

BBC Reith Lecture

The Rule of Law and its Enemies - The Human Hive

Professor Niall Ferguson

Laurence A. Tisch Professor of History, Harvard University

London School of Economics and Political Science

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Sue Lawley: Hello and welcome to the London School of Economics and Political Science – to the first of the 2012 Reith Lectures. Our lecturer this year is Niall Ferguson, an historian who enjoys using his analysis of the past to explain where we might be heading in the future. A native of Glasgow, and now professor of history at Harvard, and a fellow of Jesus College, Oxford, his books and television programmes on economic and financial history, and history of empires, are entertaining, and they are controversial.

In these lectures, he is going to explore the rule of law and its enemies, asking has the triumphant growth of western civilisation over the past 500 years has now reached a point of decline. And if it has, how much of that is due to the weakening of the institutions, which he believes created and drove that growth in the first place.

We should expect a few fireworks, because Niall Ferguson is not frightened of creating a stir. “What the media want,” he said “from a public intellectual is someone is absolutely certain of his views – and I can do that. But as a teacher my strategy is to encourage questioning.”

Well, here at the LSE we have an audience of historians and economists, both students and experts, ready to question him once he's delivered the first of his four lectures. It's called The Human Hive – ladies and gentlemen, please welcome Niall Ferguson.

Audience applause

Niall Ferguson: Let me begin by saying what a great honour it is to be invited to give these lectures, named after another greater Glasgow Academical, who also believed that British broadcasting should aim to educate, inform and entertain.

Introduction

“Nature is a thyng of great myghte and efficacye,” wrote the English humanist Richard Taverner in his ‘Garden of Wysdom’, “but surely institution or bringynge up, is moche myghtier.” Taverner’s words sum up what is fast becoming a compelling consensus: that institutions, in the broadest sense of the term, determine modern historical outcomes, more than natural forces like the weather, geography or even the incidence of disease.

Why, after around 1500, did Western civilisation – as found in the quarrelsome petty states of Western Eurasia and their colonies of settlement in the New World – fare so much better than other civilisations? From the 1500s until the late 1970s, there was an astonishing divergence in global living standards, as Westerners became far richer than, well, Resterners. Five hundred years ago, the average Chinese was probably a bit better off than the average North American. By 1978, the average American was at least 22 times richer than the average Chinese.

History’s ‘great divergence’ was not just economic. It was also a divergence in terms of longevity and health. As recently as 1960, life expectancy in China was in the low 40s, whereas already in the United States it had reached 70. Westerners dominated the realm of science, as well as that of popular culture.

How are we to explain this, the ultimate global imbalance, which placed a minority of mankind – at most a fifth – in such a position of material and political superiority over the rest? It seems implausible that it was due to some innate superiority of Europeans, as the racial theorists of the 19th and 20th Century often argued. The gene pool was surely not so different in the year 500, when the Western end of Eurasia was entering a period of nearly a thousand years of relative stagnation. Likewise, the climate, topography and natural resources of Europe were much the same in 1500 as they had been in 500. It cannot have been imperialism either. The other civilisations did plenty of that.

I believe the best answers to the question of what caused the great divergence focus on the role of institutions. For example, Douglass North, John Wallis and Barry Weingast distinguish between two phases or patterns of human organisation. The first is what they call the natural state or ‘limited access pattern’, characterised by:

- a slow-growing economy;
- relatively few non-state organisations;
- a small and quite centralised government, operating without the consent of the governed; and
- social relationships organised along personal and dynastic lines, which means that laws are enforced unequally.

The second is the 'open access pattern', which they say is characterised by:

- a faster growing economy;
- a rich and vibrant civil society with lots of organisations;
- a bigger, but decentralised government; and
- social relationships governed by impersonal forces like the rule of law, involving secure property rights, fairness, and (at least in theory) equality.

In their account, West European states – led by England – were the first to make the transition from 'limited access' to 'open access'.

In their book *Why Nations Fail*, Daron Acemoglu and Jim Robinson make a striking comparison between Egypt today and England in the late 17th Century:

"The reason that Britain is richer than Egypt, they write, is because in 1688, England... had a revolution that transformed the politics and thus the economics of the nation. People fought for and won more political rights and used them to expand their economic opportunities. The result was a fundamentally different political and economic trajectory, culminating in the Industrial Revolution."

In their terms, England was the first country to move to having 'inclusive' or 'pluralistic' rather than 'extractive' political institutions. Note that other West European societies – notably Spain – failed to do this. As a result, the outcomes of European colonisation in North and South America were radically different. The English exported inclusive institutions; the Spaniards were content to superimpose their extractive ones on top of those they took over from the Aztecs and Incas.

