the optimal way forward is more difficult to determine but where we at least need to recognise open issues, not close off debates with simplistic assumptions.

2. IMPLICATIONS FOR POLICY

Given what we know, or at least strongly suspect about the drivers of human contentment, about the shape of the marginal utility schedule discussed at the end of Lecture 1, public policy should place strong emphasis on maximising stability and minimising downsides, on maximising public choice, and on minimising as best possible the intensity of zero sum competition **(Exhibit 4)**. Those principles carry important implications for four specific areas of policy.

(i) Maximising stability: minimising downsides: macro management and financial regulation

When summarising the key points of my argument in Lecture I, I said that long term growth maximisation should not be the key objective of public policy, but that from today's starting point in the middle of a recession short to medium term growth is undoubtedly very important. That may seem a contradiction – but it is not.

We have reasons to doubt whether further increments in average income will make people in already rich societies significantly and permanently happier, but we have good reason to believe that set-

backs to already attained income and wealth make people unhappy **(Exhibit 5)**. Pay cuts are more negative to happiness than pay increases are permanently positive: losing one's home as a result of mortgage default and repossession makes people very unhappy: and involuntary unemployment has a major negative impact, both because of its impact on income, and because of the direct negative impact of lost self-esteem and social interaction.

So economic stability – avoiding severe recessions – matters a lot. And if we do fall into recessions, with output and employment falling below full capacity levels, growth back towards high capacity utilisation matters a lot – because it is essential if we are to avoid prolonged harmful employment, but also because recessions create high government debt levels, and once we have high government debt, we face an "imperative to grow" which does not otherwise exist.

The idea that we "need to grow" to afford high levels of future public expenditure is largely fallacious **(Exhibit 7)**: growth does not enable us to afford more teachers and nurses, because their incomes tend to grow with average earnings.[3] But indebtedness does create a growth imperative – because without growth, debt servicing and reduction requires expenditure reductions and tax increase which impose resented and resisted set-backs to people's existing income and wealth.

How we achieve growth out of the present recession, in the face of debt burdens which need to be reduced, is of course an extremely difficult issue: and not one on which I am making any comment this evening. But the objective is clear: growth out of a recession matters, even though maximising long term growth is not a sensible objective. These are not contradictory statements, but derive from the same analysis of the drivers of human satisfaction.

But far better of course not to fall into severe recession in the first place, and better to have a stable economy, even if at the margin that requires a small sacrifice of long term growth. This carries clear and important implications for decisions on future financial regulation.

Lecture II described how in the decades before the crisis we were told that increased financial intensity and financial innovation would, by complex indirect processes, increase the allocative efficiency of the economy and thus spur economic growth. Sometimes we were also told, bizarrely in retrospect, that the same developments would increase stability. But at times the proposition was more buccaneering – no reward without risk, but the dynamic world of financial liberalisation would deliver efficiency improvements sufficient to compensate us for any downside of instability.

Lecture II questioned whether any such economic efficiency benefit was actually achieved – or whether much financial activity was not distributive in form – at best zero sum, sometimes rent extracting. But let us suppose for now that financial liberalisation, intensification and innovation has somehow increased the medium term achievable growth rate but at the cost of increased instability,

[3] The point is made by Amartya Sen in *Development as Freedom* (see Chapter 2): The ends and means of development.

then the insights of Lecture I suggest that it might still have been wise to forgo those benefits. Because if financial intensity and sophistication increases the attainable medium term growth rate marginally – from say 2% to 2.05% – the benefit to long term human happiness may be minimal[4]: while if it increases the volatility of the economy, increasing the possibility of recessionary set-backs, those set-backs may have potentially serious consequences for many people's well-being.

In our reform of financial regulation, we should therefore have a very strong bias towards increased system stability. Arguably indeed a greater focus on stability than assumed in the macro economic assessments we have until now made. In those assessments, conducted by the FSA and the Bank of International Settlements we have attempted to compare the benefit of reduced probability of recessions, with the possible cost to economic growth of higher capital requirements.[5] [6] A crucial choice in that comparison is the discount rate – the relative price by which we compare benefits in one time period and costs in another. **(Exhibit 7)**. And in line with standard assumptions we have used one constant discount rate to compare those costs and benefits, allowing for timing differences, but not allowing for the possible severe asymmetry of people's happiness response to incremental income gains versus set-backs to income already attained. If we allowed for that asymmetry we would place far greater weight on the avoidance of set-backs than our current constant discount rates assume. And our estimates of optimal bank capital requirements would be higher than those we have so far calculated.

Once growth maximisation is no longer the objective, minimising set-backs becomes a vitally important objective. Macro economic management to as best possible ensure a stable economy matters a lot: overall economic policies to maximise the long term growth rate are far less important.

And that in turn carries implications for how we should view GDP figures, to what policy decisions they are useful inputs **(Exhibit 8)**.

- As measures of long term changes in human well-being they are almost useless. Even as measures of long term changes in what we think they measure – 'real income' – they are highly imperfect because dependent on conventions and assumptions which are to a

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[4] Note that while the potential benefit of improved allocative efficiency (or of a higher savings rate) is often loosely described as being 'increased growth', it should more formally be described as 'a transitional increase in the growth rate followed by a permanent steady state path of income higher than would otherwise pertain'. The term 'medium term growth rate' is therefore used to refer to this transitional effect.

[5] See Macro Economic Assessment (MAG), Long Term Economic Impact study (LEI) and FSA, etc, etc.

[6] The analysis suggests that the impact on the growth rate is transitional only, but with a transitionally lower growth rate in turn producing a permanently slightly lower long term steady state path of GDP.

degree arbitrary. How do we measure the value of financial services? Can we distinguish effectively between distributive/rent extracting and "creative" activities? If we spend more of our income on housing, competing for a positional good and driving up the price, should that show up as an increase in inflation, or as a form of real income even though we are not in aggregate consuming any more housing services than before? As we get richer, as measured by national income accounting measures, it becomes decreasingly clear what long term trends in GDP are telling us, or whether we can infer much at all from cross-country comparisons in rich country GDP per capita.

