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EDITORIAL

The horsemen of the apocalypse are abroad in the land, but your Journal remains a haven for scholarly reflection. This is not entirely your Editor's stoicism: the three articles in this issue were written last year, as entries to the Rybzcynski Prize, when Armageddon was still only a tale to frighten the guests in City dining rooms. Nor have we entirely ignored the unfolding calamities. In Speakers Corner we report on the Society's Annual Conference, which addressed the question: 'Will the US subprime crisis derail the world economy?' Well, we pretty much know the answer to that question now, and, to be fair, Gillian Tett and Willem Buiter in their discussions of what was happening in credit markets both warned of the risk of a very nasty downward spiral and called for reform of Britain's financial regulatory system. David Miles agreed that recession was the most likely prospect for the British economy, and Gerard Lyons considered that even the Chinese behemoth might grow more slowly. It was left to Paul Ormerod to offer some hope: his study of some 255 recessions in 17 countries over some 135 years showed that even the worst had recovered within a decade. As Gillian Tett had remarked, a shock is an event, not a habit.

But suppose the world is to end, not with a bang, but a whimper? That is the possibility that Tim Congdon raises in his article on the free market both as a form of economic organisation and as an ideology. He traces the origins of the idea in the work of Adam Smith and John Locke, and argues that its adoption, more or less deliberately, more or less completely, as the basis for the development of the modern industrial economy over the past 250 years has enabled the almost unimaginable multiplication of output which allows so many people *"to lead safe and healthy lives, and to fill our time with interesting and enjoyable pursuits."* But, he asks, will it continue to do so for another 250 years? There are he suggests two critical conditions for the effectiveness – and the moral and political acceptability – of the system. The first is that resources are not so scarce that they give rise to pervasive and extensive economic rents. The second is that economic activities do not generate widespread and large 'externalities' – divergences between the costs to society and those to the economic agents involved. In their absence there is increased scope for political interventions in the economy with adverse effects on its optimising character. These conditions have generally obtained over the past two centuries, but Congdon suggests there are serious questions whether they will continue in future. He believes that the scarcity of resources will grow, and he examines in particular the case of oil, such that the proportion of income based on economic rents will increase substantially, bringing with it every kind of politicking to capture them. And 'global warming', in the sense of the effects of man-made carbon emissions, threatens an externality that is *"difficult to measure and potentially vast"*, and that will generate massive political interventions in the economy. He continues to believe that a free market economy remains the system most likely to improve the lot of the world's under-developed countries and to sustain our own well-being, but he is concerned that these changes will make it less efficient and successful in the future than in the past, and may threaten its survival.

Market failure is also the theme, on an altogether more domestic scale, of our other two articles. First, Benedikt Koehler examines the retail market for investment products, which has seen *"recurring instances of mis-selling and poor advice"* to its clients, and in particular the claim that these failures have their roots in the payment of commissions to those who sell the investment products by the firms that offer them. He believes that this claim is misconceived and seeks to demonstrate this by the application of the concept of transaction costs. But first Koehler explores the implications of the concept – first introduced as an explanation of the structure of firms and industries by Ronald Coase – through studies of a number of other industries, ranging from fishing to the selling of shoes, in order to apply them to the crucial questions regarding the efficiency of the retail investment market. This application suggests that the typical business model for retailing investment products will be through independent agents who are rewarded by commission, which is, broadly, how the industry is structured. Moreover, that structure *"is consistent with that of every other market where commissions enhance efficiency"*. There may be good reasons for consumer protection, but they do not lie in the inefficiency of the market.

There is not really a market in the supply of economics teaching, as the government funds and controls the structure and operation of most schools. Yet there is a substantial independent sector, and Samuel Tombs has undertaken some very interesting original research into the differential opportunities to study economics at various levels between types of school, which suggests that, if there were a market, it would exhibit symptoms of failure. What he found following a series of requests for information from universities and schools under the Freedom of

Information Act is that what school you go to makes a substantial difference to your chance to study economics. A substantially higher proportion of those studying economics came from independent schools than would be expected from the overall numbers advancing into higher education from each type of school. Yet there was evidence that more in state schools would have studied economics if they had the opportunity; the problem is one of supply. Now, there were almost as many questions raised by this research as answered: what of the role of sixth form colleges where the numbers sitting economics at A-level seemed to be increasing? And how did the supply and demand for economics teaching sit alongside the teaching of business studies – for which there were almost twice as many sitting A-levels as for economics? We remember the concerns expressed by the Bank of England a year or two ago about the falling numbers of economists coming into the profession, and there would seem scope to take this research further.