The debate that I'm summarising about the causes of the great divergence is of more than merely historical interest. Understanding Western success helps us to frame some rather more urgent questions about the recent past, the present and possible futures. One reason the institutional argument is so compelling is that it also seems to offer a good explanation for the failure of so many non-Western countries, until recently, to achieve sustained economic growth. Acemoglu and Robinson illustrate the power of institutions relative to geography and culture by describing the city of Nogales, which is bisected by the U.S.- Mexican border. The difference in living standards between the two halves is shocking.

Development economists – I think especially of Oxford's Paul Collier – have been thinking in these terms for some time. The case of Botswana seems to illustrate the point that even a sub-Saharan African economy can achieve growth if its people are not plagued by chronic corruption and/or civil war like, say, the Democratic Republic of Congo.

The Peruvian economist Hernando de Soto is another who has been arguing for years that institutions are what matter.

Since de Soto published *The Mystery of Capital*, revolutions in countries like Tunisia and Egypt have provided compelling evidence in support of his approach. He sees the 'Arab Spring' primarily as a revolt by frustrated would-be entrepreneurs against corrupt, rent-seeking regimes that preyed on their efforts to accumulate capital.

The prime example is the story of the 26-year-old Tarek Mohamed Bouazizi, who burned himself to death in front of the governor's offices in the town of Sidi Bouzid last December 2010. Bouazizi killed himself precisely an hour after a policewoman, backed by two municipal officers, had expropriated his two crates of pears, a crate of bananas, three crates of apples and a second-hand electronic weight scale worth around \$180. Those scales were his only capital. His self-immolation sparked a revolution – though how glorious a revolution remains to be seen. It will depend on how far new constitutional arrangements in countries like Tunisia and Egypt achieve the shift from an extractive to an inclusive state; from the arbitrary power of rent-seeking elites to the rule of law for all.

If de Soto's approach is right, then it does make a great deal of sense to explain the success of the West after the 1500s in terms of institutions, and particularly the rule of law. For what was at the heart of England's 17th Century battles over parliamentary power was surely the protection of individuals from arbitrary expropriation by the Crown. To the specialist historians, of course, all this smacks suspiciously of the old Whig interpretation of history that Herbert Butterfield once held up to ridicule.

The Glorious Revolution, they argue, was backward looking, or 'conservationist', with minimal consequences outside the narrow sphere of aristocratic power and patronage. I think this is too parochial a view.

True, those 'rights and liberties of the subject' set out in the 1689 Bill of Rights were conceived at the time as ancient rather than novel. But the consequences of the Glorious Revolution really were new, not least in the way parliaments after 1689 set about energetically legislating for economic development; protecting the infant textile industry; encouraging the enclosure of common land; promoting turnpike roads and canals. Even war became an increasingly profitable activity as the Whigs launched their bid for global commercial supremacy. The sequence is clear: first the Glorious Revolution, then agricultural improvement, then imperial expansion, then industrial revolution.

The institutional approach is even more compelling, I think, when we take a comparative perspective. None of the institutional changes I am talking about happened in Ming or Qing

China, where the power of the Emperor and his officials remained unrestrained by semi-autonomous corporate bodies much less representative assemblies.

Asia had merchants. It did not have companies, nor parliaments. Institutions as they evolved in the Ottoman Empire were also significantly different in ways that hampered capital formation and economic development, as Timur Kuran has recently argued. This was because Islamic law took a fundamentally different approach to partnership, inheritance, questions of debt and corporate personalities from the legal systems that developed in Western Europe.

In these lectures, I want to do nothing more or less than to apply the insights of the institutional school of economic history to our own time - indeed, to our own Western societies. Writing in the 1770s, it seemed obvious to Adam Smith that the reasons for China's puzzling 'stationary state' of economic stagnation lay in its 'laws and institutions'. Could it be, by the same token, that the economic, social and political difficulties of the Western world today reflect some deterioration in our once world-beating institutions?

There certainly seems little doubt that the West is experiencing a relative decline unlike anything we have seen in half a millennium. Having been more than twenty times richer than the average Chinese in 1978, the average American now finds himself just five times richer.

According to the International Monetary Fund, China's GDP could overtake that of the United States in just four years' time.

Now in some ways, it is easy to explain non-Western success. China has belatedly followed a number of other East Asian countries – the first was Japan – in downloading most (not all) of what I have called the 'killer applications' of Western civilisation: economic competition; the scientific revolution; modern medicine; the consumer society and the work ethic.

Copying the Western model of industrialisation and urbanisation tends to work if your entrepreneurs have the right incentives, your labour force is basically healthy, literate and numerate, and your bureaucracy is reasonably efficient and not too corrupt. So, in these lectures I am going to say relatively little about what has gone right in the rest of the world. What interests me here is what has gone wrong in the West.

