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CULTURE AND COMMUNICATIONS IN THE 21st CENTURY – AN OXYMORON?

Extracts of a talk given by Dame Patricia Hodgson, Chief Executive of the Independent Television Commission, to members of the Economic Research Council on Wednesday 23rd June 2004

There are three things that we need to bear in mind when considering the government's communications policy. The first is that telecommunications is a fifty billion pound sector business whereas broadcasting is only a thirteen billion pound business of which about a third is public money in the forms of the BBC licence fee and the opportunity cost of not taxing the public service commercial broadcasters fully. The second is that the dot.com bubble yielded twenty one billion pounds for the Exchequer and the third is that in spite of all the wonderful new communications gismos – Gameboys and iPods and all the things that are supposed to take public attention away from broadcasting, actually the average Brit still watches and listens for forty eight hours a week (when do they do anything else?!) and even though the main networks are losing some of their audiences, the influence of the electronic media is as strong as ever.

These three illustrations of the nature of communications tell us something about the dilemma that the government has in coming up with a communications policy. It wants to deregulate telecoms, or rather delivery systems, whether it's carrying one-to-one communications or carrying broadcasting because in so de-regulating it grows the sector. It has to continue to believe in dot commary and technological boom because of the enormous yield in taxation – it's had a one-off bonanza and is looking for ways of getting more – and yet that free market is something that it can't actually take a risk on when it comes to the media because of the enormous social and political impact of television. Thus Ofcoms, the new regulator, has a curious conflict of aims – to de-regulate, to deliver spectrum tax and at the same time to undertake a fairly traditional set of tasks concerning the content of broadcasting.

So the new Communications Act raises some important issues. First, spectrum taxation is enormously complicated – it requires several degrees not only in economics but in electrical engineering to understand what is being taxed and how, and the powers were just tucked in to the Act in three different clauses, right in the middle, between sexy things like mobile phone termination charges and the duties of ITV and Channel 4. So of course our wonderful legislators spent all their time debating those issues but passed, 'on the nod', the transfer of the Radio Communications Agency's powers to tax spectrum, to Ofcom – a putatively independent body with no direct accountability through the DTI or through anyone else to the tax payers. We don't know how much tax it is proposed to levy or in what form but it seems quite extraordinary to give such substantial tax raising powers to such a body. Secondly, we may note the changes that have taken place over the past fifty odd years in the nature of 'regulation'. In the 1950s it was a fairly straightforward matter of consumer protection concerned with sex and violence and so on. Then, in the 1980s with privatisation, regulators became more concerned with price regimes aiming to mitigate the power of dominant privatised utilities. Now, first under Major and then even more so under Blair, governments have delegated everything that they might find difficult – politically difficult – so that they can hide behind the regulators. Thus super regulators like Rail, Energy and Ofcom have an enormous array of powers and duties that are very often in conflict. Great powers and responsibilities are left in the hands of regulators to make a public interest balance – a removal from government of responsibilities that you would normally associate with elected representatives. Thirdly, the Communications Act is very much more radical, in quite a clever politically cynical way than most people realise because it says that the public service networks (channels 1 to 5) will do good public service things like put on arts programmes, news, national news services, religious services and so on *insofar as it is economically realistic.* And public service is to be achieved across all five channels whereas up until the Act each of the five channels had their *own* public service obligations. So this is a clever way of letting the commercial broadcasters off the hook whilst leaving the BBC, over the next decade or so, to become the supplier of last resort – because demanding programmes do not command audiences that deliver advertising or subscription revenues.

So much then, for content. But what about standards? Here, the legislation in relation to accuracy, impartiality, taste, decency etc is very similar to the traditional requirements of the last fifty years. Here is a traffic accident waiting to happen – because clearly the market is making it impossible to sustain such values and anyway we know that there is no consensus in the nation any more about what public values should be.

I seem forced to the conclusion that the power of the market is just too strong to allow regulation as we have known it, to continue in relation to television. But there is enough, because of my history, my own professional commitment and indeed my belief that the power of the media is so great that I believe you have to think about ways in which you can try to frame it to be as least irresponsible as the market will drive it towards. I remain looking for ways in which you can try and direct the electronic media in a more reasonable direction.

So I remain, for all its faults, a supporter of the BBC and of the Licence Fee principle. The BBC may not be all that we would like it to be and it does terrible things every so often, but it remains such a powerful cultural force, and it does pull the rest back a bit. I think that it does condition popular taste to an extent, with its programming, support for historical programmes and support for reasonably serious drama. Radio 4 also produces outstanding service. For all its faults and its general propensity to be slightly left of centre we have a better resourced news service than exists anywhere else. The BBC spends four hundred and seventy odd million pounds on its news operations whilst ITN (which ought to be comparable because it services channels 3, 4 and 5 plus Independent Radio News) has a turnover of only about one hundred million pounds. During the last 7 or 8 years ITV have more than halved the money in real terms spent on news and news is more and more about crime, sport and celebrities. So I think that the BBC has the more honourable and reasonably decent news service record.

90% of the population say that their main source of information about National and International Affairs is television and between 70% and 80% (depending on who is doing the polling) say that they trust television in covering news compared to around 10% for radio and 6% for the Press. There are audiences of 5 to 6 million a night for BBC News and 3 to 5 million for ITV News. This is their main information about politics and the main influence, apart from their personal experience for voting behaviour. There are agendas. Channel 4 is undoubtedly liberal and Sky News is pretty conservative whilst the Fox News is a Bush agenda about Iraq. The legislation has, so far, constrained this reasonably. Remove those constraints and allow competitive pressures and they will have to serve their shareholders and give the public what the public wants to hear. This is very different from the needs of engendering a sense of intellectual curiosity.

I've always been a radical and I've always been pro-competition. Market forces and competition have given us a flourishing free market communications industry in this country. You can't regulate it and we shouldn't try to stop it – it's great. But I think there are some down sides and therefore you must hedge your bets, take out an insurance policy and for the time being, for the next ten years, continue to fund something which will give you a point of reference.

THE EFFECTS OF PUBLIC SPENDING AND TAXES ON ECONOMIC GROWTH

A talk given by Mr David B Smith, Chief Economist at Williams de Broë, to members of the Economic Research Council on Thursday 9th December 2004

Introduction

My talk discusses the effects of public spending – and the taxes required to finance it – on a country's economic performance. This is arguably the most important issue in economics because the state is the largest player in today's economies and governments often try to control via regulation that which they do not take in taxes.

It is easy to forget how much smaller the state was, even in the early 1960s, and to ignore the massive differences that exist between the extents of socialisation in different economies. Thus, general government outlays as a share of national output averaged $41^{1}/_{4}$% in the OECD area last year, but ranged from 29% in Korea to 59% in the case of Sweden.

Unfortunately, the extent to which the size of government might explain the substantial international differences in performances is unlikely to be seriously discussed in the forthcoming UK General Election debate. Oliver Letwin's pledge to match Labour's spending on health and education means that the next election risks being little more than a sham contest over the small change of the fiscal system.

The Increased Role of the State

The lack of serious political debate over spending and taxes is unfortunate. This is because the increase in the size of government was the dominant feature of the twentieth century, in Britain and elsewhere (see Table 1), and there are issues of liberty as well as economics involved. The share of government spending in national output was under one-tenth in Britain in the late nineteenth century, between one-quarter and well under one-third in the inter-war period, and not quite one-third in the late-1950s. There was then a rapid rise in the spending share during the second half of the 1960s and the 1970s, followed by a levelling out in the 1980s and 1990s.