What else? Well, Speakers Corner also includes reports of Jill Leyland's discussion of the gold market, which has done well out of the crisis that has engulfed other financial markets, and of DeAnne Julius's discussion of the findings of a study of the Private Finance Initiative, which had looked further into the parallel development of the public service industry – the firms and other organisations engaged in the provision of public services on behalf of the government – and had found that, despite many problems, the introduction of contestability into the provision of services had improved their delivery.

Finally, our Book Reviews bring us full circle: half of the books reviewed are about the pathology of the financial markets and the possible remedies. Economists may not have seen the crisis coming, but publishers seem to have spotted the opportunity!

Jim Hirst

Editor

Can the Free Market Deliver Rapid Economic Growth Forever?

Tim Congdon[1]

Free market fundamentalism has been one of the most persuasive belief-systems of all time. Over the last 150 years economists have not only identified the conditions for the optimal allocation of resources, but also shown that – under certain far from unrealistic conditions – free market economies will come close to achieving that allocation. To summarise a large body of theory, resources are allocated in the best way when prices are equal to the additional cost of producing one more unit (so-called 'marginal cost'), while market forces will cause output to settle at the optimal level when each of a large number of independent suppliers cannot individually alter the price (ie, they are all price-takers). The requirement that suppliers be numerous and independent – the requirement, in other words, that competition prevail – may have to be enforced by a non-market agency of some kind. Nevertheless, a central prediction of theory is that the free market economy will deliver benign outcomes. In the paradigm case the state's role can be limited to the definition of property rights and the provision of a non-discriminatory rule of law.

The Bible of free market fundamentalism is Adam Smith's ***Wealth of Nations***, published in 1776. Since the appearance of Smith's work the case for *"the system of natural liberty"*, as he termed it, has been challenged and sometimes sidelined. For much of the 20th century many ostensibly clever people believed that Karl Marx was a more profound and far-seeing thinker. But, as communism has disintegrated since the death of Chairman Mao in 1976, the free market system has been adopted virtually across the whole world. Even a nation like Russia, where Stalin once proclaimed the virtues of *"socialism in one country"*, is keen to join the World Trade Organization, and to participate in international flows of goods and capital. A better slogan for the start of the 21st century is 'capitalism in every country'. The increased economic integration of all nations has been summed up in the word 'globalisation', a phenomenon

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[1] Professor Congdon is the founder of Lombard Street Research. Slightly revised version submitted to the Rybczynski Prize competition in 2007.

widely accepted as a defining feature of our times. Adam Smith's insights in ***The Wealth of Nations*** were stimulated by the obvious benefits to Scotland from the free trade with England that followed the political union of 1707.

As he would have expected, the results of the full entry of the much larger and more populous entities of China, India and Russia into the world economy have been astounding. Roughly speaking, world output has grown at about 2½ per cent a year since Smith was writing. That may not sound dramatic, but over a period of 250 years the power of compound interest is such that it raises world output by almost 500 times. The incorporation of the big Asian nations in the world market system, and the consequent surges in trade and finance, have boosted the growth rate of world output yet again. In the opening years of the 21st century world output has been growing at almost 4 per cent a year. If that could be sustained for another 250 years, the five centuries from the publication of ***The Wealth of Nations*** would see world output climb by almost 10 million times. (This may seem incredible, but the number can be derived in two or three minutes from a table of logarithms.)