Most commentators who address that question tend to concern themselves with phenomena like excessive debt, mismanaged banks, widening inequality – that sort of thing. To my mind, however, these are nothing more than symptoms of an underlying institutional malaise - an Inglorious Revolution, if you like, which is undoing the achievements of half a millennium of Western institutional evolution.

The title of this lecture – ‘The Human Hive’ – is an allusion to the early 18th Century satirist Bernard Mandeville’s poem, *The Fable of the Bees*. Mandeville’s central point was that societies with the right institutions can flourish even when the individuals who live in them misbehave. It was not Biblical virtue that made 18th Century England richer than almost anywhere in the world, but rather secular vices. It was just that these vices had what economists like to call pretentiously ‘positive network externalities’ - precisely because the institutions of British society at that time were favourable to saving, investment and innovation.

After the Glorious Revolution of 1688, as we have seen, the monarch was subordinated to parliament. Not only did the Whigs who dominated the new regime usher in an age of agricultural and commercial improvement - not to mention imperial expansion - financial institutions also developed rapidly. William of Orange brought more than just Protestantism with him from Holland; he also brought templates for a central bank and a stock market. Meanwhile, numerous associations, societies and clubs encouraged scientific and technological innovation. But the institutions provided the indispensable framework for all this. Here is Mandeville’s version:

A Spacious Hive well stock’d with Bees,

That lived in Luxury and Ease;

And yet as fam’d for Laws and Arms,

As yielding large and early Swarms;

Was counted the great Nursery

Of Sciences and Industry.

No Bees had better Government,

More Fickleness, or less Content.

They were not Slaves to Tyranny,

Nor ruled by wild Democracy;

But Kings, that could not wrong, because

Their Power was circumscrib’d by Laws.

There was one particular institution that really altered the trajectory of English history. In a seminal article published in 1989, North and Weingast argued that the real significance of the Glorious Revolution lay in the credibility that it gave the English state as a sovereign borrower.

From 1689, Parliament controlled and improved taxation, audited royal expenditures, protected private property rights and effectively prohibited debt default. This arrangement, they argued, was 'self-reinforcing', not least because property owners were overwhelmingly the class represented in Parliament. As a result, the English state was able to borrow money on a scale that had previously been impossible because of the sovereign's habit of defaulting or arbitrarily taxing or expropriating. The late 17th and early 18th Century thus ushered in a period of rapid accumulation of public debt without any rise in borrowing costs – rather the reverse.

This was in fact a benign development. Not only did it enable England to become Great Britain and, indeed, the British Empire, by giving the English state unrivalled financial resources for making – and winning – war. By accustoming the wealthy to investment in paper securities, it also paved the way to a financial revolution that would channel English savings into everything from canals to railways, commerce to colonisation, ironworks to textile mills. Though the national debt grew enormously in the course of England's many wars with France and others, reaching a peak of more than 260 per cent of GDP in the decade after 1815, this leverage earned a handsome return, because on the other side of the balance sheet, acquired largely with a debt-financed navy, was a global empire. Moreover, in the century after Waterloo, the debt was successfully reduced with a combination of sustained growth and primary budget surpluses. There was no default. There was no inflation. And Britannia bestrode the globe.

In this lecture I want to make an argument about our modern representative government – and what ails it. My starting assumption is the conventional one - that it is generally better for government to be in some way representative of the governed, than not.

But the critics of Western democracy are right to discern that something is amiss with our political institutions. The most obvious symptom of the malaise are the huge debts we have managed to accumulate in recent decades, which, unlike in the past, cannot largely be blamed on wars. According to the International Monetary Fund, the gross government debt of Greece this year will reach 153 per cent of GDP. For Italy the figure is 123, for Ireland 113, for Portugal 112 and for the United States 107. Britain's debt is approaching 88 per cent. Japan – a special case as the first non-Western country to adopt Western institutions – is the world leader, with a mountain of government debt approaching 236 per cent of GDP - more than triple what it was twenty years ago.

Now often these debts get discussed as if they themselves are the problem, and the result is a rather sterile argument between proponents of 'austerity' and 'stimulus'. I want to suggest that they are a consequence of a more profound malfunction.

The heart of the matter is the way public debt allows the current generation of voters to live at the expense of those as yet too young to vote or as yet unborn. In this regard, the statistics

commonly cited as government debt are themselves deeply misleading, for they encompass only the sums owed by governments in the form of bonds. The rapidly rising quantity of these bonds certainly implies a growing charge on those in employment, now and in the future, since – even if the current low rates of interest enjoyed by the biggest sovereign borrowers persist – the amount of money needed to service the debt must inexorably rise. But the official debts in the form of bonds do not include the often far larger unfunded liabilities of welfare schemes like – to give the biggest American programs – Medicare, Medicaid and Social Security.