Table 1: Ratios of Public Expenditure, including Transfers, to Money GDP at Market Prices (%)

	1870	*1913*	*1920*	*1937*	*1960*	*1980*	*1990*	*2003*
Australia	18.3	16.5	-	-	21.2	31.6	36.3	36.2
Austria	-	-	14.7	15.2	35.7	48.1	53.1	51.6
Belgium	-	13.8	-	21.8	30.3	58.6	53.4	49.7
Canada	-	-	13.3	18.6	28.6	38.8	48.8	40.1
France	12.6	17.0	27.6	29.0	34.6	46.1	50.7	54.4
Germany	10.0	14.8	25.0	42.4	32.4	47.9	44.4	49.4
Italy	11.9	11.1	22.5	24.5	30.1	44.9	54.4	48.5
Ireland	-	-	-	-	28.0	48.9	43.2	35.2
Japan	8.8	8.3	14.8	25.4	17.5	32.0	32.1	38.3
Netherlands	9.1	9.0	13.5	19.0	33.7	55.2	54.8	48.6
Norway	3.7	8.3	13.7	-	29.9	37.5	52.8	48.4
Spain	-	8.3	9.3	18.4	18.8	32.2	43.4	39.3
Sweden	5.7	6.3	8.1	10.4	31.0	60.1	59.4	59.0
Switzerland	-	2.7	4.6	6.1	17.2	32.8	33.5	37.6*
United Kingdom	9.4	12.7	26.2	30.0	32.2	43.0	42.2	42.8
United States	3.9	8.1	7.0	8.6	27.0	31.8	36.5	35.8
Unweighted Average of Countries With No Missing Observations	7.7	10.9	18.1	23.7	29.8	41.4	46.8	47.1

Sources: International Monetary Fund (IMF), including May 2000 'World Economic Outlook' (see especially IMF Table 5.4 page 172), and Organisation for Economic Co-operation and Development (OECD).

* 1996 data. NB The original Tanzi & Schuknecht data for 1990 have been updated and the figures for 2003 introduced using Annex Table 26 in the most recent OECD *Economic Outlook*. Unfortunately, there are some substantial discrepancies between the Tanzi & Schuknecht and the OECD data for the overlap year of 1990, and the figures should be regarded as illustrative rather than precise. We have dropped New Zealand from the comparison and not updated the Tanzi & Schuknecht data for Switzerland, because of these problems. The most important remaining break is the USA where the OECD figure for 1990 is 3.2 percentage points higher than the Tanzi & Schuknecht one.

The Case for Lower Public Spending

The 2004 UK Budget implies that general government expenditure will account for $47^1/_4$% of Gross Domestic Product (GDP) in fiscal 2004-05, and general government receipts $44^1/_4$%, if GDP is properly defined to exclude indirect taxes and subsidies; and 41% and $38^1/_2$% respectively, if the officially preferred measure of GDP – which is gross of indirect taxes and subsidies – is used instead.

Instant versus Deferred Gratification

The real debate over public spending is, arguably, not about economics, but is over the extent to which one values instant gratification now against the deferred benefits – in the form of the increased living standards, improved life chances, and lower structural unemployment – which would result from a more parsimonious approach in the immediate future. Politicians have notoriously high rates of time discount, but especially so when an election is looming.

Conclusions from Existing Research

Because of time constraints, I will now set out my main conclusions from previous research:

- First, not only has there has been a massive increase in the share of national output absorbed by the state over the past century, but the ratio of public spending to GDP in much of Europe now exceeds anything attempted by Hitler or Mussolini in the late-1930s. I will return to the parallels between the economics of New Labour and that of the pre-War Fascists later.
- Second, measuring the proportion of national output absorbed by the state is surprisingly problematic. On balance, it looks as if the current official presentation understates the true resource costs of the public sector in Britain by some 6–$7^1/_2$ percentage points of national output.
- Third, the 'government budget constraint' means that public spending can only be financed through: taxation, long-term borrowing, or borrowing from the Central Bank, which then has to 'print money'. Few people believe the old fashioned Keynesian argument that budget deficits are stimulatory these days. This is because of: a) Ricardian equivalence theory; b) the evidence from simulations on macroeconomic models and

international panel-data studies; and c) the literature on what determines the success of official attempts at fiscal stabilisation.

- Fourth, taxes destroy property rights, and have adverse supply-side effects. All taxes discourage effort, risk taking, and investment in physical, financial and human capital. However, there are significant differences between the effects of the various taxes. It is also by no means clear that increasing UK taxes from their present high levels will lead to a smaller budget deficit, once allowance has been made for the adverse 'second-round' effects on the private sector tax base and welfare payments.
- Fifth, cross-section studies have confirmed that high public spending leads to reduced growth and, eventually, a much poorer population than would otherwise have been the case. Table 2 shows back-of-the-envelope calculations of the effects of increased government spending on economic growth, employing statistical estimates provided in Barro (1997) of the impact of public consumption on the growth performance of nations.
- Sixth, Professor Barro estimated that, other things being equal, each 1 percentage point rise in the share of government consumption in GDP was associated with a 0.14 percentage points retardation in growth of real GDP per head.
- Seventh, researchers from the OECD subsequently carried out a 'panel-data' study using data for twenty-one OECD countries and found that spending had a coefficient of plus 0.19 but taxes had a negative coefficient of 0.44, when spending and taxes were included separately. This implies that tax-financed expenditures have an overall negative impact on growth of 0.25 percentage points. This means that the figures in Table 2 may be underestimates.
- Eighth, extremely important research carried out by Tanzi and Schuknecht (2000) for a wide range of countries, and looking at data back to the late nineteenth century, *suggests that state spending need be no higher than one-third or so of market-price GDP* in order to achieve most of the important social and political objectives which justify government intervention.
- Ninth, there are many explanations of why the share of public spending in GDP appears to be far higher than the optimal level at which the marginal utility derived from extra spending exactly corresponds to the marginal loss of utility to the taxpayer which stemmed from the need to pay for it. However, the breakdown in the relationship between representation and taxation appears to be an important factor.

Table 2: Estimated Effects on Economic Growth of Growth in Public Spending Since 1960

	Change in Public Spending Burden 1960–2003 (%)	*Estimated Impact on Annual Economic Growth (%)*	*How Much Higher Output Would have Been in 2003 with 1960 Spending Levels (%)*
Australia	13.4	-1.8	117
Austria	11.2	-1.5	91
Belgium	20.8	-2.8	231
Canada	8.7	-1.2	66
France	18.9	-2.6	198
Germany	17.7	-2.4	177
Italy	17.2	-2.3	170
Ireland	5.2	-0.7	35
Japan	20.4	-2.8	224
Netherlands	14.1	-1.9	126
Norway	19.5	-2.7	208
Spain	19.1	-2.6	201
Sweden	27.7	-3.8	390
Switzerland	20.4	-2.8	224
United Kingdom	8.3	-1.1	62
United States	5.6	-0.8	39
Unweighted Average	**15.5**	**-2.1**	**145**

Source: Williams de Broë calculations, OECD and IMF, as quoted in footnote to Table 1. The Change in the Public Spending Burden has been 'break corrected' to allow for discrepancies in overlap years. However, the figures should be regarded as highly approximate only.

- Tenth, one growth-retarding thing that New Labour has done is to deliberately transfer resources from the high- to the low-productivity areas of the economy. This process has had two dimensions. The first is the shift from the more productive private sector into public provision. The other is the transfer of resources from the high productivity regions of Britain to the less productive ones. The latter is doing serious 'real' injustice to the expensive and productive areas, in the same way as Portugal's tax bands would if imposed on Germany.

Table 3: Estimated Impact of Changes in Institutional or Policy Factors on GDP Per Capita[1]

Variable	*Impact on Output Per Working-Age Person (%)*[2] *Effect Via Economic Efficiency*	*Effect Via Investment*	*Overall Effect*
Inflation Rate (Fall of 1% Point)		0.4 to 0.5	0.4 to 0.5
Variability of Inflation (1% Point Fall in Standard Deviation of Inflation)	2.0		2.0
Tax Burden[3] (Increase of 1% Point)	-0.3	-0.3 to -0.4	-0.6 to -0.7
Business Research & Development Intensity[3] (Increase of 0.1% Points)	1.2		1.2
Trade Exposure[3] (Increase of 10% Points)	4.0		4.0

1. The values reported in this table are the estimated long-run effects on output per working-age person of a given policy change. The range reported reflects the values obtained in different specifications of the growth equation.
2. The direct effect refers to the impact on output *per capita* over and above any potential influence on the accumulation of physical capital. The indirect effect refers to the combined impact of the variable on the investment rate and by that channel, on output *per capita*.
3. In percentage of GDP.

Source: *The Driving Forces of Economic Growth: Panel Data Evidence for the OECD Countries*, OECD Economic Studies No.33, 2001/II.

New Labour, and Old Fascist, Economics

I said earlier that there were disturbing similarities between the present highly interventionist New Labour approach and the economic systems of the pre-War fascists. However, I must emphasise that I am solely concerned with the question of economic systems, not the poisonous racial ideology of the German Nazis. Pure free-market capitalism can be regarded as a system in which the owners of human, physical and financial capital can do what they like with their resources and are free to allocate the returns from their enterprise and endeavours as they see fit. Pure socialism is a system in which all the means of production are expropriated and controlled by the State, and the government decides how the resulting output is allocated. An old-fashioned mixed economy, such as Britain's in the 1950s, is one in which the ownership of capital and the production process are left to market forces but a proportion of the ensuing output is creamed off – preferably by non-distortionary taxes – to support wider social goals.