One of Smith's contemporaries, Edmund Burke, complained at the start of the process that *"the age of chivalry is gone"* and *"that of sophisters, economists and calculators, has succeeded, and the glory of Europe is extinguished for ever"*. But – when the numbers are set out starkly – it is easy to see why the case for the free market has been so compelling. The multiplication of output allows us all to lead safe and healthy lives, and to fill our time with interesting and enjoyable pursuits. Globalisation is a force for the good. A number of books – such as Deepak Lal's ***Reviving the Invisible Hand*** and Martin Wolf's ***Why Globalization Works*** – have appeared, explaining why the liberalisation of market forces both within and across borders should be encouraged. These books were provoked by the attacks on market economics and globalisation from so-called 'non-governmental organizations' (NGOs), often with an environmental agenda, which have proliferated over the last 20 years. Lal, Wolf and others have rightly argued that, by spreading technology and knowledge, globalisation helps poor nations more than rich. Indeed, by increasing the demand for labour, it may benefit particularly the poorest people in poor nations. Many NGOs are backward-looking, reactionary and narrowly focused on one issue. Their opposition to globalisation can be characterised as an anti-intellectual, anti-rational 'neo-luddism'.

But will the next 250 years demonstrate the beneficence of the free market in the same way as the last 250 years? Will Adam Smith remain as convincing to his readers in the late 23rd century as he was in the late 20th century? The argument here will be that the nature of the economic problem is changing The growth delivered by the free market has been easy to defend, as the earth itself has seemed boundless and the state has been able to compensate the relatively small numbers who have been disadvantaged by technical change. Because virtually everyone has benefited in the end, public policy has been right to emphasize growth rather than redistribution. But, if growth were now to become increasingly constrained, will distributional issues acquire more prominence?

In most market contexts people are paid, if in a rough and ready way, according to what they produce. In a simple case, if a self-employed contractor works 40 hours a week, no one denies that there is a reasonable moral and practical case for him to be paid twice as much as another contractor who works 20 hours a week. Effort and return are proportionate. More generally, in market-based systems the outputs of individuals, companies and nations have some correspondence with their inputs.

In his ***Two Treatises of Government***, published in 1690, John Locke proposed a convincing case for property rights. He remarked that, when a person mixed his or her labour with nature, the person thereby gained ownership of that part of nature. The Lockean theory of property rights was and remains an ally of the Smithian view on 'natural liberty' in a larger justification of the market economy. But Locke inserted a proviso. In his words, an individual's appropriation of part of nature was acceptable as long as *"enough, and as good"* is *"left in common for others"*. Two major difficulties with market-determined income distribution are implicit in this proviso.

The first is that, when a resource is scarce, market forces may operate unfairly. The trouble with a scarce resource is that its owner may be able to extract a 'rent' which breaks the connection between input and effort on the one side, and output and reward on the other. David Ricardo, a famous English economist in the early years of the 19th century, showed that a landlord who owned fields of higher-than-average productivity would be able to obtain a higher rent than the landlord of fields of the same size with lower-than-average productivity, even though the landlord himself might have done nothing to deserve it. Further, as population and the demand for food grew, and as land of steadily declining quality came into use, the income of each tenant would fall because of the 'law of diminishing returns' whereas the rent received by the landlords with the best land would rise. The lucky landlords would gain, even though they had not worked in the fields and done something productive.

The divergence between input and output was the more anomalous, in that the landlord would have been prepared to let out the land at a much lower rent if that had been all that the market would bear. In jargon, 'economic rent' is the payment that a factor of production receives in excess of its supply price (ie, the price that would be just high enough to induce supply). Ricardo developed his explanation of 'rent' in the context of English agriculture, which benefited unfairly in his day from the Corn Laws. But the idea has much wider applicability. Film stars and the members of successful pop groups, lawyers who have exceptional knowledge of relevant case law and investment bankers with valuable lists of business contacts, all receive incomes above – and sometimes many multiples higher than – the supply prices of their particular talents. On the geopolitical scale, economic rents arise whenever the extraction costs of energy and minerals vary sharply between locations. Just as the incomes of pop stars and investment bankers raise the temperature of political debate within nations, so the economic rents accruing in resource-rich countries heighten international tensions.