The most recent estimate for the difference between the net present value of federal government liabilities and the net present value of future federal revenues is \$200 trillion - nearly thirteen times the debt as stated by the U.S. Treasury. Notice that these figures, too, are incomplete, since they omit the unfunded liabilities of state and local governments, which are estimated to be around \$38 trillion. These mind-boggling numbers represent nothing less than a vast claim by the generation currently retired or about to retire on their children and grandchildren, who are obligated by current law to find the money in the future, by submitting either to substantial increases in taxation or to drastic cuts in other forms of public expenditure.

In his *Reflections on the Revolution in France* (1790) Edmund Burke wrote that the real social contract is not Rousseau's contract between the sovereign and the people or 'general will', but the 'partnership' between the generations. In his words:

"... One of the first and most leading principles on which the commonwealth and the laws are consecrated is, lest the temporary possessors and life-renters in it, unmindful of what they have received from their ancestors or of what is due to their posterity, should act as if they were the entire masters, that they should not think it among their rights to cut off the entail or commit waste on the inheritance by destroying at their pleasure the whole original fabric of their society, hazarding to leave to those who come after them a ruin instead of an habitation — and teaching these successors as little to respect their contrivances as they had themselves respected the institutions of their forefathers.

"Society," says Burke, "is indeed a contract. The state ... is ... a partnership not only between those who are living, but between those who are living, those who are dead, and those who are to be born."

In the enormous inter-generational transfers implied by current fiscal policies we see a shocking and perhaps unparalleled breach of precisely that partnership.

I want to suggest that the biggest challenge facing mature democracies is how to restore the social contract between the generations. But I recognize that the obstacles to doing so are daunting. Not the least of these is that the young find it quite hard to compute their own long-term

economic interests. It is surprisingly easy to win the support of young voters for policies that would ultimately make matters even worse for them, like maintaining defined benefit pensions for public employees. If young Americans knew what was good for them, they would all be in the Tea Party.

A second problem is that today's Western democracies now play such a large part in redistributing income that politicians who argue for cutting expenditures nearly always run into the well-organised opposition of one or both of two groups: recipients of public sector pay and recipients of government benefits.

Is there a constitutional solution to this problem? The simplistic answer – which has already been adopted in a number of American states as well as in Germany – is some kind of balanced budget amendment, which would reduce the discretion of lawmakers to engage in deficit spending, much as the practice of giving central banks independence reduced lawmakers' discretion over monetary policy. The trouble is that the experience of the financial crisis has substantially strengthened the case for using the government deficit as a tool to stimulate the economy in times of recession.

Last year, following a German lead, continental European leaders sought to solve that problem by resolving to limit only their structural deficits, leaving themselves room for manoeuvre for cyclical deficits as and when required. But the problem with this 'fiscal compact' is that only two eurozone governments are currently below the mandated 0.5 per cent of GDP ceiling, most have structural deficits at least four times too large, and experience suggests that any government tries seriously to reduce its structural deficit ends up being driven from power.

It is perhaps not surprising that a majority of current voters should support policies of intergenerational inequity, especially when older voters are so much more likely to vote than younger voters. But what if the net result of passing the bill for baby-boomers' profligacy is not just unfair to the young but economically deleterious for everyone? What if uncertainty about the future is already starting to weigh on the present?

It seems as if there are only two possible ways out of this mess. In the good but less likely scenario, the proponents of reform succeed, through a heroic effort of leadership, in persuading not only the young but also a significant proportion of their parents and grandparents to vote for a more responsible fiscal policy. As I have already explained, this is very hard to do. But I believe there is a way of making such leadership more likely to succeed, and that is to alter the way in which governments account for their finances.

The present system is, to put it bluntly, fraudulent. There are no regularly published and accurate official balance sheets. Huge liabilities are simply hidden from view. Not even the current income

and expenditure statements can be relied upon in some countries. No legitimate business could possibly carry on in this fashion. The last corporation to publish financial statements this misleading was Enron.

There is in fact a better way. Public sector balance sheets can - and should be - drawn up so that the liabilities of governments can be compared with their assets. That would help clarify the difference between deficits to finance investment and deficits to finance current consumption. Governments should also follow the lead of business and adopt the Generally Accepted Accounting Principles. And, above all, generational accounts should be prepared on a regular basis to make absolutely clear the inter-generational implications of current policy.

If we do not do these things – if we do not embark on a wholesale reform of government finance – then I am afraid we are going to end up with the bad, but more likely, second scenario. Western democracies are going to carry on in their current feckless fashion until, one after another, they follow Greece and the other Mediterranean economies into the fiscal death spiral that begins with a loss of credibility, continues with a rise in borrowing costs, and ends as governments are forced to impose spending cuts and higher taxes at the worst possible moment. In this scenario, the endgame involves some combination of default and inflation. We all end up as Argentina.