New Labour's so-called 'third way' appears to be a system under which the private sector maintains a nominal legal control over its capital and labour, but the returns on these factors of production are so heavily influenced by tax and regulation that the public sector ends up effectively controlling them. This sham form of mixed economy has traditionally been associated with Fascist regimes – for example, the *gelenkte Wirtschaft* (supple or 'joined-up' economy) that Goering implemented in Nazi Germany in 1936. Such systems tend to be popular with politicians and bureaucrats because it forces all sectors of society to keep on good terms with the state and its functionaries. 'Third-way' economies seem capable of generating good growth in their early years, when GDP is being boosted by its public spending component, but eventually seize up because regulations and controls create inefficiencies, which lead to more regulations and controls, until everything jams up to the point at which deregulation becomes essential if the system is to survive. Speer's 'big-bang' deregulation of the German economy in 1944, for example, allowed Germany to produce twice as many Messerschmitt fighters in 1945 as in 1942.

Closing Remarks

I have strayed a long way from economics. However, Milton Friedman remarked that he supported liberal-market capitalism because it was the best guarantor of personal liberty, and not personal liberty as the best guarantor of free-market capitalism. The fact that New Labour has surreptitiously imposed his own *gelenkte Wirtschaft* on Britain should not conceal the fact that its obsessive micro-management is a serious threat to the most basic personal freedoms.

This does not mean that a cost-benefit analysis of New Labour policies would not produce a damning balance sheet. Thus, the deceleration in the growth of Britain's non-oil real GDP per worker from 2.3% each year during Mr Major's administration (1990 to 1997) to 1.6% each year under New Labour had already built up to be the equivalent of 4% of national output by 2003, or some £39bn in cash terms.

The real political debate in Britain should be one between the 'growth maximisers', who want eventually to constrain the share of public spending in national output until it is, say, some 7½ percentage points below today's level – putting Britain on a par with the US, Ireland and Australia – and the Brownian 'redistributionists', who would rather achieve equality of misery in a poor, static and heavily controlled society.

Anyone who believes that advocating smaller government is not realistic should consider the Republic of Ireland, where the share of government outlays in GDP has fallen from 54% in 1986 to 35¼% last year. Today's Conservatives could also learn from the way in which the early 1950s Churchill administration, and its Chancellor 'Rab' Butler, managed to implement the 'bonfire of controls' that paved the way for Britain's mini-W*irtschaftwunder* between 1952 and 1962.

Another issue a potential Conservative administration ought to think about is improving the linkages between representation and taxation. The only partial solutions which I can see are: a) to make the maximum possible use of flat rate proportionate taxes; b) to reinstate the Beveridge insurance principle; c) to contemplate a more federal approach to setting tax rates, possibly modelled on that of the Swiss cantons; and, d) to try and reverse the growth in pernicious means-tested benefits.

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THE LAZY FRENCH

by Russell Lewis

When I was in France in the summer there was a great fuss in the newspapers there about the threat by the German manufacturer Bosch to close down its French plant. Bosch warned that it would move operations to the Czech Republic unless the unions accepted an increase in the working week with no increase in pay to 36 instead of 35 hours. No big deal, you might say, but the 35-hour week in France is a sort of totem for many: even Jacques Chirac called it a social right.

It had been made broadly obligatory by Madame Aubrey's legislation under the previous Jospin (Socialist) government. I say 'broadly' because there were various get-outs available to employers. Anyway the Bosch affair reopened the whole debate about what the French were doing with a 35-hour week when unemployment was hovering around 10 per cent and jobs were being lost to developing countries where wage-rates were 80 per cent lower. The Conservative newspaper, Figaro, denounced the endemic dogmatism of the unions and, in one angry editorial, harked back to 1938 when the Socialist Prime Minister, Leon Blum, made a speech warning that the Germans were working an average 48 hours a week. This was alarmingly more than the French 40-hour week introduced by the Socialist National Front in 1936. The French union reaction to this speech – on the eve of Munich remember! – was to threaten a strike.

In a subsequent issue this Figaro editorial was followed up by an article from Sorbonne History Professor, Jacques Marseilles. He denounced the 35-hour week as a law for an 'imaginary' France. It sprang, he said, from the Left's Dickensian idea of the economy as an overwhelmingly manufacturing one in which masses of industrial serfs are exploited and oppressed by grasping capitalists. The reality, he said was that only 16 per cent of the economy was now industrial. Nearly all the rest was services in which it was essential that labour be adaptable not crippled by regulation. If the French were still comparatively well-off, he went on, this was only because they had worked hard and evaded the legal 40-hour week during the 'thirty glorious years' from 1945 to 1974. The popular cult of minimum effort could only impoverish the French people in an ever more competitive world.

Soon afterwards I saw a reference to a new French best-seller called 'Bonjour Paresse' ('Hello Laziness') by a lady economist, Corinne Maier, working at the Electricite de France. I thought it must be a follow-up of the Jacques Marseilles' theme with more detail and had it posted to me. Judge my surprise when I actually found it to be a eulogy of idleness, infused with a Herbert Marcuse-style critique of the capitalist economy, accusing it of oppressing people with material abundance and stifling their freedom by satisfying their wants. Along with such twaddle it provided handy hints for the dedicated slacker on how to get away with doing the absolute minimum. It offered such advice as 'Avoid all responsibility! Choose the most useless type of job like research or counselling – it's the hardest to check up on! Don't work, network!'

All this served to buttress my impression that the French have indeed been seduced by the cult of the workshy. However it hardly explains how they have changed in the space of a single generation from toilers in the same class as the Americans – judged by the number of hours worked per year – to 32 per cent less.

At this point it's worthwhile turning for explanation to the views of the prolific historian, Neil Ferguson, who has specialised in this subject. He has recently sought to present an updated version of the ideas of the great sociologist Max Weber about the historic role of the Protestant work ethic in capitalist development. Ferguson believes that the continuing vigour of the Protestant ethic in America accounts for the way in which, during the last couple of decades its economic growth has forged ahead of Europe where religion has declined. He contrasts thriving churchgoing America with declining, increasingly atheist Europe. This is intriguing and at first sight convincing, because the statistical correlation between worshipping God and serving Mammon is close. It makes one ponder whether chasing the moneychangers out of the temple was such a good idea after all.

However coincidence doesn't prove causation. Besides, it is not intuitively obvious that believers must be keener workers than non-believers. Indeed one might plausibly argue that the devout may take it easy, confident that God will provide, whereas atheists will roll up their sleeves, uneasily aware that, as there is nobody 'up there' to look after them, they have only themselves to rely on. Moreover I've never been very taken with the Protestant work ethic theory ever since as a schoolboy I read a book by Amintore Fanfani (decades before he became Italy's Prime Minister) suggesting that the historic and rapid industrial advance of the Protestant compared with the Catholic countries had more to do with the location of coal and iron ore deposits than religion. In any case, economic performance in Europe is patchy. The fastest GDP growth in Europe in the nineties decade – all of 6.9 per cent per annum – has been by Ireland, that is in still ardently Catholic Eire not Protestant Ulster.

Besides, the performance of the Americans in the post-war period has been pretty up and down. They were rather laggard at the time when the Europeans were having their economic miracles. Their racing ahead later I would attribute less to a swelling of the numbers being born again, more to swingeing tax cuts, first by Kennedy and then by Reagan. Nor should we ignore the effect of America's huge investment in computers and other high technology kit from the sixties onwards which took time to become productive – and even more time to get into the official statistics – but which is now bearing fruit.

Turning to this side of the Atlantic, the 'thirty glorious years' in France's post-war history were shared by Germany and Italy and were labelled economic miracles at the time. These were attributable to a host of factors, which had nothing to do with religion. They included post-war reconstruction, world trade liberalisation, the removal of trade barriers within the European Community, the expansion of industrial investment under the NATO security umbrella, the boost from the Marshall Plan and the seismic shift of workers out of agriculture into industry and services. Nor should we forget that deregulation and monetary reform played a part, not only, and famously, in Germany under Ludwig Erhard, but also in France where the planners disguised deregulation under the heading 'structural planning' while the franc was rebuilt (for the second time in his life) by Jacques Rueff.