- But as measures of short run changes in the level of activity and thus as information relevant to optimal macro management – hitting inflation targets and ensuring recovery from recessions – they are relevant and valid, because over the short run the impact of arbitrary accounting conventions makes little difference. Quarter-by-quarter changes in GDP tell us something useful: changes in GDP per capita over decades tell us much less. A point indeed which Lionel Robbins made, writing at a time when the techniques of national income accounting were in their infancy. "Both the concept of world money and national money income" he noted "have strict significance only for monetary theory".[7]

(ii) Minimising set-backs: climate change mitigation

The objective of minimising downsides is also highly relevant to optimal climate change policy **(Exhibit 9)**.

Climate change could impose on humanity severe costs – severe reductions in human well-being. But reducing greenhouse gas emissions to limit the harmful impacts will involve some sacrifice of future growth. How to compare the costs and benefits? That of course was the question handed to Nick Stern, and his response was his brilliant and seminal report on the Economics of Climate Change.[8]

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[7] Lionel Robbins, Essay, page 57. Robbins indeed argued that even in principle the use of GDP or GDP per capita figures to make inferences relating to aggregate or average utility was methodologically flawed. "The addition of prices or individual incomes to form social aggregates is an operation with very little meaning… As expressions of an order of preference, a relative scale, they are incapable of addition. Their aggregate has no meaning. They are only significant in relation to each other. Estimates of the social income may have a quite definitive meaning for monetary theory, but beyond this they have only conventional underlined significance". This insight has important relevance to the issue of "Good and bad" growth, discussed below (see Section 2 (vi)).

[8] Nicholas Stern, *The Economics of Climate Change*, Cambridge University Press, 2006.

On the costs to growth, Nick argued that we could achieve radical cuts in emissions, of the scale needed to contain global warming to 2℃, at a cost to global and UK GDP in 2050 of only about 1 to 2 percentage points, a sacrifice which would mean the UK growing at perhaps 1.95% per annum from 2005 to 2050, rather than the 2.0% per annum which we might otherwise achieve **(Exhibit 10)**. A difference whose impact on human well-being, in the developed world at least, could well be nil, given uncertainties of the link between growth in measured GDP and growth in well-being/happiness.

Against these costs, the benefits of avoiding climate change – i.e., avoiding the costs which it would impose – are more difficult to quantify **(Exhibit 11)**.

- Some are conceptually easy to envisage – changes in agricultural yields and the cost of food – but difficult to quantify because of the uncertainty of regional climate change models.

- But some are more inherently uncertain because contingent on social and political reactions – the danger that changes in agricultural yields may be so significant as to produce movements of people and the political instability that could result.

- And one of the most important factors to consider is the small probability of catastrophic events, again an area where quantification is inherently judgemental.

But Nick Stern argued persuasively that a reasonable estimate placed the net present value of benefits of harm avoided far above the cost of mitigation – the equivalent of 5 to 20% of global GDP in harm avoided versus something like 1% of costs.

That judgement, however, necessarily depended on the use of a discount rate to compare costs and benefits over time. And Stern's choice of discount rate proved controversial, because it makes a lot of difference **(Exhibit 12)**[9]. Valued with a discount rate of 2% real, £1,000 of benefits in 2150 are worth £59 today: discounted at 4% they are worth £3.67. And on that basis 100% of GDP in 2050 is worth only 6% of GDP today: so that if you believed that money income fully measures human utility, and that climate change would destroy the world entirely in 2150, you still wouldn't pay more than 6% of today's GDP to stop that happening.

So the discount rate matters – but the logic of declining marginal utility can be used to argue for a high discount rate: if further growth delivers little additional benefit, why sacrifice present prosperity for the benefit of future richer people: let them, out of the additional income which they will hardly value, pay the costs of climate change. The higher the elasticity of the marginal utility of consumption, (i.e., the flatter the curve becomes) the higher it seems should be the discount rate **(Exhibit 13)**.

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[9] See, e.g. William Nordhaus's, *A Question of Balance,* Yale University Press, 2008, Chapter IX, for a criticism of Stern's choice.

But that logic is flawed – because it assumes, first that those who will suffer from climate change will be richer than those who make the sacrifice: and secondly that the detriments of climate change can be offset by future higher income. And neither of those assumptions is valid **(Exhibit 14)**.

- Even if climate change is moderate, the future sufferers may be poorer than we are today, because concentrated in the poorest countries: and if that is true, the discount rate should actually be negative.[10]

- And if climate change is catastrophic, it will reduce everyone's well-being below present levels – and that small probability of catastrophic loss, should also enter the calculation at a negative discount rate.

- And if the losses from climate change include losses of perceived well-being deriving directly from environmental degradation – the loss I feel if the beauty of the coral reefs or of major animal species is lost – then the idea that we can count our future additional material prosperity as offsetting such losses – is invalid.[11]

In thinking about climate change, we need to place high value on minimising the risks of downsides for the poorest, of catastrophic downsides for all, and of downsides that cannot be offset by increased consumption, given that, in the rich developed world, increased consumption per se gives an uncertain human happiness dividend.

If we re-do Nick Stern's cautious figures to allow for those downsides, the developed world should commit to radical carbon emissions, even if the cost to measured growth is much higher than the 1 to 2% which he estimated.

(iii) Maximising public choice

Climate change is a global environmental problem, a global externality **(Exhibit 15)**. Economic growth and change arising from economic freedom can also of course impose very local environmental impacts relevant to human well-being - the impact of new roads on much loved countryside via visual or noise pollution, the impact of out of town supermarket developments on the

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[10] Partha Dasgupta, reference.