There is, it is true, a third possibility, and that is what we now see in Japan and the United States, and maybe also the United Kingdom. The debt continues to mount up. But deflationary fears, central bank bond purchases and flight to safety from the rest of the world keeps government borrowing costs down at unprecedented lows. The trouble with this scenario is that it also implies low to zero growth over decades: a new version of Adam Smith's stationary state - only now it is the West that is stationary.

As our economic difficulties have worsened, we voters have struggled to find the appropriate scapegoat. We blame the politicians whose hard lot it is to bring public finances under control. But we also like to blame bankers and financial markets, as if their reckless lending was to blame for our reckless borrowing. We bay for tougher regulation, though not of ourselves. And this brings me to the subject of my second lecture. In it, I shall turn from the realm of politics to the realm of economics – from the human hive of democracy to the Darwinian jungle of the market – to ask if here, too, we are witnessing a tendency towards institutional degeneration in the Western world.

The rule of law has many enemies, as we shall see. But among its most dangerous foes are the authors of very long and convoluted laws.

Thank you very much

Audience applause

SUE LAWLEY: Niall Ferguson thank you very much for that...

NIALL FERGUSON: ...I hope you didn't come expecting jokes tonight.

SUE LAWLEY: <Laughs> Now we have with us here at The London School of Economics an invited audience of people with a keen interest in history, economics and politics, you won't be surprised to hear. So let's now explore with them your analysis of Western dominance, the institutions you say are the backbone of our democracy, and the heroic effort of leadership you say, that we need to get us out of this economic mess. Now who will ask the first question?

STEVE CRAWSHAW: My name is Steve Crawshaw from the International Secretariat of Amnesty International. It was interesting to hear you make the argument that 1688 was such a powerful, important moment. That was, after all, more than three hundred years ago. And especially in an internet world, is it difficult, is it possible, is it reasonable to expect people all around the world to somehow be able to catch up on those three hundred years so quickly when they're seeing what else can be achieved elsewhere?

SUE LAWLEY: Do you mean the countries of the Arab Spring, or others too? China, for example?

STEVE CRAWSHAW: Yes, I mean to give two particular examples - both Egypt and China I was thinking of - both of those places are places where the rule of law even since the Arab Spring, the rule of law is not there sufficiently, to put it very mildly, in both of those countries. In China, you may have the affluence, but you don't have the rule of law.

SUE LAWLEY: Niall?

NIALL FERGUSON: Well these are issues that I'll return to in the course of the lecture series and they're very much in my mind right now. Let's begin with North Africa. De Soto's work on Egypt, in particular, set the scene for me because he identified very clearly what was dysfunctional about the Mubarak regime. It perfectly fits the Acemoglu-Robinson model of an extractive regime that keeps all the fruits of growth in the hands of a tiny elite and you begin to understand the motivation for the revolutionaries when you think about it in those terms.

I think it was Mark Malloch-Brown who spotted somewhere some graffiti in Libya just before Gaddafi's final demise, which he translated as 'we want institutions'. I got hold of the photograph and it was actually slightly more precise than that. It was something like 'we want constitutional government and a four-term presidency' and further details - not the kind of graffiti I've ever seen in Glasgow, it must be said. (Audience Laughter) But that's because they don't need it there and they do in North Africa. So, part of what is going on at the moment there is a huge struggle to see

whether those constitutional ambitions, which are clearly fresh in the minds of those who made the revolution, can be fulfilled.

China is a whole different story because there it's very much a debate within the party elite about how far the party should subordinate itself to the rule of law. And the fall of Bo Xilai, which has been the big story of the year in China, is all about that because he really overstepped the mark in terms of official corruption/extortion/homicide – suspected, alleged homicide (Audience Laughter) Quickly added! What we are going to see in China in the course of this year is whether or not the proponents of a rule of law model prevail.

SUE LAWLEY: Okay, question here.

EDWARD LONGINOTTI: Edward Longinotti, student of Economic History at LSE. The institutional argument does seem to beg the question: why do efficient economic institutions evolve? Why did Britain have the Glorious Revolution in 1688, and not Spain? Because surely the people that lived in Spain, the coercive and arbitrary intervention of authority was equally unsettling. It meant that they couldn't plan their economic lives and there would have been equal incentives for them to restrain that power, and yet it didn't happen there. Is there a general rule for institutional formation or do we have to sort of resort to a rather unsatisfying combination of contingent historical factors?

NIALL FERGUSON: I think there's nothing unsatisfying about contingency in history, Edward. In fact it's part of what makes history more interesting than social science. In the end ... (Audience Laughter) Couldn't resist it! In the end there's a significant amount of luck and happenstance involved in what happens in England. It was by no means inevitable that the settlement of 1689 would endure. I mean the repeated attempts to overthrow it, the last was in 1745.