The end of the Erhard/Rueff era saw the ballooning of Rhine-style corporatism, and mounting regulation, in tandem with a steady rise in bureaucracy and taxation. Meantime the flow of rural workers into the towns tailed off, while on the international scene there was a series of oil crises, which, as a recent report in the WSJE has shown, have been more damaging to Europe than to America.

So, while religion must surely influence economic behaviour – it is far from clear what that influence is. People may work harder because their faith condemns sloth. But what if the most devoted, God-fearing workers are economic regulators? It might be better if they were on a 35-hour week, or, better still, too idle to show up at the office. Perhaps the real trouble with France is not the cult of laziness, but the fact that the most conscientious workers are in the Public Sector.

DANGERS IN DERIVATIVES

*By Nick Leeson**

> *We view them as time bombs, both for the parties that deal in them and the economic system … Derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.*
>
> *Warren Buffett*

This warning should be heeded by all financial institutions that trade with derivative instruments.

On Dec. 9, BBC-TV screened the drama 'The Man Who Broke Britain'. It told the fictional story of Samir Badr, a derivatives trader who had posted substantial profits for the bank that he worked for.

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* Reproduced with kind permission from The Japan Times where it was published under the title 'Derivative terrorism: the new threat' on 20th December 2004

Through the trading of Samir and his associates, the bank is heavily exposed to the fluctuations in the price of oil. Following a terrorist attack on an oil field at Ras Tanura in Saudi Arabia, Samir's strategy that oil prices had already peaked is thrown into turmoil.

As the bank desperately tries to close its exposure to the rising prices, the heightened effect of the 'over-the-counter' derivatives positions is really brought to bear.

The stock markets start falling and a video shown on Al-Jazeera hints at an al-Qaeda terror plot that seeks to destabilise the economies of the world. Samir goes missing, is accused of 'doing a Leeson' and eventually is discovered dead. The plot thickens, the losses escalate and the bank is eventually supported with a government rescue package.

Several days later the true implications of the credit derivative position become clear. The knock-on effect to other institutions that had dealt with Samir's bank reverberates throughout the financial system. Their confidence and credibility is openly called into question as investors start withdrawing money.

The system grinds to a halt, the economy is thrown into reverse, house prices collapse and many firms hit the wall, with unemployment hitting record levels. If not broken, Britain has definitely ground to a halt.

Far-fetched? I don't think so. As security has been tightened since 9/11, it would make sense for terrorists to look for a softer target. Terrorist financiers have been using the banking system and the financial markets to launder money for decades, moving from one haven to the next far quicker than anyone can catch them. It would not be beyond the realm of possibility that they could use their expertise in these markets to wreak more terror. Either in conjunction with a terror attack, or as a stand-alone event, the impact on the financial markets could be significant.

Derivatives markets remain the Achilles' heel of the financial markets; they continually evolve into new, hybrid forms and many industry professionals still don't understand how they are structured or how they work. Banks have already been physically attacked, in Istanbul for instance, and elsewhere. Why not an attack from within?

The banks remain a soft target for terrorist attacks: they recruit large numbers of people, based on hastily performed interviews, and perform little or none of the security checks that are essential in the current environment. Psychometric tests and handwriting samples may go some way to dispel some of the banks' fears, but these are easily subverted.

What of a 'sleeper' that has been groomed toward this end? Are the banks prepared for this? Are they even thinking about it, or do they treat this threat with the same cavalier attitude that they treat risk management and compliance?

The derivatives markets were originally started to take the uncertainty out of the future for traders and financial institutions alike. But they have grown to such an extent that the total value of the derivatives markets now far outstrips the value of most leading economies.

Their stability in Finance Minister Gordon Brown's 'new global age' is of great importance. You would imagine that risk management and compliance have kept pace with these developments. Unfortunately that is not the case.

Sir Julian Hodge, the late Welsh banker, issued an apocalyptic warning several years before the first rash of derivatives disasters in 1994. These involved Metallgesellschaft, Orange County, Sears Roebuck, and Procter & Gamble. More was to come in 1995 with my own involvement in the Barings scandal.

On their own, however, none threatened to bring the world financial system to its knees. The crisis that has so far come closest to doing so involved LTCM in September 1998, but could a mega-catastrophe lie around the corner? With the economy already in a rather fragile state, a pensions crisis looming, personal debt at record levels, how much more of a knock to confidence is needed before we all start exiting the banks wholesale? The knock-on effect of that on the global economy would be calamitous.

The banks foolishly believe that they are beyond reproach. My own actions in Singapore caused the collapse of Barings Bank, but other institutions that have suffered similar rogue trading episodes recently have just dusted themselves off and ploughed on regardless.

No lessons have been learned – Allied Irish Bank (AIB) is the best case in point. Ansbacher, John Rusnak, Faldor Investments and an eight-year period of overcharging really should have hit the bank's bottom line. Not at all; profits go from strength to strength.

Fines and compensation for the overcharging cost €60 million, roughly two days' profits, but AIB posted profits of more than €1 billion for the year so it is not overly concerned. The reckless abandon with which it treats risk management, compliance and other threats may one day come home to haunt it.

EVERLASTING LIGHT BULBS

John Kay
Published by The Erasmus Press 2004 Price £7.99

What a delightful book of short stories each with an economic twist in the tail: fifty odd separate pieces each of just 3 to 4 pages and each illustrating a lesson or a principle or a misunderstanding to correct – and each one in plain English well illustrating the point that 'anything worth saying in economics, though it may if one wishes be expressed in algebra and jargon, can also be said, if one has a true understanding of the subject, in straightforward language'. So all sorts of things from exchange rates to inflation, from immigration to industrial structures and from corporate governance to films are given the John Kay treatment – and it is a pleasure to read.

That said, there is hardly a single theme to review and so 'Britain and Overseas' will reproduce a sample chapter and let the author speak for himself.

Copyright and creativity

In common with Nana Mouskouri, Iron Maiden, Tom Jones und die Fantastischen Vier, I regard myself as a creative person, providing original material for the entertainment and edification of the citizens of the European Union. Unlike my fellow artists, who recently successfully petitioned the European Parliament under the banner of 'artistes for strong copyright', I think that the draft directive they commented on will damage, not help, our interests.

Like die EantastischenVier and other artistes, my first concern is to propagate my ideas as widely as possible. My second concern is to get credit for these ideas. My third objective is to be well paid for them. So why is it that the proposed directive has at its heart the obligation to allow a right 'to prohibit direct or indirect, temporary or permanent reproduction by any means and in any form', when prohibiting reproduction is exactly the opposite of what we creatives want to achieve? The answer is that the law of intellectual property has been hijacked by a group of producer interests which want to build commercial monopolies in books, journals, records and software on the back of their exclusive access to original talent.

Now I doubt if Iron Maiden had thought deeply about the future of the knowledge economy when their agent or publisher persuaded them to sign a petition headed 'take a stand for creativity, take a stand for copyright'.

They were probably told that dissemination of their work depended on a strong publishing industry. There is some truth in this claim. But the interests of creative talent and its publishers are far from identical.

Publishers may tell us that the distribution of the songs of Iron Maiden, or of my nearly completed and nearly unreadable monograph, depends on their ability to protect their copyright. But there is little basis for this assertion. Iron Maiden is in the same position as Jane Austen and Charles Dickens, whose books are widely available despite the absence of copyright, because the demand for their output is large. And my monograph does not gain anything from copyright because the demand for it is small and in practice no-one is going to copy it. My problem is to find any publisher at all and if I succeed in that, I can be entirely certain that no-one else will bother to launch a competing diversion.

The proposed copyright directive attempts to protect rights holders, rather than creative people. The production of scholarly journals emphasises the distinction. When you submit an article to an academic journal, the publisher requires you to assign the copyright, and the rightsholder takes over from the author. The main producers of academic articles are universities, and the main users of academic articles are universities. The net effect of the system is that universities pay large sums to publishers for severely restricted rights to use the material they themselves have created. Indeed under the proposed directive, the only way to avoid paying for a copy of an article you yourself have written is to write it again.

It is difficult to fathom how this system represents ‘a stand for creativity’. It is true that in its absence there would be fewer academic journals. But almost everyone I know in the university world thinks there are too many academic journals. Robert Maxwell led the exploitation of this system. He launched dozens of journals. Some were successful. They became the leading publications in their field, and all universities had to subscribe, whatever the cost. Most failed, and continued to publish second-rate material. The result has been a proliferation of journals, many of them publishing only bad articles, to the profit of no-one but the publisher. And the growth in the range of outlets has reinforced the publish or perish culture, in which it is the number rather than the quality of academic publications that counts.

