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A DIGEST OF NEWS AND VIEWS ON BRITAIN'S ECONOMY
AND OUR ROLE IN OVERSEAS TRADE AND PAYMENTS

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BRITAIN'S £1.2 TRILLION PERSONAL DEBT MOUNTAIN CRISIS OR SCARE STORY?

Extracts from contributions to a debate by Mr Vincent Cable MP, Liberal Democrat Shadow Chancellor, Mr Mark Hoban MP, Conservative Shadow Financial Secretary, Mr Martin Lewis, broadcaster, author and web site owner of moneysavingexpert.com, and Mr Phil Tinsley, Policy Director of the British Banking Association, held before members of the Economic Research Council on Thursday 22nd February 2007.

Mr Vincent Cable and Mr Martin Lewis spoke in favour of the motion that this *is* a crisis whilst Mr Mark Hoban and Mr Phil Tinsley *opposed*.

After the debate and a long question and answer session, the Chairman invited a show-of-hands vote on whether members concluded that there was a 'crisis' or just a 'scare story'. The result was a fairly even split with perhaps a narrow majority voting 'crisis'.

Mr Vincent Cable

There is a spectrum of views between those who may say that there isn't a debt problem at all – just some individuals who get into difficulties (which is just providence or bad luck) and those who believe that personal indebtedness is a much bigger issue which has the potential to become a debt crisis. The reason why I take a position closer to the latter view (and I will slightly caricature it) is in part based on historical experience – experience of the household debt problems and the country loans problems – Brazil, Mexico, Venezuela, Korea, of the 1990s. Those problems were not the end of history and we have a tradition of building up again, but this persuades me to be at the more nervous end of the spectrum.

There are several specific reasons why I am concerned that the personal debt problem could become very serious. First of all the current aggregate ratio of personal debt in relation to disposable income is at an historically unprecedented high and higher than in any other country (possibly excepting the Dutch). Secondly, the proportion of disposable income people are paying out for debt servicing including credit cards (OECD figures show just over 18%) is roughly comparable to what it was before we had the last big debt crisis in the early 1990s. Thirdly I am concerned because of the nature of mortgage lending.

There are two reasons why I am worried about mortgage lending. First of all, a lot of banks are lending considerably more in terms of people's income than is historically regarded as prudent. Traditionally the bench mark has been 3 times income, but now it can rise to 5 or 6 or even 7 times income. There used to be safety net elements such as mortgage protection insurance and help from the Social Security system but now a lot of people are borrowing very heavily without any fundamental safety net. If all goes well this may not be a problem but we can already see a lot of evidence from the very rapid increase in repossessions, particularly over the last year to 18 months and even more of repossession orders, which is the first stage in the process... nothing like the levels of the early 90s, but are we getting back to that. Secondly, whilst it can be argued that the British economy is currently doing well, the housing market is buoyant and interest rates are low, this jolly atmosphere may change. In the company where I worked before I became an MP we undertook 'scenario planning' to look at a range of possible futures. The basic concept was that you may hope for the best but you should always plan for the worst and it doesn't take a great deal of imagination to envisage circumstances when interest rates go up somewhat beyond present levels, perhaps not to the astronomical figures of inflationary periods in the past, but they could certainly go up. It is possible that in the next recession house prices might decline in real terms and the problems I have spoken about could move from being quite serious to becoming dramatically bad.

So what should we do about all this? More personal finance education and a cooling of debt, particularly student debt would help. But I think that overall we need to think much more creatively about how credit is managed because otherwise the cycle of boom and bust, the propensity to crisis, is potentially very strong and could leave us in a very very messy situation.

Mr Mark Hoban

50,000 people became insolvent in the last quarter of last year, twice the number of the same quarter in 2005. For them, debt was indeed a crisis. This leads to alarmist headlines in newspapers and growing enquiries for debt counselling services. Figures for household debt and consumer credit do indeed seem scary. But, rather like the post bag I get as an MP, one only hears the bad side of the story and so I want to look at the details to try and understand whether debt represents a crisis or just a scare story. Perhaps it is closer to the latter.

We need to look at the spread of debt, not at the absolute level. Reports from counselling services indicate that mostly the people with the greatest difficulty in repaying debt are the ones with rather modest indebtedness.

Research published last year found that about 66% of people didn't actually have a problem with managing their debt, they were able to meet their mortgage payments and had no problem at all. About 24% sometimes struggled – which means that a total of about 90% of people didn't have a problem with their finances. The problem pay with the other 10% and there were two very distinct categories wrapped up in that 10%. 7% had a constant struggle to balance the books and about 3% of people were actually falling behind in terms of debt repayment.

The 3% were struggling but were not, by and large, taking out credit cards, increasing their overdraft limits and taking new loans. They weren't adding to their debt. The 3% shared some common characteristics – they tended to be under 40, had families and dependent children, were dual income but were still failing to manage their debts.

I would not want to minimise the problems or pain of those people who are likely to declare themselves insolvent over the coming months but it is important to recognise the scale of the problem.

Just as whether or not an individual falls into debt difficulties often depends on a change in circumstance, perhaps losing their job, so the size of the '10%' depends on what happens to the economy in the months ahead. I have seen figures suggesting that a ½% increase in mortgage interest rates leads to a doubling in the number of people who would he struggling financially. So actually, one of the most important issues that will determine whether a person can ever recover from a financial crisis is the state of the economy. And there are a set of links here – if individuals fail to meet their debts the banks start to restrict their lending, the flow of debt into the economy is affected, then more people lose their jobs – and the cycle continues.

So if we can maintain economic stability and improve people's skills in handling their finances together with a careful look at the way that credit is marketed, there is a very good chance that our present credit worries can be overcome.

Mr Martin Lewis

Two and a half million users came to my website (moneysavingexpert.com) in January. My debt-free forum is the second biggest such forum in the world. I can tell you – what people are telling me – that a major debt crisis exists.

Let's talk about what's actually going on out there. 10% of people are technically what I would describe as 'debt-crisised'. That means being unable to meet minimum repayments, unable to pay their bills. That is a debt crisis. Is this debt reasonable, rational, budgeted and as cheap as it possibly can be? So often a figure like '£8000 on the credit card' is something not planned or budgeted for, not used to buy any lasting asset but just the result of current expenditure beyond current income. If you want to know how to borrow, who do you ask? We used to ask the bank manager but they just offer you their product. When I get a flyer through my door telling me that I can borrow £20,000 pre-approved, what am I to think? Surely, if we have a problem with debt junkies in this country, we should deal with these 'pushers'.

Then look at our students – whom we educate *into* debt but never *about* debt. It is a tragedy. Let me tell you what happens to a student these days. You go to university because you have done well at school and because you have the opportunity to go to university. There they say 'here you have to borrow'. So you borrow. Then they give you an interest-free overdraft, which is sold at Freshers' Fairs by students unions. So you borrow your interest-free overdraft. That's commercial debt. And now you get your credit card, and you've got your credit card debt, your commercial debt and your student loan debt and you leave university and start work. Now you've got so much debt you really don't care about borrowing more money because you are repaying for years so you borrow a bit more – and you're f...ed till you're 30. That is what is going on in our society since we introduced student loans.

Actually, my anger is not so much with the student loans system as with the failure of the education system to teach people how debt works. Whilst we hear people saying that what we need is responsible lending what we really need is responsible borrowing. We shouldn't give the people who sell debt the control over who moderates our debt. The banks' job is to make as much money out of us as they possibly can. That is their role. They are not there to look after us, they are not there to tell us what we can borrow, they are not there to help us – they are there to make money. The sooner the consumer understands this, the sooner we can move away from this debt crisis.

Don't define debt crisis to me in technical terms of people not being able to meet their minimum repayments. I have dealt with three suicides

– two on radio, and one on my website – because of bad and severe debt. I hear people crying and losing their relationships and breaking down, and these are people who can't meet their minimum repayments, these are people who desperately struggle because they don't want to go bankrupt, they don't want to go to a debt crisis agency.

So who can you ask if you want to know how to borrow? The answer is absolutely bloody no-one, because it doesn't exist. I set up my website four years ago with the relevant information and so for those who can read it for themselves there is some help. But for everybody else – those with mental health capacity issues, those with low incomes, those with poor education – there is absolutely none.

If you don't define that as a debt crisis, I don't know what is.

Mr Phil Tinsley

As Policy Director at the British Banking Association, responsible for consumer credit matters here and for that coming out of Brussels, I can share some thoughts with you tonight in support of the assertion that there are at present scare stories rather than a crisis.

I think it's worth clarifying a few points about people's personal debt. The debt mountain as it is described is not the same as overindebtedness. Most if not all of you will have at least one line of credit in your wallet or handbag but that does not mean you use it to excess. Overindebtedness is where a person can no longer afford to pay day to day bills and their position is becoming worse. Whilst not at all playing down the personal tragedy that lies behind such a situation it is a fact that the overwhelming majority of people do not fall into that category. The £1.2 trillion debt is the nation's debt and does not present a problem for the United Kingdom.

The vast majority of UK consumers are handling their debts responsibly, as evidenced by the report late last year of Prof Elaine Kempson entitled 'Overstretched – People at risk of financial difficulties'. The report said 60% of people show no financial strain at all, of the rest most are managing reasonably well and just 2% could be considered overindebted (as an aside 55% of that 2% were middle income households and not low income consumers).