One of the big problems with the argument that's been made by people like Doug North and Barry Weingast is it significantly underestimates the risk that the whole thing would have simply failed; and certainly if you were an investor in the national debt, you must have had some pretty sweaty palms at around the time of the Jacobite risings. So no, I'm not unsatisfied about the role of contingency. There was a great deal of luck and the law of unintended consequences playing a role here.

SUE LAWLEY: Let's come up to date from the Glorious Revolution to what you call the "Inglorious Revolution", and you've talked about the deterioration of our own institutions today - once world beating, you said, but now going to pot from what you were saying. Give us some examples. Which institutions are you pointing at?

NIALL FERGUSON: Well in the course of the series, I'm going to be looking not only at the problem of public finance, which is where I've started, but also I want to explore the increasing complexity and the dysfunctional complexity of economic regulation. That will really be the theme of the next lecture. On both sides of the Atlantic, we are creating complexity upon complexity, and if one looks back at the straightforward propositions in Walter Bagehot's 'Lombard Street' - perhaps the best book ever written on financial regulation - you find yourself thinking 'if only we could get back to that kind of clarity'.

I'll also be talking in the third lecture about why the rule of law, narrowly defined in terms of the experience of litigation, has become so very disagreeable. I don't know if anybody in the audience has had the experience of actually dealing with the law in recent years. Was it fun? Did you love it? Would you like to do it again? I doubt it. And the reason is that - and this is a really important way of answering your question, Sue - that I think the rule of law has degenerated in some subtle ways, to the point that one reads Charles Dickens' account of Chancery in Bleak House and thinks, 'wow, that seems familiar, I think I just had that happen to me!'

SUE LAWLEY: It's labyrinthine, expensive and perpetual, huh?

NIALL FERGUSON: Right. (Sue Lawley laughs) Yes. That's ... I think that's even ... an even bigger problem in the United States than here, before any lawyers start to throw things at me. I think the problem in the United States is such that one can say they no longer have the rule of law there. They have the rule of lawyers, which is very different.

SUE LAWLEY: I'm going to come to a woman on the third row there.

ROS KELLY: Thank you. My name is Ros Kelly. I was Environment Minister in Australia. So I just want to follow that point through. Do you think if we're going to be fair to next generations, do we have to put a proper price on environmental pollution and carbon taxes, etcetera?

NIALL FERGUSON: There's no question that any serious system of public financial accounting, and indeed private financial accounting, needs to take into account the kinds of depreciation that are associated with environmental degradation. The really obvious point which you will have dealt with but people here probably haven't thought so much about is that if a country has really large-scale natural resources, the simple act of mining them and selling them essentially takes away the future wealth of the country. It's a finite resource. So what you've got to do there if you're serious about future generations is to do what say Norway has done and have a meaningful sovereign wealth fund rather than a non-meaningful sovereign wealth fund, which I think is what Australia has (Audience Laughter).

SUE LAWLEY: Thank you for that. I wonder if anybody else has got a question on this inter-generational inheritance ...

NIALL FERGUSON: (over) Yeah kids.

SUE LAWLEY: (over)... with this partnership. Debts that you are inheriting from ...

NIALL FERGUSON: (over) Where are the indignados? (Audience Laughter)

SUE LAWLEY: ... from the baby boomer generation?

EDWARD HARPER: Edward Harper – recently, thankfully, employed graduate. I wonder when the... or if a change will come, will the young become politically aware as to the future we've been sold, or will the older generation realise the future they're giving to their children?

NIALL FERGUSON: It's hugely... hugely difficult to get youthful support of the kind of radical fiscal reforms that are clearly needed. And I think one of our biggest problems at the moment is a problem of political language. On both sides of the Atlantic last year, it became tremendously exciting to young people to explain the distributional conflicts of our time in terms of percentiles and so implausibly we had people proclaiming themselves to be members of the 99 per cent and hurling abuse at members of the one per cent.

This made it very hard to concentrate in my office in The London School of Economics because of the very noisy demonstrations inspired by the Occupy Movement, which also reached Harvard. We had Occupy Harvard Yard. I can't imagine a less plausible and worthwhile place to occupy. (Audience Laughter).

If you're on the Left, I mean this has to be one of the most liberal parts of the United States, except maybe Berkeley. So there's huge confusion, huge confusion about how to articulate the grievances of this generation. And boy, do they have grievances! I mean, we think we have troubles here.

Youth unemployment in Spain and Greece right now is above 50 per cent - 50, five zero per cent - and yet if young people are mobilised politically, they are much more likely to be mobilised on the Left and they're very likely to be in some measure manipulated by precisely the people who are screwing them like public sector trade unions.

SUE LAWLEY: (over) Why is that?

NIALL FERGUSON: Because it's very un-cool to be Conservative, you know. (Audience Laughter) Just look at me. (Audience Laughter).