[11] The crucial theoretical issues here are (i) whether it is possible meaningfully to aggregate different categories of utility (e.g., the utility I gain from buying a bigger car and the utility from beautiful countryside), (ii) whether one can always trade off additional units of category A utility versus category B utility, and (iii) whether one can assume that money prices (or heroic attempts to infer what money prices would be for unpriced goods) capture the terms of this aggregate trade off. This issue is considered in Section 2 (vi) 'Good and bad growth'.

survival of local village stores or on the vibrancy of town centre urban space. But those developments may also be valued, reducing journey times, or reducing prices for consumers.[12]

A crucial issue is, therefore, how such trade offs of costs and benefits should be decided. If you believe that GDP per capita growth is the key objective, the trade off should place great weight on the importance of national productivity growth. And that apparent imperative was indeed given considerable weight in recent years – with studies of the productivity gap between the UK and the US revealing that much of it lay in retailing and wholesale distribution, implying, it seemed, the need for planning deregulation as the way to close the gap.[13]

But if the last increments of average income growth are of no necessary value to human happiness: if what matters is the exercise of economic freedom and the possibility of change and technological advance but <u>not</u> the maximisation of measured income as an end per se; then the imperative of national productivity enhancement should have little if any weight. Instead, decisions on planning philosophy should be based on political debate, at either national or local level, over the balance of benefits and costs which different policies would produce, benefits and costs which may not be reducible to a single quantitative figure. A political debate which has value not only because the factors to be brought into account are inherently judgemental, but as Frey and Stutzer point out, because participation in political processes, including local political processes, is in itself something that people value, something that seems to deliver life satisfaction. People gain utility from participation in decision making processes in themselves as well as from outcomes more attuned with local needs[14].

As Amartya Sen says, freedom to choose is a key merit of the market, in and of itself, independent of its “culmination outcomes”: but that choice is also important in respect to public goods – preserved countryside, attractive and vibrant urban space – which can only be delivered collectively.

The “instrumental conventional wisdom” stresses the imperative of national productivity enhancement: one of the key findings of more subtle economics, is that no such <u>imperative</u> exists but choices which people should be free to make.

(iv) Minimising positional goods competition: welcome population stabilisation

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[12] Estimated benefits of reduced journey times are often only accurate in the period before additional induced traffic produces congestion externalities. But in principle, developments could clearly have benefits as well as disadvantages.

[13] See McKinsey Global Institute

[14] Frey and Stutzer, Happiness and Economics, Chapter 8 and 9.

One of the key reasons why we should not expect economic growth to deliver continually increasing human well-being, is that as we get richer individual well-being is influenced by the income of others – by congestion externalities and by the need to devote an increasing proportion of income to competition for locally specific positional goods **(Exhibit 16)**.

As we get richer, we choose to travel more, but everybody else travelling degrades our quality of experience. We travel to uncrowded beaches, countryside or skiing pistes, but the richer everybody else gets, the more crowded they are; and we devote more of our income to competing to buy houses in the most pleasant areas of town or countryside, but increased average income doesn't help us achieve this, only increased relative income; and urban and road developments meanwhile, driven by increased prosperity, can degrade some aspects of housing amenity, increasing therefore the importance of winning the relative income competition.

This is inherent to increasing income levels; but the pressures are made worse – the intensity of relative competition increased – the higher the population density. If the British population, as now forecast by the United Nations Medium Projection, increases from 62 to 72 million in 2050, these pressures will increase, and relative status competition will become more severe. **(Exhibit 17)** Conversely, if our population stabilises, through some combination of a lower birth rate or lower immigration, aspects of that competition will become less intense. If Europe's population grows, pressure on limited supply leisure amenities – beaches, countryside, skiing pistes, historic cities – will increase: if it stabilises less so.

And across the world, if the global population stabilises at around 10 billion, as the UN Medium Variant Projection suggests, the negative environmental and congestion externalities of growth will be less than if it continues to increase.

This is so obvious that it is odd that it needs saying. But it does: because the conventional wisdom of a growth maximisation imperative is frequently used to argue the inverse – that Britain or Europe *"need more immigrants"* and *"need to raise their birth rate"*, since otherwise our GDP per capita growth rate, or even more absurdly our aggregate national growth rate, will decline.[15] [16]

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[15] See Adair Turner's lecture *Do we need more immigrants or babies? London School of Economics, 28 November 2007* (reprinted in Philosophical Transactions of the Royal Society, October 2009) for more detailed rebuttal of the argument that population stabilisation and an ageing population creates severe economic problems and requires a demographic (immigration or birth rate) response. In that lecture I recognise that rapid population decline could produce severe adjustment difficulties, but argue that few if any major developed countries are presently suffering or likely to suffer from such a problem, and that conversely unsustainably rapid population growth creates in major problems in many parts of the world.

[16] Of course an argument for a focus on aggregate notional GDP can be based not on the belief that this increases human contentment, but that relative notional geopolitical and military power are important to the avoidance of negative setbacks to income and life satisfaction. See e.g. Robert Kagan, *Paradise and Power*, Atlantic Books 2003, for the argument that Europe in particular is deluding itself if it believes that it can concentrate on what gives Europeans life satisfaction rather than on military power relative to other nations. The argument that any one country of the world

But to accept that logic is to trap us in a hamster wheel of ever rising population density, every more intense externalities, ever more intense competition for relative income and positional goods.

What follows is not a policy to manage birth rates down, but simply to accept as fortunate the remarkably universal finding that if women are educated and free to make their own decisions, fertility rates tend to fall to around or a bit below replacement levels. Nor does it resolve optimal immigration policy: the freedom to migrate, particularly for those threatened by political persecution, is one which no liberal can restrict lightly. But it does mean that the instrumentalist argument for immigration – immigration is good because it will help drive the growth rate – is a very poor one.

(v) The Common Principle

So across a wide range of policy areas – financial regulation to climate change, local planning decisions to demographic concerns – optimal policy choices change significantly when we shift from growth as the objective to growth as the result of other ends desirable in themselves – economic freedom and a spirit of enquiry, change and innovation **(Exhibit 17)**.