Does it really matter that personal debt has reached £1.2 trillion? Well over 80% of that figure is in mortgages so the largest chunk is tied up in the housing market. But the rise in mortgage debt has in almost all cases been offset by a rise in the underlying value of the property. So lenders have performing loans and borrowers have increasing assets. The continuous debate concerning house price booms and crashes will exercise the minds of economists for the foreseeable future but the market eventually adjusts and if prices fall so ultimately will the level of borrowing.

The remaining part of the debt mountain is unsecured – credit cards and loans and here there has been a fair amount of flack for the banks. I would maintain that such credit if managed responsibly does not pose any structural danger. There may be a number of you who are thinking that by turning off the tap and lending less money any problems will go away. Traditionally that was the case. In fact it was so effective that governments often used restrictions on credit to help them manage the macro economy. Credit is a reflection of the 21st century – rainy day savings have been replaced by rainy day credit lines.

So the level of unsecured credit we see is not here today and gone tomorrow – it is a reflection of the way we live our lives. Volumes may be high but do not forget that within this individuals are making rational decisions and choices – recently there have been a number of consecutive months where overall balances have been reduced. Most people want consumer goods and have aspirational lifestyles and for most credit is the best way to afford it..

We cannot say that the nation as a whole is overindebted – we can only say that the nation as a whole is increasingly using credit. The challenge for all stakeholders is to ensure that consumers are clear as to the risks as well as the benefits. Lenders will play their part by ensuring lending policies are responsible but equally personal responsibility means we must encourage responsible borrowers.

So, ladies and gentlemen, there may be a debt mountain but it is scaleable and is not a crisis.

DOES BRITAIN HAVE REGIONAL JUSTICE, OR INJUSTICE, IN ITS GOVERNMENT SPENDING AND TAXATION?

By David B Smith

Introduction

The United Kingdom of Great Britain and Northern Ireland – to use its full title – has a highly centralised political system by international standards. It is only recently that even quasi-reliable regional statistics have become available. This has partly resulted from the initiatives of the European Union (EU). One result is that the Office for National Statistics (ONS) publication *Regional Trends* – which is the source for much of the data I will be examining here – provides pan-European, as well as purely British, regional comparisons (see: Philpotts and Causer (2006)). I will examine the data for the twelve main regions into which the UK is officially sub-divided.

The main finding from my analysis is the striking difference between the various parts of the UK with respect to living costs, output per capita, propensities to work, and the degree of socialisation. The most important policy conclusion is that Britain's onerous and interventionist tax and benefit systems are seriously unjust to the parts of our nation with a high marginal product in cash terms, and over transfer resources to the cheaper and less productive areas. However, and like alcohol, too much government spending can be of more harm than benefit, even when it is provided as a 'free good'. In particular, the regional transfers generated by the UK tax and spending systems may have surpassed the point at which they have started to damage local employment, even when expenditure is paid for from outside. This means that the inhabitants of the recipient areas, as well as those of the donating ones, may both be adversely affected by the 'money illusion' in the present system.

Key Differences Between the UK Regions

Table 1 summarises the main demographic and labour-market features of the twelve main regions into which the UK is sub-divided, while some further background information appears in Table 5. I will not discuss the highly disaggregated data that is available, though even a cursory examination of the data suggests that the intra-regional differences are far larger than the inter-regional ones. This needs to be born in mind when considering the data presented here. A number of features emerge from Table 1. The first is the wide spread of population sizes between the regions, with Northern Ireland containing just over 1.7m people but South-East England over 8m. Second, there are the different propensities to be employed, with 9.2 percentage points more of the population of working age having jobs in the South-East than in Northern Ireland. Third, there are noticeable differences in unemployment, as measured by the official Labour Force Survey (LFS). Fourth, there exist huge differences in the ethnic composition of the regions; with 32.1% of Londoners being non-white in 2004, but only 0.9% of the Northern Irish and 2.3% of the Scots and Welsh. Finally, there are different propensities to be on benefits, with 'only' 36% of households receiving non-retirement-related benefits in the South-East, but 41% in Wales, 44% in the North-East and 51% in Northern Ireland.

Table 1: Key Demographic Statistics for the UK Regions

	Population Mid-2004 (000s)	*Economically Active in June to August 2006 (%)*	*Employ. Rate in June to August 2006 (%)*	*Labour Force Survey Unemp. in June to August 2006 (%)*	*Non-White Population in 2004 (%)*	*H'holds in Receipt of Benefits in 2003/04* (%)*	*Workless H'holds in Autumn 2005 (%)*
North-East	2,545.1	76.4	71.2	6.7	2.9	76(32)	21.8
North-West	6,827.2	77.7	73.3	5.5	6.0	72(31)	17.8
Yorks & Humber	5,038.8	78.6	73.9	6.0	7.5	72(30)	16.7
East Midlands	4,279.7	81.5	77.2	5.1	7.4	68(30)	12.8
West Midlands	5,334.0	78.6	73.6	6.2	11.4	70(29)	15.9
South-West	5,038.2	81.1	78.3	3.4	2.6	69(34)	13.6
East	5,491.3	81.3	77.3	4.8	5.5	68(31)	12.6
London	7,429.2	76.1	69.8	8.2	32.1	60(22)	20.1
South-East	8,110.2	83.0	78.9	4.8	5.8	67(31)	11.9
England	50,093.8	79.5	74.8	5.6	10.1	69(30)	15.7
Scotland	5,078.4	78.9	75.1	4.8	2.3	71(30)	18.5
Wales	2,952.5	76.6	72.0	5.8	2.3	73(32)	19.5
Northern Ireland	1,710.3	73.0	69.7	4.3	0.9	78(27)	19.6
UK	59,834.9	79.1	74.6	5.5	8.8	69(30)	16.2

Sources: UK Office for National Statistics *Regional Trends 2006* and *Labour Market Statistics First Release,* 18 October 2006.

* Figures in brackets are retirement benefits only.

Regional contributions to GDP

Table 2 (below) sets out the contribution of the various regions to national output, defined as UK Gross Domestic Product measured at basic prices

– that is net of the majority of indirect taxes and subsidies – I will discuss the various competing measures of national output in more detail later on. The basic-price measure of GDP is also called Gross Value Added – or GVA in short – by the ONS, who compile the figures, and I will be employing the two terms interchangeably. The figures nominally refer to 2004 and are taken from Marais (2006). There are three caveats with respect to the ONS data presented by Marais, however, and these mean that it has to be interpreted with some care. One odd feature of the ONS regional statistics is that the so-called annual regional GDP/GVA figures are not genuine annual data but five year moving averages. This means that the alleged 2004 figure is an average of the period 2000 to 2004 and is centred on 2002, but has then been scaled up to match the cash value of UK GVA in 2004. The ONS has highlighted the five-year averages because the raw annual figures are too volatile to be relied upon, although the raw series are available on the ONS data bank. Another quirk in the ONS data is that there is an *extra-regio* component of GVA, which reflects activities such as North Sea energy production that cannot be allocated to specific regions, and explains why the UK total exceeds the sum of its components. The final point to be aware of is that regional incomes have been allocated on a residence basis in Table 2. This means that the income of commuters has been allocated to where they live, rather than their

Table 2: Regional Gross Value Added (GVA) in Nominal and in Real Terms

	GVA at Current Basic Prices (£m in 2004)	*GVA as Share of UK Total (%)*	*GVA Per Capita (£)*	*GVA Per Capita as Indices (UK=100)*	*Average Regional Price in 2004 (UK=100)*	*GVA Corrected for Price Diff. (£m)*	*Real GVA per Capita as Indices (UK=100)*
North East	34,188	3.4	13,433	79.9	94.2	14,260	84.9
North West	101,996	10.1	14,940	88.9	96.9	15,418	91.8
Yorks & Humber	75,219	7.5	14,928	88.8	94.2	15,847	94.3
East Midlands	65,770	6.5	15,368	91.5	97.4	15,778	93.9
West Midlands	81,745	8.1	15,325	91.2	97.8	15,670	93.3
South West	78,650	7.8	15,611	92.9	101.3	15,411	91.7
East	100,307	10.0	18,267	108.7	101.1	18,068	107.5
London	164,961	16.4	22,204	132.2	109.7	20,241	120.5
South East	158,187	15.7	19,505	116.1	105.3	18,523	110.2
England	861,022	85.6	17,188	102.3	n/a	n/a	n/a
Scotland	82,050	8.2	16,157	96.2	94.5	17,098	101.8
Wales	39,243	3.9	13,292	79.1	93.7	14,186	84.4
Northern Ireland	23,058	2.3	13,482	80.2	93.1	14,481	86.2
UK	1,033,324	100.0	16,802	100.0	100.0	16,802	100.0

Source: Office for National Statistics. See articles cited in main text.

place of work. However, workplace-based estimates are also compiled by the ONS and are presented in Marais (2006). In practice, the figures are identical for all regions apart from London, whose GVA rises by 12.4% to £185,398m on a workplace basis, and Eastern England and the South East, where GVA falls by 10.9% and 6% to £89,405m and £148,651m, respectively, reflecting the well known commuting patterns in the area concerned.

Differences in nominal and real regional output

Table 2 brings out the extent to which England dominates the UK total, and the fact that London, the East, and the South-East – which might be regarded as one large 'travel-to-work' area – together contribute 42.1% of UK GVA, compared to Scotland's 8.2%, Wales's 3.9%, and Northern Ireland's 2.3%. The third and fourth columns of Table 2 show the variations in the value of GVA per capita in cash terms, also expressed as indices. This is as far as the official statistics normally go. However, it is possible using the data in Wingfield, Fenwick and Smith (2005) to correct the cash GVA figures for the differences in regional living costs (including housing) observed in 2004 and this is done in the final two columns. The table indicates that nominal GVA per capita in the East Midlands, for example, is 8.5% below the UK average, but its living costs are 2.6% lower, implying that its real GVA per head is some 6.1% below the UK average.