Such anomalies and distortions could be reduced if universities retained copyright in the work of their employees, rather than allowing them to give it away to publishers. If there is to be a copyright licensing agency it would surely be more sensible if universities licensed publishers to use the material produced in universities rather than – as at present – publishers licensing universities to use the material produced in universities.

Reforms of copyright should genuinely be aimed at fostering creativity. It is important to creative people – Iron Maiden, Jane Austen, and John Kay – that they should be able to insist that their work appears only in ways which respect the integrity of the original (this is described as the moral right of authors). It is important to creative people that they should be able to disseminate their work as widely as possible and in the ways that they think best. It is important to creative people that they should be rewarded for the work they do. The right of their publisher to prevent unauthorised reproduction – which is at the heart of the copyright directive – achieves these objects incidentally at best, and often conflicts with them.

The legal rules which govern the production and distribution of original materials really matter in a knowledge economy and an information age. We need to encourage the widest possible dissemination of new ideas and innovations and reward those who produce them in direct relation to the originality and economic importance of these ideas and innovations. A system of intellectual property that achieves this will be based, not on a legal analysis of rights, but an economic analysis of costs and benefits. The basic principle should be open reproduction for reasonable reward. One of the first things the new European Commission should do is rethink the copyright directive from scratch. And perhaps there might even be an advantage in having a Professor of Economics as its President.

Romano Prodi, President of the European Commission from 1999 to 2004, was formerly Prime Minister of Italy and Professor of Economics at the University of Bologna.

THE KNOWLEDGE ECONOMY
The Dawn of a New Era of Global Prosperity

By Robert McGarvey

Capitalism, the Continuing Revolution

There once was a man more attractive than any other.
'You can't own him,' the sisters said.
'Yes I can – he's mine' she gloated, flourishing the marriage vow.
'You can't own what has yet to come,' they said.
'Yes you can,' we said – and we invented money.
'You can't own land – that belongs to everyone,' laughed the Indians.
'Yes you can' we said, and told them about title deeds and land registers.
'You can't own part of a factory and owe nothing if it goes bankrupt in debt.'
'Yes you can' we said and invented 'limited liability shareholding'.
'You can't own an invention' the person who invented the wheel believed.
'Yes you can' we said and enforced patent laws.
'You can't own a name, a shape, a picture or a piece of music' they said.
'Oh yes you can,' we said, 'by passing laws which make it so.'

'So what else can we own to make us wealthy – can anything
known be owned?'
'We're working on it' we replied.[1]

This little narrative is wonderfully simple and obvious, but is – at the same time – a profound statement on the nature of capitalism. We (society) have an almost unlimited capacity to invent new property forms, and in so doing establish new ways and means of creating wealth. This is not particularly new or revolutionary; in fact creating new property forms is something that's been happening since capitalism was invented. What this little poem does illustrate clearly is capitalism's internally generated dynamism; the confidence of a dynamo that never rests on its laurels. Strange as it may seem, capitalism is – to borrow a famous Maoist concept – a Continuing Revolution[2].

Ironically, Karl Marx was one of the first to observe this dynamic quality in capitalism. For Marx, capitalism was a governing philosophy, a set of principles and interests that, once adopted, set not only the economy – but also the entire body politic – into motion. '*The bourgeoisie cannot exist without constantly revolutionising the instruments of production, and thereby the relations of production, and with them the whole relations of society.*[3]' Capitalism evolves and grows very much as described in the little poem above by expanding the forms of economic property available in the economy.

This revolution in the *means of production* has been characteristic of capitalism since its re-awakening in the 15th century; and it continues to this day. Beginning in the late stages of the 20th century the capitalist system began to undergo a further metamorphosis of the property matrix incorporating a new class of assets, a new engine of capitalist growth, founded in intangible 'knowledge'. This revolutionary new class of assets will not only contribute significantly to economic growth in future, but will also, as industrialisation before it, '*change thereby the relations of production, and with them the whole relations of society*'[4].

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1 Jim Bourlet is the author of this illustration, which I believe captures the essential quality of capitalist dynamism.

2 Credit for this turn of phrase in defining capitalism belongs to my good friend and colleague Tony Baron who co-authored a number of papers with me in the ERC in the early 90s.

3 *The Communist Manifesto*, Karl Marx, Friedrich Engels 1848, Oxford University Press 1992, p. 6

4 *The Communist Manifesto*, p. 6

The Ascendancy of Knowledge Assets

> Knowledge assets now account for six of every seven dollars of corporate market value. … most of the productive resources of business enterprises are intangible, or knowledge assets (KA). Such assets include rights to future benefits emanating from *discovery* and *development* activities (e.g., patents, know-how); brands, franchises and other customer-related assets; and unique organizational designs of corporations.
>
> *Knowledge and Shareholder Value*, Baruch Lev, 2000
> Stern School of Business, NYU

The late 20th century stock market collapse brought the dot.com era to an end, burying in the minds of many practical business people and economists the entire notion of a 'new' post-industrial economy. While it is true that the Crash of 2000 did incalculable damage to investors and fledgling knowledge-based companies around the world, what it did not do was blunt the relentless rise in the importance of knowledge assets or diminish their impact on business culture, management practices and financial success in future.

Throughout the 1990s knowledge-based industries (those industries founded principally upon knowledge assets) grew over four times faster than traditional manufacturing. The growth in knowledge assets was reflected most clearly in patent applications. Between 1990 and 2000 the US copyright and patent offices increased their output at an average rate of 7.75% a year, nearly double the rate of economic growth in the economy at large.[5] Revenues (royalties) from patent licensing have increased in the US from $15 billion in 1990 to more than $110 billion in 1999[6]. Today, market services and intangible assets contribute over three-quarters of US GDP[7].

Significantly the growth in knowledge assets is not confined to the technology sector; according to the Washington-based Brookings Institute, intangible inputs account for over 70% of value added, even in the traditional 'bricks and mortar' industries such as automotive and consumer goods[8].

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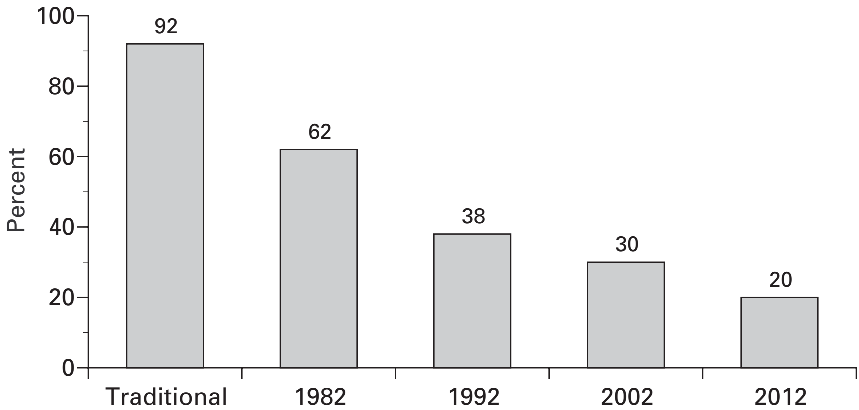
5 TFA special report, Patent Statistics United States Patent and Trade Office, http://www.uspto.gov/web/offices/ac/ido/oeip/taf/apat.pdf, p. 4.

6 *Rembrandts in the Attic*, Rivette and Klein, p. 59.

7 *Knowledge and Shareholder Value*, Baruch Lev, January 2000, p. 2.

Tangible assets as a Proportion of Total Market Capitalization



Source: Brookings Institution

In spite of the dot.com bust a quiet revolution has occurred: the economic landscape in the United States and many other advanced 'post industrial' economies is no longer underpinned by traditional industrial-age assets (material goods), but is driven by the flow of ideas, brand images, symbols and information[9]. Given the massive changes that have and are occurring in the economy, it is clear that the 'new economy' is not simply IT (information technology) or the Internet, but a seismic shift in the underlying asset foundation of the economy; or as Marx would describe it, a further revolution in the capitalist *'means of production'*.

The Unique Character of Knowledge Assets

Knowledge Assets are rapidly changing the engine of growth in major economies around the world. These new assets are quite different in many ways from traditional assets and we all need to understand the strengths and weaknesses of this new class of assets more clearly. Knowledge assets have detractors who point to the intangible nature of 'knowledge', suggesting intellectual forms of property are simply not as real as land or industrial plant, which – they say – 'you can get your hands on, in a sense feel'. The

8 *Understanding Intangible Sources of Value*, Brookings Institution, Research and Development Sub-Group Report, 2000.