The aim should not be to maximise growth: but to create a stable economic environment in which freedom to choose can be expressed, both individually and via political processes, while minimising the downsides and managing the externalities that the exercise of freedom can sometimes produce.

But while that overall aim, and the more subtle account of economic objectives and human preferences which underpins it, drives some specific policy implications – such as the four discussed above – they do not provide answers to all questions. Rather, on some issues, they tell us what is not true or what is not resolvable by economics alone, leaving us with difficult and judgemental social and political choices. That is the case on two issues in particular **(Exhibit 18)**.

- Whether some forms of growth, some types of consumption, are better for human well being than others.
- And what can we say and do about inequality?

(vi) Good and bad growth?

We have no good reason to believe that growth in average income beyond the level already achieved in rich developed countries will <u>necessarily</u> deliver improvements in human well being or self perceived happiness. The aggregate marginal utility schedule may over the long term be quite flat.

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needs to maintain population growth in order to measure status and power relative to others, is clearly however not likely to produce an attractive global result.

But that still leaves the possibility – indeed the probability – that different aspects of consumption, different goods to which we could devote increased income, are characterised by very differently shaped curves **(Exhibit 19)**. That there are some consumption categories to which we could devote our income where there is as yet no declining marginal return: others where the curve has flattened: and others where beyond some level, rising income drives aggregate utility decline.

- In the first category, we might find good health, long and healthy life expectancy. Early death of loved ones is a major driver of unhappiness. And when people are asked to evaluate the importance to their self-contentment of different factors, good health often achieves the highest rating. Richard Layard has highlighted that poor mental health is a key driver of unhappiness[17]. And economic growth can – through better diet, better resourced healthcare, better sports facilities, better designed environment, better mental health practices – help deliver good physical and mental health.

- In the second category, may be much expenditure on branded fashion goods, a constant process of relative status competition, essential to some people's desire for change and novelty, never delivering permanent increases in happiness, but at least not necessarily driving any detriment to utility already attained.

- In the third, congestion and environmental effects where higher aggregate income can actually degrade aspects of quality of life.

It feels intuitively obvious that we face a mix of patterns of this sort[18]. But perfect market economics tells us that this cannot be the case if all markets are complete, all goods traded in markets, and all individuals rationally capable of discerning their own self-interest. For in those circumstances, the curves cannot at any one time display a different curvature – because if they did consumption would be shifted from one category to another so as to make the curves exactly the same at the margin.

But we know these conditions of perfect markets and rationally self-interested individuals do not apply. For three reasons: **(Exhibit 20)**

- First because some goods are inherently public, or most efficiently produced in a public form, so that the trade off between expenditures has to be a social and political choice as

[17] Richard Layard, *Happiness*, Chapters 11 and 12.

[18] If the reality is that we face a variety of impacts of economic growth – some positive and some negative – the aggregate relationship between income growth and human well being for any one country might be either flat, increasing slightly or declining slightly, depending on the balance of the three factors at work. The empirical evidence for rich developed countries considered in Lecture I (e.g., Exhibits 2 - 10) is compatible with the possibilities that different countries have achieved different measures in the translation of rising income into rising contentment.

well as a private one. How much to spend on school sports facilities, or on attractive public spaces, or on public healthcare?

- Second because people's preferences, which drive the allocation of income to alternative consumption possibilities, are not pure products of a rational satisfaction-maximising process, but deeply influenced by social mores, by herd-like fashions, and by the deliberate efforts of marketing departments and advertising: advertisements which can persuade people to buy things that will not permanently make them happier, or to buy things which make them unhealthy and as a result less happy.

- Third, products and services can produce externalities – my decision to drive along the road imposing a congestion penalty on others which does not enter my individual decision making process.

For those three reasons, we can have no confidence that the fruits of economic growth will actually be used in a way most likely to foster increased life satisfaction – that we will have good growth rather than bad. And public policy has always to a degree recognised that fact.

- We do make public choices which allocate some resources to inherently public amenities and goods.

- We try to contain environmental externalities.

- And the concept of "nudge" is about to enter our pension policy: recognising that people do not make rationally self-interest choices in relation to long term savings, and "nudging them" to do so via auto enrolment into pension savings.[19]

The question is whether we have the balance right, or whether we should adjust it. If the marginal utility schedules are truly shaped as shown on this chart, an omniscient paternalist might devote more resources to those consumption categories that ensure longer life and better health, and seek to limit the more harmful side effects of poor individual choices; through for instance, restrictions or taxes on the advertising of some categories of goods. But the former might require additional taxes or nanny state interventions which many would resent, and the latter would restrict freedom: and we cannot be free to choose without some people making choices they subsequently regret.

So I have no magic answer to the "good growth/bad growth" issue. But simply the conclusion that good economics gives us no magic answer. We have no reason to be certain that the free flow of

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[19] The UK government will introduce in 2012 a policy requiring employers to auto enrol all employees in a pension savings scheme: employees will be able to opt out, but will need to make that conscious decision. The UK Pensions Commission recommended this policy on the basis of insights from behavioural economics (see First Report, November 2005, page 208 - 209)

purely individual market driven choice, operating under the influence of social fashion and self-interested marketing, will produce the allocation of consumption expenditures which maximises life satisfaction. And we cannot therefore escape the need for a continual process of political debate about whether and how we might influence the allocation in a more favourable direction.

(vii) What to do about inequality?

The second difficult rather than clear issue, is what if anything to do about inequality. The instrumental conventional wisdom has justified inequality because and to the extent that it creates incentives which help generate faster growth, which in turn fosters happiness. But if that logic is not correct, what follows?

Well what I am not going to do is attempt a full resolution of that issue – because I don't think that a definite answer is possible, and I certainly do not think that economics provides us with one. Rather I think we have to recognise that issues relating to income distribution, to inequality, are inherently political and judgemental, with economics simply able to point out what is not true and to identify some limits within which the political debate has to proceed.