Wide differences in living costs distort cash picture

It should be clear from Table 2 that the fact that the price level in London is some 16½% greater than in the North-East and 12½% higher than in the East Midlands, for example, means that the simple cash figures overstate the degree of regional inequality. Incidentally, much the same issue arose in the early days of development economics when people became aware that comparisons of national GDP per head calculated using market-exchange rates were misleading. This was because many developing countries had little trade exposure. It is now accepted that the correct methodology is to use purchasing power parities, which allow for the differences in the price of all goods and services, not just those that are traded internationally.

Money illusion in the current system

The marked regional differences in living costs within the British Isles are important, because much of the justification for government transfers from one part of the UK to another is based on the idea that certain places are systematically poorer than others. However, if these transfers do not allow for regional price differences, they can end up suffering from a 'money illusion', and shift resources from places which are poorer in real terms to those which are better off. Thus, in cash terms, London appears to have a GVA per head that is 65¼% higher than that of the North-East, for example, but this gap shrinks to 42% once relative living costs are taken into account. Likewise, Scotland appears to have a 3¾% lower GVA per head in cash terms than the UK average, but this reverses to being 1¾% above the national average once relative costs are allowed for; while the Welsh shortfall drops from almost 21% to 15½%. This does not mean that the relative regional consumer price level is a perfect measure for deflating GVA, and there are numerous measurement problems involved, which are discussed in Wingfield, Fenwick and Smith (2005). Even so, it is clearly better, as a general principle, to carry out a rough and ready adjustment than to make no allowance whatsoever for the wide differences in regional price levels that prevail within the UK.

Regional Breakdown of Public Spending

British governments have been engaging in regional policies ever since the Great Depression of the 1930s. This support has taken both overt forms, such as regional development grants, and implicit ones, such as the transfer of resources from one region to another by means of the tax and benefit systems. The HM Treasury publication *Public Expenditure: Statistical Analyses 2006* breaks down government spending by region and it is possible to combine these figures with the regional GDP data to estimate the degree of socialisation of each part of the UK. There are a number of adjustments that have to be made to the figures before this is possible, however. This means that the data should be regarded as approximate, rather than precise.

Different measures of Gross Domestic Product

One problem is that the regional spending figures refer to fiscal years, while the GVA statistics are smoothed calendar year ones. This problem has been tackled by scaling the GVA figures onto a financial-year basis, using the corresponding ratios for national GVA, which is available in both forms. A second difficulty is that it is not possible to allocate large parts of government spending onto a regional basis. What has been done here is to scale up the HM Treasury regional figures so that they sum to the equivalent national totals. In practice, this means that they have been boosted by no less than 23.9%. A third issue is that there are three separate ways of measuring GDP, and the chosen option can make a noticeable difference to the ratios concerned. *GDP at market prices* is reported gross of indirect taxes and subsidies, and therefore understates the tax and public spending burdens, but is the officially preferred measure and is widely employed for international comparisons because many countries only publish such figures. *GDP at factor cost* excludes all indirect taxes and subsidies, and is arguably the best overall measure of the resource costs of government (Smith (2006)), but is now given less prominence than the hybrid *GVA/GDP basic-price measure*, already encountered, which excludes some, but not all, indirect taxes.

As a result, Table 3 presents the regional public spending ratios on all three GDP bases for 2004–05, where the basic-price regional GDP estimates have been scaled up to their factor cost and market-price equivalents, using the UK ratios for the same financial year. The *Public Expenditure: Statistical Analyses 2006* provides historic figures back to the fiscal year 2000–01 and 'plans' for 2005–06. However, it was decided not to use the latter because it was not yet hard data and more than enough ropey calculations had been engaged in already.

Table 3: General Government Expenditure in 2004–05 by Country and Region

	Indentified Public Spending 2004–05 (£m)	*Scaled Public Spending 2004–05 (£m)*	*Estimated GDP at Basic Prices in 2004–05 (£m)*	*Ratio to GDP at Factor Cost (%)*	*Ratio to GDP at Basic Prices (%)*	*Ratio to GDP at Market Prices (%)*	*Propn. Empl'ed in Public Sector* (%)*
North-East	18,241	22,592	34,566	66.4	65.4	58.1	23.7
North-West	47,312	58,596	103,125	57.7	56.8	50.4	21.5
Yorks & Humber	32,063	39,710	76,051	53.0	52.2	46.3	20.3
East Midlands	25,099	31,085	66,498	47.4	46.7	41.5	17.9
West Midlands	33,559	41,563	82,650	51.1	50.3	44.7	19.5
South-West	30,036	37,200	79,520	47.5	46.8	41.5	20.4
East	30,779	38,120	101,417	38.2	37.6	31.3	18.6
London	55,938	69,280	166,787	42.2	41.5	36.8	19.0
South-East	45,609	56,487	159,938	35.8	35.2	31.3	17.6
England	318,636	394633	870,551	46.0	45.3	40.2	19.5
Scotland	38,581	47,783	82,958	58.5	57.6	51.1	23.8
Wales	21,400	26,504	39,677	67.9	66.8	59.3	23.3
Northern Ireland	14,052	17,403	23,313	75.8	74.6	66.2	29.8
UK	392,669	486,323	1,044,760	47.2	46.5	41.3	20.3

Sources: HM Treasury and Office for National Statistics.

*Average of four quarters to 2005 Q2. The original Labour Force Survey figures have been scaled down by the ONS (see: Hicks et al (2005) for details).

The first thing that emerges from Table 3 is the incredible differences that can be observed between different areas of the economy, with government expenditure in South-East England amounting to only 31.3% of the market-price measure of GDP, while the equivalent figures for Scotland, Wales and Northern Ireland are 51.1%, 59.3% and 66.2%, respectively. Even if these figures may not be correct to more than a few percentage points, they still suggest that North-East England, Wales and Northern Ireland almost qualify as Potemkin economies, with virtually no ability to stand on their own two feet. It is also worth noting that even the Soviet Union in the 1970s had a black-market sector of around 25% of GDP, while many other Eastern European economies at the time had even larger non-socialised sectors, with above quota agricultural production, owner occupied housing, and small scale personal services often being left to their own devices. If a 75% public spending ratio is taken as a working definition of Communism, rather than 100%, then only three UK regions (East, South-East and London at 49%) are not more than half way there, while England as a whole is not quite 54% of the way to the 75% mark, Scotland is 68% of the way, Wales 79%, and Northern Ireland over 88%. Many academic economists spend a lot of time analysing the consequences of 'market failure' in the private sector. However, no more than the remnants of a market economy now survive in many parts of the British Isles. Irrespective of whether one regards this as a good or bad thing, it is difficult to avoid the conclusion that 'government failure' could now be a more important source of the problems facing certain UK regions than any failure in the private market sector. The implicit null hypothesis here is that the relative contributions to a given area's problems are likely to reflect the relative sizes of the government and private sectors in regional output.

How UK regions compare with OECD member countries

At this point, it is instructive to compare the regional government spending ratios in Table 3 with the corresponding data for the twenty-seven Organisation for Economic Co-operation and Development (OECD) members provided in the Annex to the OECD's June 2006 *Economic Outlook* (*ibid* Table 25, page 187). This comparison reveals that, if it were a nation, South-East England would qualify as possessing the lowest public spending ratio in the OECD after South Korea, while the government spending share in Wales exceeds Sweden's top-side record by almost 1 percentage point and Northern Ireland overshoots it by 7¾ percentage points. It is also interesting that if London, the South-East and the East are treated as a unit, their combined government expenditure amounts to 34% of market price GDP. This is below Ireland, the

US, Switzerland, and Australia, which are all usually considered to be low tax economies, and would again leave this Southern bloc with the second lowest OECD public spending share after South Korea.

Is High Public Spending Damaging, Even When Provided Free?

Before UK regional spending data became available a few years ago, I used to believe that the main problem with pushing government spending beyond its optimal point was not that it inevitably generated zero or negative marginal social benefits, but that it had to be paid for (economists call this the government's Budget constraint) and that all three possible funding methods – higher taxes, bond issuance, or borrowing from the central bank – had adverse consequences that, beyond a certain optimum point increasingly outweighed the gains and led to slower growth, increased structural unemployment, and possibly higher inflation, if the monetary authority became subservient to the politicians.