9 *Understanding Intangible Sources of Value*, ibid. p. 63.

question is: how can something so whimsical as knowledge become a major repository of corporate wealth? The answer is not easy or simple but as the legal definitions solidify and social norms evolve, the rights and privileges of intellectual forms of property (IP) come to resemble, more and more, the rights of traditional property; a fact some businesses are now beginning to realise to their immense profit.

Consider the case of IBM's direct Internet sales initiative a few years back. No sooner had IBM put up its e-commerce site selling computers and related equipment over the web than attorneys from Dell were banging at the door with cease and desist orders. Much to IBM's surprise, Dell had, at the time, over 40 patents issued or pending on its built-to-order Internet direct sales model. In the spring of 1999 Dell and IBM duelled back and forth legally until finally resolving the issue with a $16 billion dollar cross-licensing deal: IBM gave Dell access to its extensive intellectual property assets (thereby significantly improving Dell's competitive advantage against arch-rival HP) while Dell granted IBM access to its patented systems for selling over the Internet. As a result of these and other similar developments licensing of IP is exploding. For example IBM's IP department has gone from a standing start to over $1 billion in annual licensing income in a decade. IP licensing revenue is now a significant part of IBM's financial model, contributing 1.5% of total revenues, and better than 13% of pretax net income[10].

So in spite of its seemingly whimsical nature the asset value in intellectual forms of property is a social and legal issue that basically comes down to enforcement. We are entering the Knowledge Age because we are evolving the mechanisms, procedures and laws to encourage the development of intellectual forms of property and to enforce intellectual property rights (while defining and encouraging their corresponding social responsibilities). In doing so, as a society we have instituted an expansion in the property matrix, in effect creating vast new opportunities for wealth creation.

The Knowledge Revolution is changing the way business is done, revolutionising the types of products that are produced, the means by which they are distributed and sold, as well as increasing the number and variety of profit centres in major industries. As with Dell and IBM, the existence of intellectual assets has changed the competitive landscape, creating new areas for conflict and cooperation between competitors. Furthermore, this asset revolution has dramatically challenged the

10 *Markets in Intangibles: Patent Licensing*, Feng Gu and Baruch lev, p. 4.

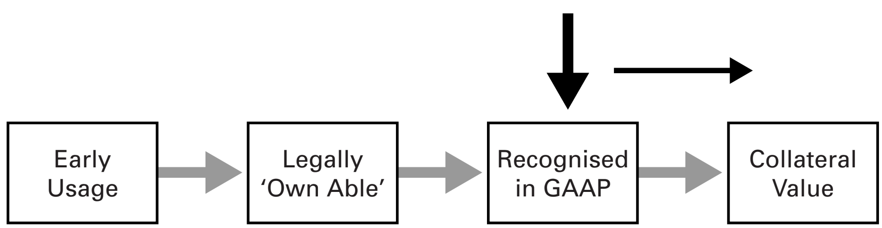
effectiveness of traditional command and control management structure, placing increasing stress on managers in all organisations.

Where are we in this Asset Revolution?

The maturation process of a new class of assets takes time and experience. Appreciating the special risks and responsibilities of a new property form are major challenges for management and society. It takes a social consensus for any individual property form to come into existence, to become defined legally; and it is social agreement that establishes the 'just' limits to the rights of property, the accepted responsibilities and privileges that are attached to property. Naturally as new property forms are brought into existence the rules around ownership need to be re-examined. For instance the patenting of the human genome raises important questions regarding ethics, access and timing limits on intellectual assets, which need to be answered by society before it will confer the rights of ownership with confidence.

Just as industrial assets grew and matured before they became established institutionally, so do all new property forms. Computer software, one of the most 'tangible' forms of intellectual property, spent a period of time in general usage before it became protect-able under law and therefore technically 'own able'. It took the success of Microsoft, Oracle and others before investors and serious analysts would even consider software as a legitimate corporate asset.

Maturity Pathway for Intangible Assets



GAAP (Generally Accepted Accounting Principles) defines an 'asset' in FASB 6 (US Financial Accounting Standards Board) as: 'anything you own that will provide future economic benefit'. In Canada CICA (Canadian Institute of Chartered Accountants) (section 1000.29 & .30) defines assets as: 'economic resources controlled by an entity as a result of past transactions or events and from which future economic benefits may be obtained'. Assets have three essential characteristics: (1) they embody a future benefit that involves a capacity, singly or in combination with other assets, in the case of profit oriented enterprises, to contribute directly or indirectly to future net cash flows, and, in the case of not-for-profit organisations, to provide services; (2) the entity can control access to the benefit; and (3) the transaction or event giving rise to the entity's right to, or control of, the benefit has already occurred.

As we can see, according to present GAAP and other recent changes in the United States (FASB 141, 142) nowadays knowledge assets should be recognized in their own right, and not automatically ignored or lumbered into 'goodwill' for accounting purposes. Intangible knowledge assets, meeting minimal criteria, should be accounted for separately, individually capitalised on the balance sheet and considered a 'real' asset for purposes of capitalisation, borrowing or security.

In practice however there is still a long way to go, even in the relatively advanced Western economies; management practices and auditing conventions have not adapted to this new reality according to accounting visionary Joseph Batty C.A., '*An analysis of the financial statements of today's companies would reveal that the* value *of these new (knowledge) assets are never included on company balance sheet. In many cases, even the* costs *of these valuable corporate assets are never included.' … If knowledge assets account for upwards of three quarters of corporate market value in 2002 how can auditors, in all conscience, state (as they are expected to) that the financial statements 'present fairly, in all material aspects, the financial position of the company'?*

Despite clear guidance from GAAP and other regulatory authorities, the message from the accounting profession is clear: the most productive assets in the economy are still being treated as suspect, almost illegitimate by the majority of accountants and auditors in the normal course of business. The legal profession, which deals with intellectual property rights in law, has a much more intimate relationship with knowledge as property, and as a result is very much closer to understanding the reality of knowledge asset value. But it is clear that intellectual property is still in the West a maturing concept, whose development will accelerate considerably over the next decade.

Capitalism's seemingly endless capacity to revolutionise the *means of production* has larger social and political consequences. Consider the impact of trade on the (pre-capitalist) feudal economy, (Karl Marx) '*At a certain stage in the development of these means of production and of exchange, the conditions under which feudal society produced and exchanged, the feudal organisation of agriculture and manufacturing industry, in one word, the feudal relations of property became no longer compatible with the already developed productive forces; they became so many fetters. They had to be burst asunder; they were burst asunder*'[11]. During the 16th–18th centuries in northern Europe trade flourished as capitalism revolutionised the older feudal (agricultural) economic structure, adding to it a new asset foundation, a new engine of growth and prosperity. The larger societal consequences of this economic revolution included the development of a 'national' consciousness paralleling the growth in markets and the national scale of economic control. These economic and social changes had profound political impact, eventually '*bursting asunder*' the feudal political order: or perhaps more accurately – tipping the overall balance of political power in favour of the national monarchies at the expense of the more localised feudal aristocracy.

By the late 18th century the capitalist revolution was on the move again, instituting another categorical expansion in the asset foundation. During this period British capitalism led the world into the Industrial Revolution, a phenomenon founded in another more advanced engine of growth, mechanised production and distribution. Industrialism in turn spawned its own political and social revolution. It was during this period of economic transformation that the rather novel concepts of democracy and the 'Rights of Man' emerged, supporting the reform movements of the 19th century. These reforms ultimately helped facilitate the transitions from absolute monarchy to elected (and more or less representative) democratic assemblies.

The revolution continues. The development of knowledge assets is having enormous economic impact, generating new forms of wealth in new and different ways. This new engine of growth is also (anticipated by Marx) '*changing thereby the relations of production*'. The reformation taking shape in the workplace is something that we've been experiencing for some time now, as the older management-worker hierarchies that characterised the industrial era are replaced by what is best described as a 'Silicon Valley' joint-

11 *The Communist Manifesto*, p. 3.

ownership approach. The modern workplace is more democratic and infinitely more accommodating of new ideas, shared responsibility and rapid change. These changes in the '*relations of production*' are still in their early stages, but it is clear that they will impact *'the whole relations of society*' in what are predictable but as yet unrealised ways.