SUE LAWLEY: Do you want to come back on that?

EDWARD HARPER: I'd completely agree: it is... it is un-cool to be Conservative (Audience Laughter).

NIALL FERGUSON: However...

SUE LAWLEY: (over)...On this subject?

NIALL FERGUSON: ...however, however, we are right. (Audience Laughter) Being un-cool and right is way better than being cool and wrong.

ALEX VELKOV: Hi, my name's Alex Velkov. I work in a small firm that deals with crowd sourcing and engaging large groups of people using social media. My question is... is around the role of social media and movements such as the Pirate Party in Germany and Wikileaks, to a certain extent, [and] how you see the role of these sorts of movements in (a) bringing governments to account more, and (b) engaging young people in the political debate - mainly because they're seeing the data, they're seeing the real activity rather than the rhetoric being given by politicians?

NIALL FERGUSON: Eric Schmidt of Google has a book coming out which essentially says, you know, the revolution is Google and Google is the revolution and Facebook is the revolution, and information flows plus algorithms plus social networking equal revolution. And I... I can see the power of that argument in the following way: if you're trying to explain the Arab Spring - so-called - I think that's a misnomer. Let's maybe call it the Islamist Revolution, which I think is how it will look about five years from now - if you're trying to explain it, what you're really going to talk about when writing its history will be not only the de Soto argument about economic inequalities, but you're also going to talk about the explosive growth of cell phone usage and of internet access in all the countries that were affected. I think that played a huge part in mobilising young people and mobilising them in just the ways that you allude to.

But! But we must not be naïve in our thinking about this, and this will be a point I return to in the fourth lecture. Social networks of the sort that Facebook exemplifies are not the same as meaningful, real on-the-ground associations.

LYNN FORESTER DE ROTHSCHILD: I'm Lynn Forrester de Rothschild, CEO of EL Rothschild. And Professor Ferguson, my question is that I was totally with you through the Glorious Revolution and 1688 and how Britain ruled the world and Hernando de Soto's view of what went wrong in Egypt. But then when you were asked about the Inglorious Revolution and what would you say was the institutional malaise and failure, you went right to the debt as the example. But it seems to me that really what you have to say is that the institution that's under siege is almost

our democracy itself. Because the reason that debt happens is because politicians can't make the choice between spending cuts or tax increases.

NIALL FERGUSON: The debt is a symptom of something much more profound that's wrong with representative government, and what's wrong - and this I think is really the point - is that decision-making has ceased to have any reference whatsoever to the notion of Burke's contract between the generations. A pretty blithe disregard for the legacy of the past characterises, it seems to me, a great many legislators. But perhaps more seriously a real neglect of the interests of future generations. And that's really the problem. If representative government operates with a real sense of continuity between the generations, then fine. But if one's trying to ask what has gone wrong with democracy, I think the debt is just a symptom of a chronic inability to take difficult decisions in the present when it is so much easier to pass the cheque to a future generation that isn't represented. And that's the point: the young aren't represented and the unborn for sure aren't represented.

RICHARD PASS: Richard Pass, Masters Student at UCL. Niall, if you were 22, 23, and the current policies of, you know, necessary fiscal austerity were to continue, where perhaps would you be heading in the world? Would you be heading to maybe Singapore? Or Australia? You know, for a prosperous future for yourself - and for indeed your offspring's future?

SUE LAWLEY: Good question.

NIALL FERGUSON: This is a great question. It's one that I often discuss with my 18-year-old son who has to ask himself just that kind of thing after he completes his A levels. I think the answer to this is take a look at where the institutions are improving. Take a look at where the rule of law is getting stronger. Take a look at places where public finances are being responsibly managed. And that you can do. One of the joys of writing these lectures ...

SUE LAWLEY: (over) Where are these places? Don't tantalise!

NIALL FERGUSON: Wait, wait! (Audience Laughter) Contain your excitement, Sue! (Audience Laughter) If you do... If you analyse the quality of, say, rule of law using World Bank or World Economic Forum data, one of the most striking things apart from the deterioration of its quality in, say, the United States is its improvement in Hong Kong. If I were you, I'd go to Hong Kong.

SUE LAWLEY: Okay, I'm going to move on because we've only got time for a few more questions. There's someone up there who's had his hand up forever. Yes, gentleman in the spectacles...

DAVID JENKINS: Yeah, my name is David Jenkins and I'm an Associate Professor at the University of Copenhagen School of Law. I'm intrigued - coming back to it again because it

intrigues me so much - this idea of an inter-generational compact, and someone else used the word 'morality', because it suggests to me the importance ... the fundamental importance of something resembling a civic virtue and that civic institutions, as important as they are, I would agree, fundamentally rest upon a very healthy and vibrant civic virtue.