The persistent underperformance of certain areas of the UK, despite decades of massive transfers from outside, gives rise to the more disturbing possibility that high levels of government spending may themselves be responsible for many of the problems of the poorer regions of our nation – even if the public spending is not financed through local taxation but by transfers from other parts of the country. This might seem paradoxical at first sight, and gives rise to the question of how large amounts of free money can possibly be damaging. One possible political-economy explanation is that being in receipt of transfers is positively harmful to a region's economic dynamism, because it encourages people to look towards political activism and state dependency, rather than their own efforts in the marketplace. This explanation is entirely consistent with the traditional concept of the rational economic person, who tries to maximise his or her rewards while putting in minimum effort. It may be easier to lobby for a handout than to work a ten-hour shift in a steel mill, for example. There is also the interesting phenomenon that high government spending regions, such as Scotland, Wales and the North-East, seem to produce large numbers of political entrepreneurs, who live off and lobby for a large state, but few of the traditional wealth creating kind these days – compare and contrast the careers of James Watt and Gordon Brown, or George Stephenson and Alan Milburn, for example. Again this is entirely consistent with the predictions of the rational economic behaviour approach, which states that enterprise will be channelled to where it attracts the highest rewards. If this appears too simple, a more sophisticated view of human motivation can be found in the relatively new approach of behavioural economics, which attempts to integrate the insights from psychology into traditional models of economic behaviour (see: Beaulier and Caplan (2002)), for example). This suggests that welfare benefits can perversely encourage the pursuit of instant gratification and even self-destructive behaviour, such as drug addiction, on the part of recipients. It was recently revealed that more than 100,000 UK recipients of invalidity benefit suffered from drug or alcohol dependency, for example. It is certainly arguable that sustaining such people indefinitely in this state is probably one of the cruellest things that one can do to them. However, there are also good reasons in the traditional economics of labour markets that explain why inter-regional transfers can become a problem, rather than a solution, to which I will now turn.

Thus, most economic textbooks have a diagram such as Diagram A that shows the marginal product of labour and the cost of employing labour on the vertical axis, and a curve that slopes downwards to the right relating the two. The chart can then be used to show why introducing a mandatory minimum wage, paying benefits to people who do not want to work, or imposing high levels of social overhead costs, such as employers' National Insurance Contributions, can cause the employment of the least productive workers to be truncated. This is because it either costs more to employ them than they are worth, or they would rather sit at home and draw benefits (this benefit rate, minimum wage or social overhead cost

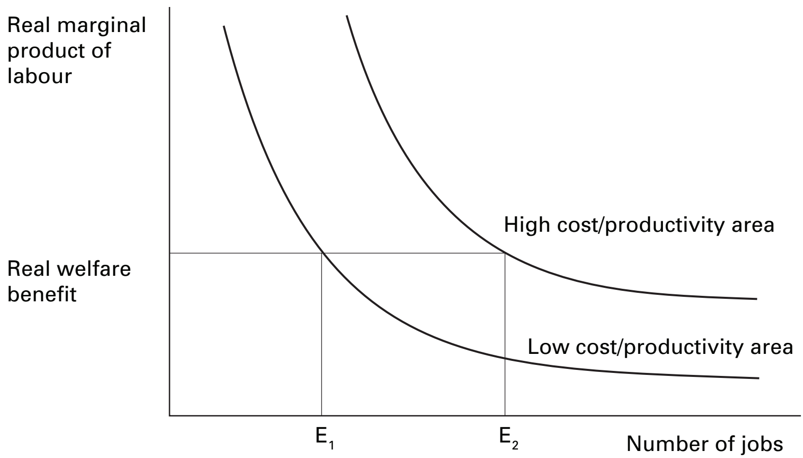

Diagram A: How Government Imposed Costs Destroy Jobs appears as a horizontal line in Diagram A). There is considerable debate with respect to the scale of these effects, and Diagram A applies best to a fixed absolute levy like the minimum wage, but few economists would deny the logic of this argument.

Such textbook diagrams are usually taken to refer to the economy as a whole. However, if there are a series of distinct regional labour markets, with imperfect mobility between them, there will not be one such curve but many, with the high productivity/high cost of living areas having curves well above those of the cheaper and less productive regions. Imposing one national minimum wage or level of unemployment benefit, in cash terms, will correspondingly have quite different employment-destroying effects in different areas of the country. For example, employment in a low productivity area, such as the North East of England, will settle at E1 representing fewer jobs than in a high nominal productivity area such as the South East (E2) if both areas have the same level of welfare benefits or minimum wage etc. Because welfare benefits (and the minimum wage) are indeed the same in cash terms throughout the UK, they have greater adverse effects on employment in the low productivity areas as measured in current prices. This point is illustrated in the third column of Table 5, which scales the current £5.35 per hour minimum wage for the differences in median gross weekly earnings in the various regions of Britain. This suggests that the minimum wage should range from £4.78 in the North-East, to £5.05 in the East Midlands, £5.58 in South-East England, and £6.90 in London, if it were to reflect regional differences in median earnings. The fact that it does not do so explains why the minimum wage is likely to price more people out of employment in the North East than in London, for example.

However, the situation may be worse than this because there appears to be a far larger 'tail' of poorly educated, unskilled and elderly workers in the old industrial areas (see: Lad (2006)) suggesting that the two curves in Diagram A are not parallel. The implication is that the 'free money' that finances welfare benefits in Northern Ireland, Wales, Scotland and Northern England through taxes collected in London and the South East diminishes employment in the former regions due to its micro-economic effects. This seems to be what has happened in the UK, and is also the situation in East Germany, where West German employment costs were imposed on an economy where output per head was only around one-third of that in the West. A transatlantic example of the same adverse processes at work can be found in Puerto Rico, where the availability of US levels of social support seems to have destroyed what at one point looked like a prospective economic miracle (see: *The Economist* (2006-1)).

Having Higher Taxes and Benefits does Reduce Willingness to Work

Left-liberal economists still tend to argue that the effect of higher taxes on work effort is theoretically ambiguous. This is because the loss of income caused by increased taxes encourages people to work harder and that this offsets the so-called substitution effect, whereby leisure was made more attractive than work effort. However, Heitger (2002) researched into the effects of the tax burden and other labour market interventions on unemployment and found that a high tax burden had a particularly powerful adverse impact on long-term unemployment, and could explain why there were far higher jobless rates in Continental Europe than in the USA. Subsequent research by the 2004 Nobel Laureate Edward Prescott has also demonstrated that the substitution effect is more powerful in practice and that the elasticity of labour supply with respect to the post tax real wage is probably around three, and certainly nowhere near zero. He was then able to use this phenomenon to explain why working hours appear to have fallen sharply in Europe over the past three decades but not in the US (see: Prescott (2004)). Prescott's research was subsequently taken further in a European Central Bank *Occasional Paper* by Leiner-Killinger, *et al* (2005) who found:

> Countries with a relatively high tax wedge (which captures the amount of social security contributions, payroll taxes, personal income tax and consumer taxes that create a wedge between real labour costs for employers and the real take-home pay of employees) tend to record a lower level of annual hours worked per capita. Belgium, France, Italy and the Netherlands, for example, which were at the low end of the annual hours worked per capita scale in the euro area in 2004, have particularly high tax wedges. Countries with high marginal tax rates, for example, Belgium Germany and the Netherlands, also show some tendency towards shorter average annual hours per worker, especially among women. Reductions in labour taxes probably contributed to the increase in average annual hours worked per capita in some countries, such as Ireland, in the second half of the 1990s.

… and Needs to Vary Regionally

Such research indicates that pricing out effects both exist, and are powerful, at the level of individual economies. The corollary is that regional differences in the replacement ratio (the ratio of out of work benefits to post-tax earnings) may also help explain regional disparities in employment rates. However, one has also to bear in mind the complexity of the present tax and benefit systems, including the 'passporting effect', whereby entitlement to one benefit opens the door to others; the recent Institute for Fiscal Studies (IFS) paper by Adam *et al.* (2006) examines this 'poverty trade-off' in some detail at the national level. One palliative to the regional anomalies associated with the present system would be to introduce regional differentials in welfare benefits and the minimum wage, to reflect the divergent productivity and living costs of the regions concerned, and the present government has toyed with a similar idea with respect to public sector pay. Indeed, it is arguably extremely unfortunate that the government did not pursue this approach because the 44.2% excess of median earnings in London over those in the North East, for example, explains why the alternative employment opportunities for anyone contemplating a career in public services, such as teaching, are far more tempting in one place than another.

Another alleviative approach, widely practised in nations with a Federal structure, is to make welfare benefits a responsibility of devolved arms of government, such as states, provinces or cantons. Historically, in Britain, much welfare was provided at the Parish level, which meant that the beneficiary and the administrator often knew each other well, something that tended to be more helpful to the 'deserving poor' who had been rendered destitute by genuine misfortune than the so-called 'undeserving poor'. The local administration of welfare allows benefits to be set more appropriately to local conditions, and can reduce the problems caused by setting one benefit level across a heterogeneous area. It also explains why social harmonisation at the EU level would be a potential disaster, since almost no one would bother to work in Portugal, Southern Italy or Greece if they could access Swedish or German levels of unemployment benefit. However, it is an interesting thought experiment to think what would happen to German unemployment, or the number of Dutch sickness benefit claimants – which contains a remarkably large number of young males with alleged depression – if benefits in these countries were harmonised at Portuguese levels.

… If it is not to Lead to 'Crowding Out'

That the crowding out of private employment is not just a theoretical possibility, but is now a growing concern for real businessmen in the high-spending regions of the British Isles, can be seen from an article by Eddie Barnes that appeared in *Scotland on Sunday* on 9 October 2005, describing research by economists at Scottish Enterprise into the scale of public spending in each of Scotland's fifteen health board regions. The study revealed that in Argyll and Clyde, 76% of the economy was generated by the state; in Ayrshire and Arran the figure was 74%; and in Lanarkshire it was 72%; with only oil-rich Grampian (35%) and finance-friendly Lothian (39%) anywhere close to the UK spending average. In commenting on the figures, Alan Mitchell of CBI Scotland said:

> To have that much of the economy generated by wealth spending, rather than wealth creating, can't be good for the Scottish economy in the long term. It has a major effect on the ability of companies to recruit and retain staff. Their margins are tight and they cannot compete in terms of holiday, pensions, child-care and all the other add-ons that the public sector can offer. If we don't have ambitious small- to medium-size businesses growth, then we aren't going to develop the economy long term.