So what does economics tell us?

- First, I think the economics of happiness, which I considered in Lecture I, tells us that relative income does matter to a significant degree – that people care about relative status competition as well as and perhaps more than absolute income, and that economists interested in understanding end objectives, such as welfare or happiness, need to recognise that fact rather than dismiss it in Martin Feldstein's terms as "spiteful egalitarianism". How much inequality matters and what particular forms of inequality matter can of course be debated. Inequality between the bottom of the income distribution and the middle probably matters a lot: a sense of being excluded from key elements of the majority lifestyle of one's fellow citizens a key barrier to contentment. But extreme and growing equality between the middle and the top probably matters as well. Not perhaps in relation to the very top – the existence of a few billionaires whose lifestyle can be vicariously followed without any particular sense of resentment or exclusion. But, it is I think a reasonable hypotheses, as Pickett and Wilkinson are effectively arguing, that if a large slice of the top decile moves far and further away from the median, (in the UK say several hundreds of thousands or a few millions rather than simply a few thousands), the impact of that highly visible and large income elite on the intensity of status competition, and on the ability of societies to share common concerns and coalesce around collective objectives, may be significant. Certainly there is nothing in economics which excludes that possibility, and it is a crucial issue which we need to understand – particular if, as I argued in Lecture I – the very process of increasing average income may tend to lead naturally to greater inequality at the top end.

- Second, sound economics and social science suggest that there are some apparent answers to the issue of inequality which are not convincing or certainly not in themselves adequate. Three in particular:

  - First that, if inequality is important, its negative impact cannot be overcome by growth in average income alone, since growth in absolute income leaves the intensity of relative income competition unchanged.

  - Second "increasing skills" – the all purpose and all party response to the problem – is unlikely to be sufficient. The skills argument often focuses on the issue of international competition, skilling up our workforce so that a larger percentage of the population can work in high paid internationally competitive sectors – high tech engineering not textile industry manual labour for instance.

    But actually in modern economies only a relatively small percentage of all jobs are found in internationally competitive sectors – and success in those sectors often involves capital intensity, automation, and minimal potential for new employment creation. The vast majority of jobs in a rich developed economy are in non-traded sectors of the economy – retailing, wholesale distribution, leisure, health, education. Only 35,000 people work for Microsoft: over a million for Wal-Mart – "it's <u>not</u> the <u>e</u>-conomy stupid".[20] So the crucial issue is: what determines the relative pay rate of the shelf-stacker in the supermarket versus the top manager of the supermarket chain, a differential which has widened greatly over the last 30 years? And it is not clear that higher skills for the unskilled will change the income differentials resulting from the process of <u>relative</u> skill competition which determines who ends up in what job.[21]

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[20] See Adair Turner, *Just Capital: the Liberal Economy*, Chapter 4, MacMillan 2001.

[21] Skill enhancement might narrow this differential, but through a mechanism different from that often described. Thus rather than the skill enhancement producing a "better more productive shelf stacker", if shelf stackers were trained to a higher level in generic skills potentially applicable to some <u>other</u> higher paid job, this might reduce the pay differential between shelf-stacking and the slightly higher paid job. This would be because the differential would be limited by the potential for companies to employ an <u>adequate</u> alternative for the higher skilled job, rather than pay a higher differential to those <u>best</u> able to perform it. Differentials could thus be reduced not by ensuring that everyone has a "high skilled high paid job" (the standard political statement) but by ensuring that those in lower skilled jobs have sufficient skills that they could adequately perform jobs for which they are not in fact selected (given the presence of people with still higher skills) and thus are at least relevant to equilibrium market price for such jobs. How far this effect operates in a world where skills are not just learnt initially, but systematically refined and developed by doing, is however unclear. Thus while increasing skills to ensure that people have as many chances as possible is for many reasons undoubtedly desirable, we cannot be certain that it will in itself significantly ameliorate rising inequality.

- And thirdly, how about equality of opportunity – removing the unfair influences of inheritance and unequal access to educational and other opportunities? Well, opportunities for all are certainly desirable: but also not a panacea – as Michael Young set out 52 years ago in "The Rise of the Meritocracy"[22], a prescient book which deserves wider reading or re-reading today. There is nothing in the Pickett and Wilkinson analysis or in the economics of happiness which suggest that adverse impacts of relative failure in the competition for relative status would be mitigated by knowing that the fault lay in your genes not in your inheritance.

  So there are no easy escape routes which allow us to avoid the issues of inequality of outcome.

- Third, however, there are some constraints on our ability to offset income and equality through progressive taxation – though not perhaps as extreme, and somewhat different in nature from those which are often proposed. The key constraint often mentioned is the impact on incentives. And incentives do matter even if growth will not deliver permanently increased happiness – without any incentives we would face the economic regression and stagnation of the pure planned economy. But the idea that incentives require lower tax rates for the rich – which only three years ago had some commentators talking excitedly about the merits of a flat income tax – is often hugely overstated. For most of my adult life I have been lucky enough to earn incomes that put me in the highest tax band: that has been first 60%, then 40% and now 50%. Those variations have made no difference whatever to how hard I worked, nor have I observed any change in the work effort of other high paid people around me. For the simple reason, that – insofar as high paid people are driven by income rather than by job status and professionalism per se – they are driven by relative income, since it is relative income which determines their ability to win in the competition for relative status goods and positional goods (above all pleasantly located houses) which account for an increasingly large share of expenditure the richer we become. And income tax rates paid by everyone do not change the relative status pecking order. From an incentives point of view, the range within which variations in progressive income tax make little difference, is wider than often supposed. But other important limits are probably more important: the fact that beyond some level international competition issues could become significant;[23] and that beyond some level tax avoidance activities will proliferate, both because the greater pay off from avoidance will cover the costs of ever more complex devices, and because the higher the rates go,

[22] Michael Young, *The Rise of the Meritocracy*, Penguin 1958.