A New Era of Global Prosperity

At each stage in the past where capitalism has revolutionised the asset foundation it has unleashed vast new wells of human energy – and (somewhat after the fact) delivered significant increases in living standards. Marx himself could hardly suppress his enthusiasm for the energy and vigour unleashed by the industrial economy. '*It (industrial capitalism) has been the first to show what man's activity can bring about. It has accomplished wonders far surpassing Egyptian pyramids, Roman aqueducts, and Gothic cathedrals; it has conducted expeditions that put in the shade all former exoduses of nations and crusades.'* It is fair to assume that (when not if) society recognises the importance of these new knowledge assets and puts in place the appropriate legal, regulatory and institutional support infrastructure the economic impact will be on a scale with the earlier commercial and industrial revolutions.

The consequences for world growth are intriguing. After the fall of the dot.com's and the subsequent stock market malaise, which continues into the present century, there was a genuine feeling among analysts and planners that the western economies had peaked, were stagnating. Conventional wisdom even today assumes that serious growth has shifted out of the western economies to the 'industrialisation' taking place in the newly emerging economies in Asia, and to a lesser extent, eastern and central Europe.

Clearly the situation is more complex than this simple picture. The western economies are in transition, in effect moving beyond the industrial age. They are, however, presently limited by chronic underdevelopment in the new asset potential that awaits them. Nevertheless, given the social, political and institutional challenges ahead (which inevitably accompany an economic revolution of this magnitude) the most likely centres for serious knowledge growth lie in the post-industrial societies of the western world.

In the developing world, the situation is less clear. The present growth in emerging economies is still largely confined to traditional industrialisation – albeit in the case of China on a very large scale. However even in these developing economies the educated 'knowledge elites' have, through their instant access to the new computerised engines of growth and the global digital distribution infrastructure, direct access to this new global knowledge economy, which they are exploiting to their great profit.

An asset class with virtually unlimited growth potential; and an ever-widening global playing field for development underpin the emerging knowledge economy. Problems in both the developed and the developing world, as Marx foretold, will be related to social justice issues, with the challenge of integrating society as a whole to this new economic and political reality. Despite these problems, which will no doubt challenge planners and political leaders for decades to come, the prospects for global growth are enormous.

Areas of Policy Study

Going forward, the knowledge revolution clearly illustrates the emerging sources of wealth, and points to institutional and attitudinal reforms necessary to accelerate the economic and political transition. In the developed 'post industrial' economies of the West, unlocking the full potential of the new asset categories will require reforms in government priorities, monetary policy, banking practices, accounting regulations and business thinking. Although many of these reforms are proceeding in an uncoordinated fashion at the moment, all need further analysis and study in order to meet the challenges ahead.

In the developing world the situation is complex. Hernando de Soto has identified key barriers to growth in 'weak' institutions: '*the institutions that make markets function efficiently in the developed world – including contract law, financial markets and respected judicial systems, are too often lacking in countries such as Peru*'. The western institutional stability so admired by Mr de Soto has only been accomplished after centuries of trial, error and reform. Accelerating the cycle in the developing world will require a model of development based on the dynamics inherent in capitalist political economy; in a dynamic system founded in an expanding estate of ownership driven by a constant revolution in the '*means of production*'. Building the consensus in support of this evolving dynamo in the developing world will require additional study and support, but once realised could open exciting new opportunities across the globe.

CHINA'S POPULATION POLICY

By Jim Bourlet

Having just spent 3 days in Beijing, Council members will appreciate that I am now an expert on China! But all the same, a few observations on population are in order, given the fact that whilst I was there, China's population reached 1.3 billion (around 20 times that of the UK, 10 times that of Japan, 4 times that of the USA – indeed some 21% of the total world) so that conversations were often on this topic.

There is both an overall resources problem – much publicised – and a class conflict problem which is much less discussed. China's leaders forever emphasise that resources are finite, that economic plans just cannot find ways to raise income levels when 'burdened' with excess population growth and that national success thus depends on controlling family size. This is the argument well depicted in the cartoon. The class conflict problem is, to say the least, less creditable. It is, in a way, simply a conflict between town and country. China's elite, both old and new, live in a modern world of city life and, on the back of hard work by plentiful labour, live a fairly recognisable 'western' style of life – a life in which children go through costly education and upbringing and where, in line with the developed world, small families of just one, maybe two children are close to the lifestyle choice they would make even without a population policy limiting childbirth. They resent migrants from the countryside 'taking away the jobs' which their children should have – indeed their children's inheritance at the pinnacle of this society is something to protect.

So a Communist planning system and a modern capitalist and professional city elite have combined to foster a population limiting policy. China's population was indeed rising spectacularly in the post-war years from around 600 million in 1953 to over 1000 million by the mid 1970s. The 'one child per family' policy then led to quite a dramatic slowdown – and an equally dramatic ageing of the population so that today's 1,300 million looks almost 'modest' – and could well begin to decline in the near future – but the future could be pretty bleak for many older people in countryside areas.

How was it achieved and what are some of the stresses as a result? Contraception education and policy promotion played a part but the main levers were laws and resources. It seems that there are fines, no free education, loss of state benefits and social ostracism for those who have more than one child – and maybe even the loss of jobs. And it has worked

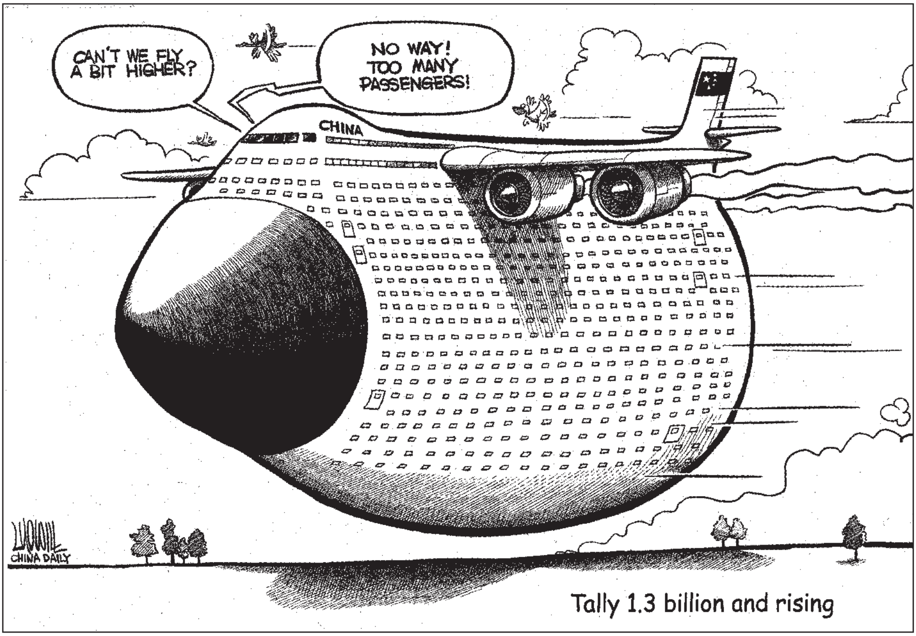
– with grandparents often still alive people talk of the spoilt child in the '4-2-1' family.

One well known result is the resort to female infanticide such that today there are only 100 newborn girls for every 120 newborn boys. This is raw primitive emotion at work. Over millions of years – before the worldwide acceptance of the idea of monogamous marriage a 'successful' male might produce many more grandchildren than a 'successful' female and so we developed an instinctive preference for boy offspring. But that is a very long time ago and today such feelings are as useless a relic as one's appendix or coccyx. But the resulting surplus of males in China has odd consequences – not the least being the increased relative value of females which is helping to overturn China's traditionally male dominated culture – but not necessarily in the cities since females are often more free to migrate there than males

As if to emphasise the essentially political rather than economic true nature of China's population policy there are important exceptions. Parents from Tibet or from minority ethnic groups of less than 10 million people are allowed more children. As far as I could gather, more or less as many as they liked. So what, I asked, if a member of one of these groups 'married out'? What happened to that right to have more children? Did it depend on whether it was a male or a female? My tour guide was emphatic on this one 'Either a man or a woman from an ethnic minority marrying outside of their group continued to have the right to more children'. Well now, that is an interesting dowry (and, if true, shows a rather enlightened cosmopolitanism)! And the authorities now say that population policy implementation is in the hands of regional authorities who have the powers to make many exceptions and variations to the 'one child' policy – another indication of the essentially political nature of the programme given the ever present threat of regional fracture within the hotchpotch amalgam that calls itself China. There seemed an echo of this issue in the tourist literature for Beijing which paraded the words 'Welcome to Beijing, the Capital of China'. Would we ever print 'Welcome to London, the Capital of Britain' or 'Welcome to Paris, the Capital of France'?