The background to this concern is that the UK's real GDP rose by 22.9% between 1998 and the first half of this year while the Scottish equivalent only increased by 16.1% over the same period, despite the large increase in the government component of Scotland's GDP.

Regional Justice, or Regional Injustice, in Tax and Spend

A fair tax system should levy the same real burden on people with the same real income, and does not take a larger share of, say, a plumber's real wages in London than it does in Derby, simply because the cost of living is dearer in the former than the latter. Likewise, the allocation of government spending should be based on providing citizens who have the same physical needs with the same volume of public services, regardless of whether the services cost more to provide in one location than another. Otherwise, the distributional effects of what is now a highly interventionist state become arbitrary and unjustifiable. This is arguably now the case in Britain, and the situation is likely to get worse as the scale of government spending and other interventions continues to rise.

Table 4 shows the reported level of government spending on a per capita basis (not scaled up, unlike Table 3) in cash terms, and also after correction for regional variations in the cost of living. It can be seen that the South-East and the East get a raw deal, even in nominal terms. However, this becomes more noticeable in real terms, while the relatively privileged positions of the Celtic fringe and the North East become more apparent. One example is that per capita expenditure in Northern Ireland is 46% higher than in the South-East

Table 4: Public Expenditure Per Capita and Tax Thresholds Adjusted for Relative Regional Incomes and House Prices

	Public Spending Per Capita in 2004–05 (£)	*Price-Deflated Public Spending (£)*	*Personal Allowance for Income Tax (£)*	*Starting Point for 40% Income Tax (£)*	*IHT Threshold Corrected for House Prices (£)*	*Regional House Prices in March 2006*	*Gross Value Added Per Filled Job (UK=100)*
North-East	7,167	7,608	4,501	29,770	199,226	135,125	92.2
North-West	6,930	7,152	4,753	31,435	218,219	148,007	91.4
Yorks & Humber	6,363	6,755	4,662	30,836	217,828	147,742	90.2
East Midlands	5,865	6,022	4,748	31,402	234,437	159,007	97.5
West Midlands	6,291	6,433	4,698	31,069	242,997	164,813	94.6
South-West	5,962	5,885	4,683	30,969	297,251	201,611	92.8
East	5,605	5,544	5,005	33,100	302,917	205,454	100.9
London	7,530	6,864	6,490	42,924	404,147	274,113	124.7
South-East	5,624	5,341	5,257	34,765	343,708	233,120	104.2
England	6,361	n/a	n/a	n/a	287,506	195,001	101.3
Scotland	7,597	8,039	4,783	31,635	195,018	132,271	96.8
Wales	7,248	7,735	4,552	30,103	219,267	148,718	89.7
Northern Ireland	8,216	8,825	4,516	29,870	208,628	141,502	85.8
UK	6,563	6,563	5,035	33,300	275,000	186,519	100.0

Source: Office for National Statistics and Department of Communities and Local Government (2006).

in nominal terms, but 65¼% higher in real terms.

Unfortunately, there are no definitive figures for the tax receipts generated by the various parts of the UK, although MacSearraigh, *et al.* (2006), provide some interesting figures for the partial concept of current taxes, which show the *per capita* current taxes paid by Inner Londoners running some 60% to 80% above the UK average over the past decade, while at the other extreme the inhabitants of Cornwell and the Isles of Scilly have paid some 36% less *per capita* in recent years. Instead, the next two columns of Table 4 attempt to adjust the starting points for income tax, and the higher rate threshold, for the difference in median weekly earnings in each region, while leaving readers free to use the regional price indices set out in Table 2 or the regional GVA per head data in Table 4, if they prefer. The next column adjusts the Inheritance Tax (IHT) threshold to take account of regional differences in house prices. Clearly, estates contain assets other than houses, but homes appear to be the dominant asset in the case of small estates, where inheritance tax first starts to bite. It is notable that people in London face house prices 2.1 times higher than those in Scotland and are far more likely to be owner occupiers, for example, and that the starting point for higher rate income tax should be £13,054 higher in London than in Northern Ireland, if people at the same point in their regional income distributions were to be taxed equivalently.

Conclusions

The main conclusion is the striking variation between the different parts of the UK. The main policy implication is that imposing an onerous and interventionist tax and benefit system on a nation with such wide regional differences does substantial injustice to the parts of the country with a high cost of living and a high output per head, and unduly benefits the cheaper and less productive areas. However, the failure of large parts of the UK to prosper, despite the fact that their public spending comes as a free good from outside, suggests that high public spending, like excessive consumption of alcohol, can be directly harmful in itself. Employment is probably reduced by regional transfers because nationally set benefit scales, and interventions such as the minimum wage, price more people out of work in the cheaper and less productive areas of the country, and engender a 'dole culture', if sustained over several generations. This 'pricing out' may also explain the differences in joblessness between superficially similar ethnic groups; Indians have the highest employment rates of any ethnic group, for example, while other groups originating from the sub-Continent have some of the lowest. These differences are far too wide to be explained by racial prejudice. They can, however, be explained by Diagram A if it is posited that the marginal product of certain native as well as immigrant groups is much lower than that of others (see: The Economist (2006-2)), because their educational attainments and other economic determinants of their productivity are also lower, so that Indians are on the high curve and certain other distinctive groups are on the lower. The failure of the British education system to eliminate such differences in attainment and productivity, even after several generations have grown up here, clearly has a lot to answer for.

The fact that London, the South-East and East England together account for almost 42% of UK GDP, and have a combined government-spending burden of only 34% of the market-price measure of GDP is consistent with the views of economists, who have argued that there are almost no welfare gains from pushing government expenditure beyond the 30-35% mark. Unfortunately, one can only dream about how much wealth could potentially have been generated for the country as a whole if these areas had not been used as milch cows to sustain other regions in semi-permanent quasi-dependency. Money is not everything, of course, and it can be argued that the real concern is the moral-hazard effects of the present intrusive and arbitrary system of welfare payments in real terms on what the Victorians would have called the 'moral character' of the recipients. Many international studies seem to indicate that poverty is a highly dynamic process and that the same individuals tend not to stay in that condition for very long. Unfortunately, there are features of the UK and other EU welfare systems that seem to encourage people to stay on benefits almost indefinitely, once they become entitled to them. It may be significant, in this context, that one reason put forward for the success of the Clinton era welfare reforms in the US was the introduction of time limits for entitlement to benefit. Many US welfare recipients decided to save their time-limited entitlements for a rainy day and went off benefits well before their rights expired. Once in the workforce, they then seemed capable of self-improvement on a scale that caught the proclaimed 'experts' in this area completely by surprise.

A further and sobering conclusion is that the increased complexity and extent of the tax burden since 1997 means that the UK tax system may have become so unjust between the different regions that it is morally indefensible, and risks stimulating political forces that eventually lead to a break-up of the UK. The rise of the Northern League in Italy, and of secessionist sentiment in Catalonia in Spain, shows what can happen when the more economically advanced parts of a nation feel that they are being unduly exploited to benefit

Table 5: Some Further Regional Comparisons

	Median Gross Weekly Full-Time Earnings in 2005 (£)	*Median Earnings in 2005 Expressed as Indices (UK=100)*	*Real Median Earnings Expressed as Indices (UK=100)*	*Minimum Wage per Hour Scaled to Reflect Median Earnings (£)*	*Age Standardised Mortality Rates per 100,000 Popn.*	*Officially Projected Popn. Growth 2004 to 2029 (%)*	*Alcohol-Related Death Rates per 100,000 in 2001–03 (Male/Female)*
North-East	385.5	89.4	94.9	4.78	1,041	3.7%	16.8/9.6
North-West	407.2	94.4	97.4	5.05	1,025	7.4%	19.7/10.7
Yorks & Humber	399.3	92.6	98.3	4.95	960	13.9%	13.2/6.5
East Midlands	406.7	94.3	96.8	5.05	944	13.9%	12.4/7.0
West Midlands	402.5	93.3	95.4	4.99	965	7.8%	17.1/8.1
South-West	401.0	93.0	91.8	4.96	849	16.4%	11.8/5.9
East	428.7	99.4	98.3	5.32	865	14.9%	10.2/5.4
London	555.8	128.9	117.5	6.90	918	18.6%	17.6/7.4
South-East	450.0	104.4	99.1	5.58	852	12.8%	12.9/6.2
England	n/a	n/a	n/a	n/a	926	12.7%	14.7/7.4*
Scotland	409.6	95.0	100.5	5.08	1,089	n/a	n/a
Wales	389.9	90.4	96.5	4.84	979	n/a	16.0/8.4
Northern Ireland	387.0	89.7	96.3	4.80	943	n/a	n/a
UK	431.2	100.0	100.0	5.35	945	n/a	n/a

Source: Office for National Statistics. The minimum wage was raised to £5.35 per hour in October 2006.

* England and Wales.

other regions. Similar tensions contributed to the 'velvet divorce' between the Czechs and Slovaks, and appear to rear their heads wherever there are cultural, linguistic, ethnic or religious differences between groups of citizens. This is arguably now the case in Britain, where the ethnic composition of London, for example, is very different to that of Wales or Scotland. The Labour Party failed to gain a majority of the vote in England in the 2005 General Election, and the 2006 local-authority elections showed a clear voting divide between the regions that primarily lived off the state and those that paid for it.