[23] This is in part because while what matters to high income people is relative rather than absolute income the international relativity may be important: one's ability to afford a pleasant foreign holiday, or to own a house abroad, depends on income relative to others internationally not solely within the domestic economy.

the more people will feel that avoidance is fair. At 50% I am personally quite willing to pay tax as a fair contribution to a society in which I occupy a lucky position: at 80% I will employ very clever tax accountants. Each individual has their own sense of limit: the aggregate combination of those limits is a sliding scale of increasingly effective avoidance.

Which therefore leaves us with no easy definitive answers, but rather the unavoidable issue of what is "fair" and what different people perceive to be fair, operating within an economy where we are free to choose what to consume, where to work and what to purchase. And most people accept some, and indeed significant inequality as fair. Ask people whether they resent the high market value of high artistic or sporting talent and they tend not to: because they can understand what skills delivered that pay. And most people accept that jobs which have high levels of responsibility – so that doing it well or badly can make a big difference to other people's lives – should receive significantly higher pay. And most of us accept that if an entrepreneur has developed a restaurant or restaurant chain, or a hotel, or piece of engineering or software which delights us, that they should receive high return – because the deal feels fair given the benefits we feel we are receiving.

But there are other sources of income – such as from activities perceived to be entirely distributive or rent extracting – which excite resentment. The problem however, as discussed in Lecture I and stressed by Roger Bootle – is that numerous activities throughout the economy are part distributive and part creative, with no clear divide. Most jobs turn out to have both distributive and creative elements. Most successful entrepreneurs end up as rich through a mix of creative and clearly distributive activities. The real estate developer who helps create attractive new urban environments, typically also makes money from clever schemes to maximise tax efficiency and from the clever timing of purchases and sales within the asset price cycle. And competition via distributive activities is part of the process which ensures the success of the most efficient and innovative firms.

So there are no clear answers to the question of how progressive the taxation system should be and no possibility of a tax system ever distinguishing between creative and distributive activities, nor any possibility that we will ever produce an economy in which all activities are in Bootle's terms creative. Instead, only two limited but perhaps still important implications follow.

- The first is that we have to accept the fact that inequality is an inherently political issue, in which notions of "fairness" are bound to play some part, and where the limit set by purely economic considerations do not tightly constrain the range of feasible political solutions.

- Secondly, we should aim to lean against any large and obvious tendencies for the proliferation of purely distributive activities – which as argued in Lecture II, are particularly in danger of developing within the financial sector.

3. THE DISCIPLINE OF ECONOMICS

I began by referring to the dominant conventional wisdom which played a major role in the political discourse of the last three to four decades and had a pervasive influence on public policy choices. I have argued that both as regards objectives – the maximisation of measured GDP – and as regards means – free markets as the universal formula for economic efficiency and growth – the conventional wisdom is either wrong or hugely simplistic, and needs to be rejected.

But does that rejection also imply a rejection of important tendencies in academic economics? Was it the discipline of economics which was at fault? Or should we rather blame simplifications by non-academic users of economics and perversions by lobbying interests, absolving the discipline of economics from any blame. Robert Skidelsky in his brilliant latest book on Keynes *The Return of the Master* argues that our response to the financial crash should involve not just changes in policy but a reconstruction of economics itself. Is that right?[24]

The case for the prosecution of the discipline of economics would go as follows.[25]

For over half a century the dominant strain of academic economics has been concerned with exploring, through complex mathematics, how economically rational human beings interact in markets. And the conclusions reached have appeared optimistic, indeed at times panglossian. Kenneth Arrow and Gerard Debreu illustrated that a competitive market economy with a fully complete set of markets was Pareto efficient.[26] New classical macroeconomists such as Robert Lucas illustrated that if human beings are not only rational in their preferences and choices but also in their expectations, then the macro economy will have a strong tendency towards equilibrium, with sustained involuntary unemployment a non-problem. And tests of the efficient market hypothesis appeared to illustrate that liquid financial markets are not driven by the patterns of chartist fantasy, but by the efficient processing of all available information, making the actual price of a security a good estimate of its intrinsic value.

Economics therefore provided strong support for the proposition that totally free markets achieved the objective of allocative efficiency. And it also tended to assume that allocative efficiency and income growth over time were desirable objectives, that increased income delivered increased _____ which could be equated with life satisfaction. This was in part because any deeper enquiry about the

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[24] See Robert Skidelsky, *The Return of the Master,* Chapter 8, Penguin, 2009.

[25] For a summary of the prosecution case, see Skidelsky and also John Cassidy, *How Markets Fail,* Allen Lane, 2009.

[26] K. Arrow and D. Debreu, op cit.

relationship between income and welfare/happiness would have interfered with mathematical precision, which required a precisely defined maximand.

Now of course, as a description of academic economics, this is not only a simplification but a caricature. Throughout the last half century much of academic economics has been devoted quite explicitly to understanding why and under what conditions these simplistic assumptions do not apply. Kenneth Arrow himself spent much of his career exploring the market imperfections which made his illustration of a Pareto efficient equilibrium inapplicable in the real world. Lancaster and Lipsey illustrated that if some markets were imperfect, then making other markets closer to perfect might not be welfare optimal[27]. George Stigler and others considered the costs of gathering the information required to make markets efficient. Many researchers, including Larry Summers, Jim Poterba and Robert Shiller, found serial correlations and other patterns in share prices which contradicted simple efficient market hypotheses. All economic textbooks included taxonomies of potential market failure, which might justify policy interventions such as pollution taxes and provision of public goods. And, more fundamentally, the work of Nobel laureates such as James Mirrlees, Joe Stiglitz and George Akerlof, illustrated that once we really understand the implications of information economics, markets can settle far from an efficient equilibrium, and equilibria can be multiple and fragile. While the work of the behavioural economists – such as Daniel Kahneman, also awarded a Nobel prize – questioned the very assumption of rational choice, of a *homo economicus* driven solely by the parts of his brain devoted to rational information processing. Finally, the work of Nobel laureate Amartya Sen and others kept alive questions about whether we were right to assume that culmination outcomes are the sole objectives of economics and whether these could be adequately measured by GDP.