And where is the famed cheapness of everything in China? In the tourist world I visited, prices seemed pretty international – a Starbucks coffee costing much the same as here, taxis about half price and a suitcase I found at £30 was exactly the same price as the identical Chinese-made model I had bought the week before in London's Elephant & Castle shopping mall. The clue again is population. China's floating population, mainly moving from countryside to city was over 140 million in 2003. These are the workers for the many factories producing goods cheaply to order for western corporations and they manage to live on a pittance using accommodation and sustenance of impressive frugality. And all this is not made easier to accept by the fact that the Chinese authorities have refused to respect land rights claims of traditional farmers, thus fearfully refusing to expand (in Robert McGarvey's phrase) China's 'property matrix'.

Otherwise, what impressions can I report? Compared to Japan (which may as well be on a different planet) China is part of our world and one feels confident in trying to understand it. Taxi drivers hoot their horns, get mini road rage and barge around, people bargain outrageously in arcades, tourists are warned against pickpockets and I found a lightness of spirit and little examples of warm unexpected generosity. It is a land of family run firms and large state enterprises, of investments from overseas and of state run banks, of expansive road layouts and of modern office buildings with interesting and decorated roofs. And for me it seemed to be a place where at each spot visited – from a dusty antique shop to the Great Wall itself people produced something autographed to prove their proud point that 'Bill Clinton came here'.



Reproduced from the 'China Daily', 6 January 2005.

LETTERS

Some Explanations re: Contribution Holidays to Pension Funds from Mr Brian Lewis

Sir,

I have been worrying away at why public companies ceased making contributions to their pension funds, and now seem to have insufficient funds in reserve. I have now had some simple replies from the Minister, which can be summarized as follows;

1) The applicable Acts of 1986 and 1988 do not allow UK companies to hold funds in excess of 105% of (pension fund) liabilities. The Inland Revenue enforces the rule strictly.
2) Due to the rise in the value of investments over the 1990s, many UK companies exceeded the 105% figure and were able to stop contributing to their pension funds (thus paying higher dividends to their shareholders now rather than building pension funds for the future). Subsequently investment values fell and left pension funds without full support.
3) One might have imagined that actually money ought to have been set aside by UK companies for longer-term pension-fund obligations, but this was not allowed by the Inland Revenue rules.

My only comment is that Government surely cannot hide behind an argument that it is the fault of the Inland Revenue. The rules are passed by Parliament, and finally it is surely a political decision on how companies ought to contribute to their pension fluids over 40 years into the future.

Brian Lewis
15 Calcutta Street
Merville Subdivision
Parañaque MM

A response to Mr David B Smith's talk 'The effects of public spending and taxes on economic growth' from Mr Anthony Keston.

Sir,

David Smith told us that New Labour has pursued a growth-retarding policy by deliberately transferring resources from the high to the low productivity areas of the economy ..., a transfer of resources from the high productivity regions to the less productive ones ... a serious 'real' injustice. I take this to refer to (say) the North East versus London, and to imply that London tax rates should be reduced.

To reward 'achievement' in London (where the statistics are in any case highly distorted by rampant asset, house and wage inflation) by taxing London and the South East at lower rates than the North would seem to be an extremely mistaken course of action for the following reasons:

i) It would increase aggregate demand in this area of the UK and so increase the rate of inflation there. ii) It would pull in more people from outside these tax favoured areas, further increasing aggregate demand and so further adding to inflationary pressures. iii) It would act as a 'revenue reducing' factor for the government since a greater percentage of the UK population would be living and working in London and the South East. iv) It would increase pressure on public and private resources, again increasing supply side inflationary pressure. v) It would put added strain on utility supplies and the environment generally in this area. vi) In this day and age of e-mail addresses, P0 Boxes etc it would act as a recipe for fraud. Companies and individuals would be induced to state business addresses in this area whilst operating their businesses substantially outside this area. vii) It would set a very bad precedent. I believe it to be unheard of that any country with a developed democracy operates differential taxes other than between sub-sovereign territories such as between England and Scotland.

Anthony Keston
5, Dane Close
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An 'apologies for absence' from the Economic Research Council dinner on 1st November 2004, from Mr George Scales.

Sir,

Thank you for your invitation to the next Economic Research Council dinner on 1st November at which the speaker is to be Robert Worcester.

On the 1st November, 60 years ago, I took a 192 ft long LCT on the invasion of Walcheren Island (Holland). On board, we had 400 tone of ammunition and 100 Marine commandos. Three miles out, we were sunk and she went down in three minutes. The North Sea was cold and rough, but being an invasion fleet, we were soon picked up. My First Lieutenant, Jock Jamieson, was badly injured with an internal haemorrhage, but I didn't know it. As we were getting out of our wet clothes, our rescue vessel caught a packet and blew up. Jock and I were blown clear, back into the cold rough sea. Yet again we were picked up, this time by a hospital rescue vessel. Then it also got hit. We finally got back to Ostend on an LCT that had had its first tank blow-up on the way to the ramp door which had blocked all the other tanks. That ship had also been hit by a row of shells down the port side.

So please accept my apologies for absence on the grounds that on this November 1st, I will be back on Walcheren Island celebrating my survival.

George Scales
Cobbler's Pieces Abbess
Roding, ONGAR, Essex

A Response to 'The Decline of the Public Service Ethos' by Theodore Dalrymple, from Mr Stephen Baker

Sir,

In the Autumn edition of Britain & Overseas there is the text of Dr Theodore Dalrymple's talk on The Decline of the Public Service Ethos in which he lets fall an observation which caught my attention. It is at the opening of the last paragraph on p. 20 and reads 'So there's been a relentless increase in bureaucracy and all attempts to reduce it will now increase it.' It is almost a throw-away line but it strikes me with a degree of terror. If he is right (I must say I think he is or I wouldn't be writing this letter) and all attempts to reduce bureaucracy will only increase it then bureaucracy is as much a disease of society (and therefore of economics) as inflation is a disease of money and our Nation is set on a relentless course to an end as a former Chinese dynasty which collapsed under the weight of its own bureaucracy. For if internal change is impossible then there are, surely, only two alternatives: change by revolution which will only exchange one tyranny for another or some totally underived change ex nihilo such as revival.

Is bureaucracy a disease of society? I would like to know what wiser men than me have to say about it.

Stephen Baker
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Wedmore, Somerset BS28 4JT1

NEW MEMBERS

The Council, as always, needs new members so that it can continue to serve the purposes for which it was formed; meet its obligations to existing members; and extend the benefits of members to others.

Members may propose persons for membership at any time. The only requirement is that applicants should be sympathetic with the objects of the Council.

OBJECTS

i) To promote education in the science of economics with particular reference to monetary practice.

ii) To devote sympathetic and detailed study to presentations on monetary and economic subjects submitted by members and others, reporting thereon in the light of knowledge and experience.

iii) To explore with other bodies the fields of monetary and economic thought in order progressively to secure a maximum of common ground for purposes of public enlightenment.

iv) To take all necessary steps to increase the interest of the general public in the objects of the Council, by making known the results of study and research.

v) To publish reports and other documents embodying the results of study and research.

vi) To encourage the establishment by other countries of bodies having aims similar to those of the Council, and to collaborate with such bodies to the public advantage.

vii) To do such other things as may be incidental or conducive to the attainment of the aforesaid objects.

APPLICATION FORM

To the Honorary Secretary   Date ....
Economic Research Council
7 St James's Square
LONDON SW1Y 4JU

APPLICATION FOR MEMBERSHIP

I am/We are in sympathy with the objects of the Economic Research Council and hereby apply for membership.

This application is for *(delete those non-applicable)*

Individual membership (£25 per year)
Corporate membership (£55 per year)
Associate membership (£15 per year)
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Educational Institutions (£40 per year)

NAME ....
(*If Corporate membership, give name of individual to whom correspondence should be addressed*)

NAME OF ORGANISATION ....
(*if Corporate*)
ADDRESS ....
....
.... TEL. ....

PROFESSION OR BUSINESS ....
REMITTANCE HEREWITH ....
SIGNATURE OF APPLICANT ....
NAME OF PROPOSER (*in block letters*) ....
SIGNATURE OF PROPOSER ....