My suggestion is that these disturbing conclusions on regional issues mean that we need now to consider moving toward a smaller and less interventionist state, a simpler flat rate tax system and the devolution of fiscal responsibility* to lower tiers of government.

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* Possible models for the devolution of fiscal responsibilty are the Swiss cantons and the US federal system of which a detailed account is given in Laubach (2005).

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ECONOMISTS DON'T UNDERSTAND THE ECONOMY (BUT THEY CAN TELL YOU SOMETHING ABOUT THE WORLD)

Extracts from a talk given by Mr Tim Harford, author, journalist and 'undercover economist' to members of the Economic Research Council on Wednesday 22nd November 2006.

The frivolous or the trivial can often illuminate important insights, and that is how I want to try to convince you tonight of two things: the first is that economists don't understand the economy (you may already believe this) and the second is that economists nevertheless understand some things that are useful.

A psychologist recently asked hundreds of experts, in research lasting over 15 years, to provide 8,200 predictions on such topics as 'Will apartheid be dismantled?, 'Will Quebec secede from Canada within the next five years? and 'Will the Dow hit 36000 by 2006?' – the sort of predictions that certain pundits are wont to make. He managed to put all the answers down in such a way that they all expressed 'more of something', 'less of something' or 'stays about the same'. His results, which I think surprised the experts but might not surprise anybody here, was that if you took an orang-utan and gave him (or her) darts and put three panels in front, one of which said more, one that said less, and one that said about the same, and just got him to chuck darts at the targets, the orang-utan would be better than the typical expert. The implication is that experts, including economic experts, really do have a poor record as forecasters.

But I am here to defend economists. I love economics and one of the reasons for that is, I think, typified by this cup of cappuccino which I have just been drinking. Now, does anybody here actually know how to make a cappuccino? Does anyoby know how to milk cows? Does anyoby know how to grow coffee? If you can do those things and can roast the coffee and have a cappuccino machine, the china and an electricity supply, you can make a cappucino. The point is that these and many other steps mean that a cappuccino is a most phenomenally complicated product and yet we take for granted that it is produced every day for us by an incredible team effort but most people do not appreciate that there is *nobody in charge* of that team effort.

In thinking about this I am reminded of the story of the visit by an economist from the Soviet Union in 1990 who came to London, of all places, to ask how to run an economy. He said, look, we are trying very hard to understand your western system, but could you just explain to me slowly who is in charge of the supply of bread to London? Actually, the more you think about it, the more it seems like a very reasonable question, and the fact is the answer is nobody, nobody is in charge of the supply of bread to London, and yet we have our white sliced bread, we have our organic pumpernickel, we have our pumpkin bread, and our tomato bread, and our strawberry bread and whatever kind of bread you have these days, it is all there, it is all supplied. We don't run out of bread, ever, and no-one is in charge. That is a fundamental fact about the economy that if you think about it for a moment we realise must be true and yet when we engage in all our economic planning we often seem to ignore it.

So, the economy is complicated and the economy is also different. There are ways that many economic forecasters tend to defeat themselves. Everybody in this room will know about the efficient market hypothesis and that it is largely true. It is not quite true, we can argue about how true it is, but there is a lot of truth in it.

I don't know if you have heard about the efficient supermarket queue hypothesis? Let me explain that to you. The efficient supermarket queue hypothesis is similar. That is, when you walk into a supermarket, you have done your shopping and you wish now to queue up and pay, and you see the enormous queues in front of you. The efficient supermarket queue hypothesis says that *a priori* there is no shortest queue. There is no fastest queue at least because if there was obviously a fastest queue somebody would have got in there ahead of you, and the only time you can make any gain on what the market is offering you is (a) if you are a formidable expert at supermarket queues, or (b) if the supermarket has an empty checkout that suddenly opens in front of you and you dash in there. The IPO phenomenon as translated to supermarkets. The outcome of this could be quite an interesting way of looking at not just supermarkets but at the stock market as well. Incidentally, the explanation as to why you never get in the shortest queue yourself is basic maths. It is nothing to do with economics. If there are two queues on either side of yours, there is no particular reason to believe that any of them will be faster than any of the others, so the chance that you are in the fastest queue that you can see is 20%. So you are always going to see another queue that moves faster but that's not economics, that's maths.

I find the efficient supermarket queue hypothesis very compelling. It actually enables me to explain to people who don't understand economics how the efficient market hypothesis works, but also gets them thinking about the ways in which the hypothesis might break down, the reasons it might not be true, and how many of those you can apply to the housing market or to the stock market. I actually was privileged enough to make a television show about all this for the BBC recently, and I took the camera crew off to Stansted Airport and tried to persuade innocent standers-in-queues that I was a world expert on queuing – a sort of investment banker of queues – and I would tell them which queue to stand in, which would be quicker and all they needed to do was pay me the bargain price of £5 and I would put them in the right queue. And not a single person seemed to be interested in this proposition, which I think shows a lot more sense than many people show when they are faced with an estate agent or a fund manager. So I just try and get these ideas across. The best answer I got, by the way – I asked one lady, why did you choose the queue you are standing in now? And she said, because I saw you in that queue and I didn't want to go anywhere near you! I think that's reasonable.

So, economists can't forecast, we know that. We have excuses. I think we have better excuses than most. The economy is extremely complicated. As Adam Smith said, it is not just made up of chessmen and you move a chessman wherever you like. All the chessmen are moving in their own directions, they have got their own wants and needs and desires. The moment you make a forecast, the forecast itself starts to prove you wrong. So there are several excuses and apologies for economists.

I want to show that economics can tell you something useful that's not about the things that ordinary people think it can tell you something useful about. I am hopeful that economics can help you get a cheaper cup of coffee at least. This is something rather special. It is a short cappuccino and what is interesting about the short cappuccino is that it is a secret. Starbucks do not want you to know that the short cappuccino exists. In fact I am actually here under cover. Starbucks have sent out paid assassins to try and wipe me out. You can buy a short cappuccino in any Starbucks anywhere in the world (except there is a concession in an hotel in Pentagon City; they seem to run a really stripped down range, they wouldn't serve me a short cappuccino, but everywhere else I have asked – believe me, I have asked in many, many places. I have asked out in New Zealand, I have asked over in the States, in Shanghai, and was served a short cappuccino). It is simply (a piece of coffee trivia) the best cappuccino that Starbucks has to offer actually. This is official according to the World Coffee Championships (the sort of coffee Olympics) and the reason is the 24 oz thing – you can't make a 24 oz cappuccino, what you get is a short of 'children in a bubble bath' effect. A cappuccino loses its integrity if it goes too far over 6 oz, so if you do shop at Starbucks, then buy a short cappuccino. It is cheaper. It is better. Why is it secret? There is an official answer. The official answer from Starbucks is that there is no room on their menu board to tell you that the short cappuccino exists. Well, maybe. But Starbucks also has a website where they will tell you every single drink they make – and they make 55,000 drinks! These are official Starbucks figures. 55,000 of all the different combinations, the large and the squirts and all that, and there is a bunch of experts on this, there is a whole theory of latte arbitrage, everything – I might come to that if I get time. But even on their website where they will tell you the fat content of every drink that they sell, they do not mention the secret cappuccino. In a leaflet when they tell you how to order your fancy drink, they do not mention the secret cappuccino. And I know this is not just Starbucks' fault. If you go to Coffee Republic, which is a similar coffee chain, they have on their menu board a column called *Short* and a row called *cappuccino*. And what do they have at the interception between the row and the column? A blank space! But will they serve you a short cappuccino? Yes they will. They will serve you a short cappuccino. It has got a little button on the cash register. OK, fine. I think there's something else going on.

Why worry what's the economics of the short cappuccino? The economics of the short cappuccino is something that economists call product sabotage. How many of you are students of industrial organisation, pricing theory or are you more interested in macro? Product sabotage is when you are trying to target different prices on different consumers. Price discrimination. You find the consumer who looks like the biggest schmutt and you charge him the largest amount, or you find a grandmother with her vouchers and charge her very little. You try to work out what each consumer wants to pay. One of the ways you will do this is product sabotage. Product sabotage is a process of making your cheapest product worse. It is very widespread. So, if you go and buy one of those fancy digital cameras you can buy a £600 version that is a very nice camera and is aimed at the high earning amateur. Then for about £1200 there is the bottom of the range professional camera. It has got more memory, it is fancier, etc. etc. The same camera! The consumer camera that's half price has a slightly different case and it has all those whizz-bang functions switched off. The software is the difference. They took the expensive camera and just switched it off and they made a cheaper camera. If you know the right Russian who can hack into it, you can switch it back on again! IBM had a printer, the Laser Writer E. The Laser Writer E was a slower version of the very, very successful office laser printer, the Laser Writer. The Laser Writer E – E for economy – for home users or for small businesses, was very similar, just slower. Why was it slower? Because they put a computer chip in that just forced out everything before it printed a new page. So it was more expensive to produce but it was worth it for them because they were making so much money on this high end printer – and good luck to them, they were making money because it was a great product – and they realised that they could make more money if they sold a mass market version at much narrower margins. The only problem is that they had to make sure that the high end customers didn't trade down to the mass market version, and the simplest way to do that was not design it from scratch but to put something in to make it worse.