So economics has not been monolithic: it has explored complexities and made assumptions clear; it has produced multiple schools of thought. And the most prestigious prizes have gone to people of strongly opposing views; and some of those views help us understand why the financial crisis occurred and lead us to question the conventional definition of income maximisation as the overriding objective.

So if there has been such diversity, do we really need as Skidelsky argues to “reconstruct economics”? Well, my conclusion is that we do need to. Because the fact remains that while academic economics included many strains, in the translation of ideas into ideology, and ideology into policy and business practice, it was one oversimplified strain which dominated in the pre-crisis years, and that domination, while partly a perversion and simplification of economics, was also based on some dangerous tendencies within the dominant strain of economics itself.

Keynes, of course, famously wrote that *‘the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than commonly understood. Practical*

[27] Richard Lipsey and Kelvin Lancaster, *The General Theory of the Second Best,* Review of Economic Studies, 1956

men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economis"'. But I suspect the greater danger lies not with entirely practical men or women exempt from any intellectual influence, but with the reasonably intellectual men and women who are employed in the policymaking functions of central banks, regulators and governments and in the risk management departments of banks, who are aware of intellectual influences, but who tend to gravitate to simplified versions of the dominant beliefs of economists who are not yet defunct but still very much alive.

For what is striking is how the original insights of Arrow-Debreu – precise, mathematical, and limited in their implications by the limits of their assumptions – did, once simplified and shed of their complexity, appear to provide support for the conventional wisdom.

Three steps were required to turn the precision of Arrow-Debreu into the simplification of the conventional wisdom. Partly, that simplification was political, but part I think we should recognise it as an almost inherent product of dominant tendencies and methodological assumptions within academic economics itself **(Exhibit 23)**.

- The first of the three simplifications was to down-play the severity of the market imperfections which prevent the attainment of the Arrow-Debreu equilibrium. All economists and policy makers recognise for instance that financial markets are not perfect. But the dominant policy response, pursued for instance by institutions like the FSA, very clearly focussed on identifying and seeking to rectify those specific imperfections, such as inadequate information disclosure, which seemed to prevent the attainment of market completion and perfection. The insights of Keynes and Frank Knight relating to the role of inherent irreducible uncertainty; of Stiglitz relating to information deficiencies so deep that equilibria are inherently fragile; or the insights of Kahnemann about the part rational, part irrational nature of human mental processes were far less influential in the policy mainstream. And that does, I think in part, reflect the dominance of mathematics, the tendency to gravitate to assumptions which allowed mathematical tractability – which allowed "the construction of a mechanical artificial world populated by interacting robots" which, in Robert Lucas' words – "economics typically studies".

- The second simplification was to forget that the Arrow-Debreu equilibrium is merely Pareto optimal, not socially optimal, and that social optimality might require redistribution of the end results. Here perhaps the blame does lie with those who thought that they were using economics rather than with economists themselves. But what is I think striking is how frequently the simplifications are made even by those who one would hope were reasonably informed about the findings of good economics. In journals of the quality of the Financial Times or The Economist one often finds phrases like "immigration is in everyone's interest" or "free trade is clearly beneficial for society". But that is very definitely not what economics tells us: it tells us that free movement of factors of productions can take us

closer to a Pareto optimal which might be able to increase everyone's disposable income if but only if distributional consequences were offset by required redistribution.

- Finally, simplification three took us from the Arrow-Debreu illustration of a competitive equilibrium which most efficiently satisfies a given preference set at a particular time, to statements of the character "market liberalisation will drive national competitiveness and growth, which are the objectives of economic activity". There is no logical sequitur in this translation: to proceed from one to the other, we would first need to introduce a discussion of end objectives, and of the relationship between income, wealth, utility and happiness. And almost all economists would justifiably absolve themselves of having suggested that growth was the end objective.[28] But most non-economists would, I suspect, believe that most economists did define economic growth as the objective. And that surely in part reflects the tendency of the mathematics of economics to squeeze out enquiry about what the objectives should be.

I therefore end up agreeing with Robert Skidelsky that we need not only to reject the simplifications of the dominant conventional wisdom as a perversion of good economics, but to reconstruct the way in which economics is taught and practised in two key respects:

- First, it is essential that good economics deals with the real world as it is, **(Exhibit 24)** and in particular with human beings as they actually are, and does not, for the sake of mathematical tractability simply assume the existence of a rational *Homo Economicus*.

    - It must not assume that additional income will, even if to a marginally declining extent, increase utility or happiness: it has to concern itself with the mathematically and empirically imprecise but important issues of how happiness, welfare, utility and income are defined and related. And with the imperfect and judgmental techniques required if we are to attempt the measurement of possible end objectives, such as life satisfaction and happiness.

    - It must not assume that people participating in financial markets make rational assessments of future probabilities of potential outcomes, but instead

[28] At very least all economists, even if willing to assume that further increments of money income must convert into additional aggregate utility, recognise a trade off which individuals make between additional leisure and additional income. As a result while some professional economists might be willing to define the maximisation of GDP per hour worked as a reasonable end objective, none should be willing to support making maximisation of GDP per capita the explicit objective except when hedged round with suitable reservations. In the translation to "practical men" economics, however, it is GDP per capita (or even aggregate notional GDP) which tends to be assumed as the end objective.

seek to understand how different people actually make decisions in different circumstances, given a human brain endowed by our genetic inheritance with both ratiocinating and instinctive elements.

- And it must face head on the problems of Knightian/Keynesian inherent irreducible uncertainty, recognising that the assumption that the expectations of economic agents are distributed around the objective probability distribution of future outcomes is a philosophical category error, since no probability of future outcomes objectively exists.