NIALL FERGUSON: Well I'm not very virtuous (Audience Laughter) so I'm always a bit nervous when people bring up virtue. It's one of the defining characteristics of the most dangerous revolutionaries that they really do think that man can be made virtuous. But that is not, I think, likely. Man is not going to be made virtuous by any revolution or any code of laws and that's why I like the 'Fable of the Bees'. It's all about how not being terribly virtuous turns out fine if the institutional framework within which you're being rather not virtuous is good. And that's also a key argument that is there in Adam Smith. I mean I'm a Scottish Enlightenment guy and the word 'virtue' scarcely figures in the thinking of people in Scottish Enlightenment because they take men and women as they found them - flawed, prone to sin and all the rest of it - and they ask the question how can we design institutions for these real human beings with all their frailties? How can we incentivise them to behave in a responsible way even although they'll probably go out drinking on a Friday night and misbehave? And that I think is a much better approach to problems of the sort that you raise.

LUCAS WARFORD: My name is Lucas Warford. I'm a postgraduate student here. Also an American and not a Tea Party member - proudly. Anyway you presented an institutional explanation of the convergence of China in the West, but Acemoglu and Robinson say that China is growing despite, rather than because, of its institutions and that its growth is, therefore, unsustainable. Can you speak a little bit to this apparent disconnect in your argument?

NIALL FERGUSON: It's not a disconnect at all, in fact the third lecture is going to be about the missing... the missing 'killer app' because you'll notice that I very carefully said that China had downloaded most but not all of the killer apps - and I listed five. Whereas avid readers of 'Civilisation' know that there are six! (Audience Laughter) Ha! (Audience Laughter)

SUE LAWLEY: ... what's the missing one?

NIALL FERGUSON: And the sixth and absent killer app is the rule of law based on private property rights and that doesn't exist there. And that is why I completely agree with Acemoglu and Robinson on this. There's a ceiling on Chinese development. They will not make it beyond one fifth of where we are if they don't address this issue. And that will be a really, really important part of that third lecture. I'll look first at what is going wrong with the rule of law in the West and then look at whether or not China can make it in the way that, you know, the English crown made it in the late 17th Century - made it to the point of subordinating itself to the rule of law.

The Chinese Communist Party has got to decide if it is going to subordinate itself to the rule of law. At the moment it is not there, but that is the single biggest question facing China, I entirely agree.

PHILIP PIRRI: My name is Philip Pirri. I'm self-employed in management training. And I think this is leading on from that and it's picking up this point about the introduction of the rule of law in China. And my question is this: as China moves from a huge creditor country to at some point being a debtor country, is that going to encourage the downloading of this final killer app?

NIALL FERGUSON: Well they have a long way to go with, what, three trillion plus dollars of international reserves. It takes a while to blow that. (AUDIENCE LAUGHTER) There aren't that many copper mines in Africa. Even if you bought the lot, you'd still have a lot of change, so I think that it'll be a while before China is staring that kind of problem in the face as a whole. But, what is true is that more and more Chinese middle class households are discovering, dare I say it, the joy of debt. They're for the first time having credit cards and mortgages and not paying for everything out of their current income and savings.

And I think that's going to be an important part of the process because as the financial system in China gets more complex and as there are more creditor debtor relationships within Chinese society, then there will be a much greater need for law and a much more sophisticated back office for the transactions of the middle class. The rise of the Chinese middle class is a big deal precisely because it brings in its wake all kinds of institutional change like that, as well as, of course, giving voice and giving indeed power to a social group that scarcely really existed before.

SUE LAWLEY: What I want to know, just to end with, in two sentences if you will and we hope our politicians are listening - what is this heroic effort of leadership that you said might save us from the 'fiscal death spiral'?

NIALL FERGUSON: Well, I think there's been some heroism so far and more of course will be needed. I think what I find hopeful is that if you look at what George Osborne and David Cameron have said, they understand the need to go beyond the old arguments about austerity and stimulus. We need to make people recognise that overhauling the public finances is the only way of paving the way to a future of growth and anything else is snake oil. That's the kind of heroism that seems to me political leaders need today. It's not much fun making the argument for budget cuts. It is not much fun trying to sort out one of the most gargantuan fiscal messes in modern history. Just as an illustration, there are two countries with a combined public and private debt of unprecedented magnitude in this world today. When you add them together, they take it up towards the 600 per cent of GDP mark. One is Japan. The other is the United Kingdom.

SUE LAWLEY: That's all we have time for - PPB and all. Next week we'll be coming from New York where Professor Ferguson continues his analysis of our economic plight - arguing, as is indicated, that excessive regulation of the markets is in fact the disease of which it purports to be the cure.

For now, Niall Ferguson, BBC Reith Lecturer 2012, thank you very much indeed.

NIALL FERGUSON: Thank you. (Audience Applause)

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