I apply the same reasoning when I go to my favourite restaurant in Washington DC (I used to live in Washington). I can eat in the restaurant at $75 a head, it is a wonderful restaurant, and I can eat pretty much the same meal at the bar for $10 a head, and the main difference is that the barman is the rudest man I have ever met. I have worked it out – I have read the restaurant reviews, and it is a professional strategy, they are all incredibly rude and aggressive. Well, this is product sabotage. If I am on an expense account lunch, or if I am trying to impress somebody, if I am on a date, I will go to the restaurant and I will pay $75 a head, but if I am taking the wife out, well we go to the bar!

So that's the idea behind the secret cappuccino. It is a simple method of product sabotage, you keep it out of view, you don't lose too many customers from your higher mochaccino. People who really love coffee, people who are sensitive to prices, they find out about these things. There are other news groups, discussion groups and me tearing about the place telling everyone about the short cappuccino. In fact, the short cappuccino is the best deal in Starbucks. I think it is the perfect deal. The second best deal is the Kidcup chocolate. The Kidcup chocolate is the adult hot chocolate only it is 60% cheaper, so you just say I'd like a Kidcup chocolate and they charge you $1 instead of $2.50. If you have the nerve to say that they don't ask you where the kid is, they serve you a Kidcup chocolate. It is pure price discrimination. If you are too embarrassed to do that or if you don't mind paying $2.50 for the hot chocolate, then you've just made the point. Fine, we'll charge you $2.50. If you are sufficiently aggressive to demand the $1 version, they will give you the $1 version; they make money either way, they'd just rather sell you the $2.50 version.

But that's the second best deal. The best deal by the way – this is an arbitrage point, is to buy an expresso in a cappuccino cup – they don't stop you doing that – fill it up with free milk, take it to the office and put it in a microwave. It is called latte arbitrage. I have never done it, but you would save an awful lot of money because you are paying a lot of money for that milk, and, at least in America, many workers will go out to Starbucks, they will buy a latte and they will take it back to the office or they will take it home. So you can save a lot of money if you are willing to do so. Starbucks don't stop you from doing this, they don't mind if you do this. You are just signalling that you are very price sensitive. On the other hand, they are hardly going to encourage it, they are hardly going to advertise it, because then it no longer makes good price discrimination. So, economists can tell you something about the world. They can tell you about how to get a cheaper cup of coffee.

They can also tell you why we have racial discrimination. I find it fascinating. Sometimes I bring slides, not Powerpoint slides, but I bring a picture of this, but I am just going to describe it to you because I am sure you are imaginative people. This idea was developed by Thomas Shelley who is a wonderfully original thinker who, to many people's astonishment, won the Nobel Prize for 2005. He is, I think, far too smart to win the Nobel Prize, he is far too eclectic, he just writes brilliant essays. Whoever won the Nobel Prize for writing brilliant essays? Anyway, he did. And one of his essays was about racial segregation. He came up with this on a long aeroplane flight, he told me and it took quite a lot of crossing out but what he did was that he wrote down noughts and crosses – a sort of chequerboard format – 8x8 noughts and crosses, he rubbed a few out, he mixed a few around, but basically they were alternating noughts and crosses with a few randoms and a few blank spaces. The noughts and the crosses represent people of different races or different religions or speaking different languages, or they represent men and women, and they are all happy to live in a mixed neighbourhood. They are very, very happy to live in a mixed neighbourhood, but what they don't want is to be completely surrounded by somebody who is a different race or a different colour or whatever it is. Let's make this colours, let's mix those black and whites. The blacks don't want to be surrounded by the whites, the whites don't want to be surrounded by the blacks. And similarly on Tom Shelley's chessboard the noughts don't want to be surrounded by the crosses and the crosses don't want to be surrounded by the noughts. To be more specific, he says the nought is perfectly happy to stay where it is as long as its neighbours are not more than ⅔ crosses, and the cross is willing to stay where it is as long as its neighbours are not more than ⅔ noughts. So this is prejudice we are talking about here. This is not British National Party stuff, this is fairly mild prejudice and Shelley said, OK, fine, look at my chessboard, you have only to move that guy there. So he took him out and moved him somewhere else. But then you find that because that person moved, then one or two of his neighbours, the nought moves, and then another nought moves nearby, so he feels a bit outnumbered, so that nought will move, then the cross will move, then the other noughts move and suddenly the mixed jumble of noughts and crosses separates out into one half noughts and one half crosses. An amazing demonstration with a pen and paper, even back in 1970.

Since then economists, who I think under-appreciate this (it is a very interesting field of research), are using this modelling technique where, instead of modelling the economy using your calculus you model the economy by saying, imagine there is a bunch of middle guys and they have very, very simple preferences and their preferences are often quite local, so rather than taking the rational expectation's view of the entire economy pursuing the model the central bank was using, they look around and say, what do I see immediately around me? And you can run these models through computers, they are getting more and more complicated. The Pentagon runs them, the CIA runs them – I am sure you find that re-assuring to know – with hundreds of thousands of agents, and they are trying to use these models as the economics of retirement, the economics of how bad habits like smoking can spread throughout a population, or corruption. One model that I think is rather helpful is where you have a whole bunch of corruptees and suddenly overnight they become law-abiding, and the reason is that as they are pootling along inside the computer just one too many happens to get shot by the person he is trying to get a bribe from, and they suddenly realise a few too many of my neighbours have been turned in, there must be a lot of honest people around, and suddenly everybody acts honest and of course helps to enforce the equilibrium. So it may seem these models are depressing rather than helpful, but I would say it is a new area of research.

We have covered many variables: the orang-utan playing darts, supermarket queues, cappuccinos, racial segregation, and corruption inside computers. Well, I really make no apologies for this being a random stream of ideas because as a journalist we have the attention span of goldfish and I am just interested in picking out little gems from economics, little ideas that mean something to people. That's what I do, I enjoy it. There is clearly something of a boom or maybe a bubble in this sort of economics at the moment. I recently wanted to write a piece on colonialism and the economics of colonialism and what changing wind patterns over the Pacific told you about the economics of colonialism because the wind patterns influenced to an extent when the colonists arrived at the different Pacific islands, and this was some instrumental variable you could use to understand the effect of institutions on economic development. So I thought I'd write about that, but the Economist wrote about it and so did other colleagues, so I was pipped twice in one week and I thought to myself, hey there are too many freaky columnists around, I'm feeling crowded out.

So, there we are. That's what we do.

THE STERN REVIEW – THE START, NOT THE END OF THE DEBATE

By Dan Lewis

Introduction

Economists aren't used to making a massive media impact. So you have to take note when Sir Nicholas Stern's 'Economics of Climate Change' flooded the airwaves continuously for 3 days. According to Stern, through climate change, the world was facing a disruption to economic and social activity on a par with the two World Wars and the economic depression of the 1930s. Heady stuff indeed. The review, commissioned by Chancellor Gordon Brown, also caused such a stir because it attempted to bring economics into what had been – for the general public – a scientific and political debate. Yet even at the policy level, many environmentalists and climate scientists continue to be resentful that economists should have any say in this area at all.

However climate change and economics are indivisible. That's because if you are going to make predictions about climate change based on anticipated carbon emissions, you are going to have to make certain assumptions about economic growth and certain assumptions about the rate of technological change. Both of those require detailed and complex economic modelling and that's what the Stern Review has attempted to do. The expressed hope of the government was that the findings off the Stern Review would be so powerful, they could be used as a tool to influence world opinion and move the planet to a low carbon future, thus mitigating any future climate change. So just what were the conclusions of this sensationalist report and now the dust has settled, do they really hold up and what are the controversies that surround it?

STERN SAYS:

There is still time to avoid the worst impacts of climate change, if we take strong action now.

The scientific evidence is now overwhelming and that the benefits of strong and early action far outweigh the economic costs. The report's economic models put the cost of not acting – or to use the jargon, BAU (business as usual) – would be equivalent to the world economy losing at least 5% of GDP each year, now and forever. If a wider range of risks and impacts is taken into account, the estimates of damage could rise to 20% of GDP or more.

The costs of action, that is to say reducing greenhouse gas emissions to avoid the worst impacts of climate change can be limited to 1% of global GDP each year. Meanwhile, it is imperative that this investment takes place in the next 10–20 years.

OTHERS CAN SAY:

The debatable issue here is – what is the real cost of carbon?

The world's most famous climate economist, Yale University's William Nordhaus puts it at $2.50 a ton. Yet the report's economic models claims the environmental cost of emitting an extra ton of CO_2 at the equivalent of $85. Meanwhile at the time of writing, the price of Carbon at the Chicago Climate Exchange is $4–5 and €8 on the European Climate Exchange. This matters because if you are calculating the costs of mitigation along with the benefits of reduced CO_2 emission, then with a low carbon price, the benefits just don't look that great. It is of note that Stern's figure is quite the highest ever cited. Thus, he guarantees a sort of best-case scenario for benefits, which at current carbon prices, looks highly unlikely.

The second controversy is that many economists dispute his discount rate of just 1% as far too low, the lowest indeed, ever cited. This discount rate suggests that the benefits of investing a lot now of today's resources would be good value in the future.

STERN SAYS:

Climate change could have very serious impacts on growth and development.

If no action is taken to reduce emissions, greenhouse gases could be double the pre-industrial level as early as 2035, leading to a 2 degrees C rise and in the longer-term, a 50% chance that the temperature rise could be 5 degrees. All countries would be effected, the most vulnerable – the poorest countries and populations – will suffer earliest and most. Adaption to climate change over the next two to three decades – which cannot now be prevented – will be essential and cost tens of billions of dollars in developing countries alone must be accelerated.