So economics has to deal with the world as it is, not as economists have assumed it to be, in order to make the maths tractable.

- But second, it is important that economics recognises the importance of political, philosophical and ethical issues, to which mathematics is incapable of giving precise answers. There is no precise answer to the question what is the optimal degree of inequality – it is an issue of politics. And the case for the market economy which, as Amartya Sen says, has been predominantly presented in terms of income maximisation outcomes – "culmination outcomes" as he labels them – should also be one focused on freedom as an end per se. John Hicks, despite being a key figure in the development of mathematical and outcomes-oriented economics, noted that *"the liberal principles of the classical "Smithian" or "Ricardian" economists were not, in the first phase, economic principles; they were an application to economics of principles which were thought to apply in a much wider field. The contention that economic freedom made for economic efficiency was no more than a secondary support"*.[29]

  A key deficiency in the conventional wisdom is that it has focussed increasingly and almost exclusively on this secondary support, even as increasing prosperity has made further improvements in economic efficiency less certainly important to human welfare.

Economics therefore does need to return to the wider focus familiar to Smith, Hume, Ricardo or Keynes, and to treat human beings as they are, not as we wish to model them. Which does, as Robert Skidelsky argues, suggest that we should accept Keynes' dictum that "economics is a moral and not a natural science". That "no part of man's nature or his institutions must be entirely outside [the economist's] regard" and that the economist should be "mathematician, historian, statesman and philosopher in some degree." Though I have always suspected that when Keynes wrote those final words, he assumed that only one person would ever fully reach that high standard.

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[29] J R Hicks, Wealth and Welfare, (Oxford: Basil Blackwell) P138.

What this raises however is the interesting question: what would Lionel Robbins, in whose honour these lectures are given, have made of this call for a wider, more behavioural, more judgemental, less mathematical and more political economics? The predominant assumption is that he wouldn't have agreed at all **(Exhibit 25)**.

"Economics deals with observable facts" he wrote: "ethics with valuations and obligations. The two fields of enquiry are not on the same plain of discourse". And when Keynes argued that "economics is essentially a moral science" he started the sentence "As against Robbins".

Robbins' economics, and his philosophy of economics set out in the 1932 essay "On the Nature and Significance of Economic Science" was indeed precise, mathematical and somewhat conservative in its political tendency. His essay includes for instance a direct attack on the proposition, which Richard Layard has supported in his book on "Happiness", that we can infer from the existence of declining marginal utility, a case for progressive income redistribution. That proposition Robbins asserts "rests upon the extension of the concept of diminishing marginal utility into a field in which it is entirely illegitimate". [30]

But what is interesting in reading Robbins' essay, is that its rigorous definition of what economics, as he defined it, could and could not say, would if more closely followed have helped guard against the simplification of economic propositions into the instrumental conventional wisdom.

For to Robbins, the same logic which says that we cannot use marginal utility schedules to justify redistribution also tells us that we should be very wary of drawing <u>any</u> significant inferences from aggregate calculations of national income, a technique then in early stages of development. He was clear that "both the concept of world money income and of national money income have strict significance only for monetary theory".[31] A conclusion consistent with my own in this Lecture – that calculations of GDP quarter-by-quarter or year-by-year can usefully inform the important decisions we need to make in order to stabilise the economy, but that the assumption that a long term increase in GDP per capita implies something for welfare or happiness, ignores the numerous conventions and assumptions necessary for its calculation.

A similar logic, moreover, guarded Robbins against any assumption that propositions related to equilibrium and allocative efficiency carried any implications for whether a competitive equilibrium was in some ultimate sense a socially good result: "There is no penumbra of approbation around the theory of equilibrium. Equilibrium is just equilibrium".[32]

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[30] Robbins, *Essay,* Page 137

[31] Robbins, *Essay*, page 57

[32] Robbins, *Essay,* page 131

Robbins was therefore very clear that once you had defined the science of economics in the narrow sense which he preferred, economists who wished their analysis to have real world application would have to be willing to engage in wider debates. "It is highly desirable that the economist who wishes that the applications of his science should be fruitful should be fully qualified in cognate disciplines and should be prepared to invoke their assistance".[33] As a result while Robbins did not fully agree with John Stuart Mills' assertion that "A man is not likely to be a good economist if he is nothing else" he did agree that such an economist would be unlikely to be very useful.

What Robbins was therefore arguing for was very definitely not an economics which could acquiesce in the translation from the precision of Arrow-Debreu to an unlimited faith in free markets as the means and growth maximisation as the objective. Rather he was arguing for an economics profoundly aware of the very narrow range of questions to which it was capable of providing answers.

In which case the distinction between the Keynes/Skildesky point of view and that of Robbins is less extreme then it might at first appear.

- Either we say with Keynes/Skildesky that the economist must be "mathematician, historian, statesman and philosopher in some degree".

- Or we say with Robbins that economics should be defined in a very precise and narrow sense, and should be humble about the very limited range of questions to which it can in itself give answers, recognising that it needs to combine with other disciplines if we wish to address really important and difficult issues about social objectives and how to achieve them.

Either way I think that leads us to Robert Skidelsky's conclusion that we should be very wary of teaching and practising economics as a narrowly defined discipline unconnected to others.

And either way it says that public policy should never be based on the delusion that there is a corpus of mathematically precise economics which provides either a definition of desirable objectives or certainty as to the means by which to achieve them. We need to recognise that economic policy choices are political rather than narrowly economically in nature. "There is nothing in economics" wrote Lionel Robbins "which relieves us of the obligation to choose".[34] Too many policy makers and politicians who at least thought they were drawing on the insights of economists, forgot or chose to ignore that fact in the several decades of conventional wisdom and apparent certainty which led up to the financial crisis.

END

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[33] Robbins, *Essay,* page150

[34] Robbins, *Essay,* page 152