OTHERS CAN SAY:

If this is such a good argument, why do the world's two largest and fastest-growing developing countries – China and India – show no intention whatsoever of decoupling economic growth from rising carbon emissions?

Perhaps after all, these two nations have decided that the risks do not outweigh the benefits and they will continue to use their own coal resources for some time yet. Both countries have hundreds of millions of rural poor earning a mere few dollars a day. Should climate change emerge as a problem a few decades hence, the mandarins and Indian technocrats would appear to believe that they would be far better placed to deal with it with a rural population earning perhaps $20 per day rather than spend their currency reserves on pricey gas imports and untested carbon sequestration. Reducing emissions appears much more to be a concern of developed nations, yet most of the future growth of emissions will come from developing nations who manifestly do not share Stern's views on growth and development.

STERN SAYS:

The costs of stabilising the climate are significant but manageable; delay would be dangerous and much more costly.

Today's level of CO_2 *equivalent gases in the earth's atmosphere is equal to 430 ppm. If that can be stabilised at between 450 and 550 ppm then the risks of the worst impacts of climate change can be substantially reduced. Stabilisation in this range requires a 25% reduction in emissions by 2050 and perhaps more. Estimated annual costs of* *stabilisation between 500 and 550 ppm are around 1% of GDP if action starts now. It would be very difficult and costly to stabilize at 450 ppm CO_2 equivalent.*

OTHERS CAN SAY:

There is an emerging problem with this analysis – it assumes carbon to be the unicausal reason for climate change, which has, depending on your source, contributed a mere 0.3–0.6 degrees of warming throughout the 20th century. New evidence is appearing that carbon plays a much smaller part than at first thought. Solar physicist Sam Solanki says that in the past half-century, the sun has been warmer for longer than at any time during the last 11,400 years and that there is a high probability it will reduce over the next 50 years. It also goes part way to explaining why the world cooled between 1940 and 1975 – a period of unheralded economic expansion. Solar warming is measured by heat-energy forcings in watts per square metre. Throughout the course of the 20th century, that has been equal to two watts which has contributed to a rise of 0.3–0.6 degree Celsius of increased global temperatures. A staggering 1.89 of those watts are now thought to be from solar warming and just 0.11 presumably from greenhouse gas emissions only a small percentage of which are anthropogenic. Other studies suggest much less than that. But one way or another, it does appear that the importance of carbon dioxide to global warming has been overstated and that of solar warming – over which we have no control whatsoever – has been understated. So it would appear that the climatic outcomes from a wholesale transfer to low carbon technologies may turn out to be extremely marginal and at a very high price in lost opportunities for a more productive use of those resources.

STERN SAYS:

Action on climate change is required across all countries, and it need not cap the aspirations for growth of rich or poor countries.

The world does not need to choose between averting climate change and promoting growth and development. Action on climate change will also create significant business opportunities as new markets are created in low-carbon technologies. Tackling climate change is the pro-growth strategy for the longer term, and it can be done in a way that does not cap the aspirations for growth of rich and poor countries.

OTHERS CAN SAY:

Energy is an indispensable economic input and it is hard not to see prices going up with a sustained shift to low carbon technologies. Europe however will have in the short and medium term to buy more low-carbon gas from Russia and possibly from Iran and Algeria too. The long lead-times in building large carbon-free nuclear power stations and the current impact of coal-fired stations suggest that by pricing carbon exclusively, energy insecurity, an unpriced externality, is increased. For now it appears clear that the developing world is not buying the argument and growth is their priority.

STERN SAYS:

A range of options exists to cut emissions; strong, deliberate policy action is required to motivate their take-up.

Emissions can be cut through increased energy efficiency, changes in demand and through adoption of clean power, heat and transport technologies. Power sector must be 60% decarbonised by 2050 to achieve stabilisation at 550ppm CO_2e. Cuts in non-energy emissions like deforestation and agricultural and industrial processes were essential. Climate change was the greatest market failure the world has ever seen. Carbon therefore must be priced, either by tax, trading or regulation. Government must support low carbon innovation and finally barriers must be removed to energy efficiency and to inform, educate and persuade individuals about what to do to respond to climate change.

OTHERS CAN SAY:

For an economist, energy efficiency is best understood as dollars of output per barrel of oil equivalent. The more dollars a country produces per BoE, the more energy efficient it is. Using 2003 data from the International Energy Agency, it has been possible to calculate the energy efficiency world rankings. What they show overwhelmingly is that the richer a country is, the more dollars it produces per barrel of oil equivalent, but that it also uses that much more energy in total. So China produces $132 per BoE, the UK $898 and Hong Kong nearly $1400. Energy efficiency has been widely thought by policymakers as a way of achieving more from less. Yet this is actually impossible, ***you can only produce much more from more***. This is because of the 'rebound effect'. ***Saving energy is in reality only saving money***. The money saved from switching the lights off etc. rebounds back into demand and returns as an energy input spent elsewhere. This may even be larger if the 'saving' is put in the bank, because an increase in savings tends to reduce interest rates thus leading to increased investment involving increased energy inputs. Energy efficiency therefore will not cut emissions, it can only increase them. There are only two ways to reduce emissions, contract expenditure and engender a recession or more sensibly, use much more low-carbon technology.

STERN SAYS:
Climate change demands an international response, based on a shared understanding of long-term goals and agreement on frameworks for action.
More ambitious global action is required. Future international frameworks should include emissions trading, technology cooperation, action to reduce deforestation and adaptation.

OTHERS CAN SAY:
In this day and age, international divisions appear to be widening. So it is hard to imagine a world where everyone comes together and acts jointly for the common good. The record on international emissions trading is at least mixed. This is because carbon a) does not price out far enough into the future b) the price of carbon is not high enough c) European governments find it too tempting to over-allocate permits as a concession to their industries. In other words, the trading works fine, it's the capping that's the problem.

Conclusion

There is at least a very high chance that the next few decades will see very little change in the climate at all. Forecasting climate change is a science so inexact, it makes economic forecasting look accurate. That's why some believe the worst argument one can make for alternative energy and nuclear power are based around the mitigation of climate change. As an investor, you would never bet on it. There are actually far more powerful arguments that can be made for some other courses of action which would deliver tangible benefits within our lifetime. These are:

i) Improving energy security, particularly of gas for the UK
ii) Hedging against high fossil fuel prices and the approach of peak oil demand
iii) Forcing authoritarian regimes that live off a hydrocarbon resource curse to become more accountable to their people.

Throughout the course of history, mankind's ability to innovate and grow has been consistently underrated. The only certainty in predicting what the world's climate and economy will be like 100 years into the future, is that everyone will be wrong. One futurist who has had more success than others is Ray Kurzweil. In his recent book, 'The Singularity is Near' he argues that as computing power as measured by calculations per $1000, calculations per second and networks speeds continue doubling every 18 months or so, machine intelligence will not only overtake human intelligence within the next few decades, it will engender a shift from linear to exponential economic growth by 2050. The world economy is already speeding up, averaging between 4 and 5% growth in the last 3 years. Yet most 21st century climate change forecasts take into account an annual growth rate of between 2 and 3%.

The Stern Review is a good basis for discussion but his findings tend far more towards an alarmist rather than a probable scenario. That's why it has not ended the debate, it has enriched it. And for that, we should all be grateful.

THE TAO OF WARREN BUFFETT

By Mary Buffett and David Clark
Published by Simon and Schuster 2007 Price £12.99

There may be (believe it or not) some people who have barely heard of Warren Buffett. Certainly, of those who know that he heads a team who have made a huge fortune out of stock market investment, not all have read the many books, followed the websites, visited the Omaha headquarters or seriously attempted to learn investment philosophy from the great sage.

'The Tao of Warren Buffett', although thought worthy enough to be practically serialised in The Times, can easily be dismissed by the *cognoscenti* as trivial, repetitive and a mere recycling of old material. For anyone who has set out to read every scrap of advice made public over many years on this extraordinary man, this book may well appear to be a cheap parody, a bandwagon potboiler or even an insult to an almost holy cause. 125 one or two sentence pearls of wisdom often rather condescendingly 'explained' in two or four sentences leaving many a page in large part blank is a pretty thin menu for a whole book which, even when buttressed by hard covers can only be sold at £12.99. Those who are truly upset at the affrontary of this publication can also stoop to sneer at the author as only the *ex*-daughter-in-law of the man *himself*!

But what about the '*non-cognoscenti*'? What about those of us who have never read, or who have read a little and promply forgotten, the advice and guidance of Warren Buffett? For them, the task of reading the vast mountain of commentary is daunting but the need to distill this material into some kind of useful, memorable and available-on-the-moment series of points is important. Many generations in many different cultures have found that an effective way to pass on learned wisdom is to compose pithy sayings that catch the attention of younger people. Perhaps one day John Maynard Keynes will be remembered more for saying 'In the long run – we are all dead' than he will be for discovering the marginal propensity to consume. John Kenneth Galbraith will be remembered more for his sharp tongue than for his depth of perception. In short, to comprehend and remember a concept we need a little composition much more than a treatise.

'The Tao of Warren Buffett' thus ranks with books of nursery rhymes and quotations and, as such, is a perfectly good way to enter the world of Buffettology. Little (and large) thoughts 'one per page' are there to make one think, or reflect a while, or realise now why one made that mistake then. There can be no harm in this – and perhaps much good.

Each of us will get something different from this book of sayings. The fact that, after reading this book, your reviewer felt he had become a wiser investor is, in the end, all that needs to be said.

J.B.

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