The second challenge to the legitimacy of market outcomes arises because many types of production have spill-overs which affect people other than those directly involved. If the buyer pays the seller for a product, and if only the seller has borne the costs of making it and only the buyer enjoys it, the transaction is clearly private to the buyer and seller. But suppose that, in the act of making the product, the seller (say, a chemical company) pollutes a river from which many members of a society draw their water supply. Plainly, from the viewpoint of society as a whole, the cost is higher than to the chemical company alone. Such 'externalities' – which are to be defined as the difference between the private and social costs of a product – emerge frequently in complex societies. Unless private and social costs can somehow be realigned, perhaps by a law, a regulation or the more careful stipulation of property rights, externalities undermine the optimality of market solutions.

Economic rents weaken the moral defensibility of the distributive results due to freely interacting market forces; externalities suggest that, unless checked by an intervention of some sort, the free market may have results which are unsatisfactory for society as a whole. In other words, if economies are characterised by both severe resource scarcity (and so by inordinate and conspicuous rent-based incomes) and pervasive spill-overs (and hence by serious and common externalities), the consequences of free market activity may be unpalatable to many members of the society in which it is taking place. The political pressures for intervention in the market are almost certain to be stronger in societies constrained by resource scarcities and disfigured by environmental spill-overs than in societies with abundant and seemingly limitless resources. These arguments have a disturbing message for the future political attractiveness of free market thinking.

When Adam Smith was writing, North America was already colonised, but it was a frontier society of seemingly infinite territory and resources. In Locke's terms, there was an abundance of 'nature' into which a person could mix his labour and acquire a property right. From a European perspective, Australia, Africa, South America and Siberia were all just as empty. Why should anyone worry about scarcities and social costs? Even in the early 20th century when so many self-styled 'intellectuals' were beguiled by communism, the dominant critique of capitalism was not that it over-exploited natural resources, but that it under-employed the population of working age. The notion of an 'externality' was first formalised by the Cambridge economist, Arthur Pigou, in his 1920 book on ***The Economics of Welfare***. But Pigou spent more of his subsequent career – which continued until the 1950s – worrying about how to cure unemployment than about the policy implications of differences between private and social costs.

Matters are very different at the start of the 21st century. In contrast to the situation only one or two generations ago, serious and intensifying shortages of basic resources are now in prospect. The most fundamental example is oil. At the end of the Second World War global oil output was about seven millions barrels a day, with the United States of America being by far the largest producer. In the 1950s and 1960s major new discoveries were made, as the oil companies spread their search from the rich and politically dependable nations of North America and Europe to more unstable areas such as the Middle East and Latin America, and as improving technology allowed them to explore offshore as well as on land. Increased supply kept the price down and encouraged substitution away from coal to oil. By 1973 world oil output had soared to almost 60 million b/d. In a mere 28 years production was up almost ten times. Early in the 20th century doomsters had given occasional warnings of a serious eventual shortage. These had been made to look ridiculous.

But 1974 saw the first oil shock, with prices trebling as (mostly) Middle Eastern producers formed a cartel and restricted supply. Although oil prices have fluctuated in the following three decades or so, they have remained on average much above their level in the early post-war decades. At the time of writing, they are more than four times higher in real terms than in the late 1960s. Given the stronger price incentive, a logical expectation would be a greater leap in supply than between 1945 and 1973. In fact, global oil output has risen only a third between 1974 and 2007. It is particularly telling that production from the US mainland (ie, excluding Alaska) has dropped. If supply has fallen when price has risen, a reasonable conclusion is that the resource has been depleted and can ultimately be exhausted. On a wider canvas exploration technologies are much more advanced now than 50 years ago, but oil companies cannot find new fields of the same size and such low unit extraction costs.

For the world as a whole the average size of fields remaining in production is also lower than in the 1960s and 1970s. Will the world find enough oil to support its future transport, power and heating needs? The scale of the challenge ahead is made more daunting by remembering the growth arithmetic earlier in this essay. Since the middle of the 18th century the world's output of goods and services has risen about 500 times and, at the somewhat faster rate of advance (4 per cent a year) currently being recorded, it would rise by about seven times in the next 50 years and 50 times over the coming century. Oil is the most important single exhaustible natural resource in the modern world. Yet most experts believe that oil production will reach a physically determined peak in the next 20 or 30 years. Although supply is of course always responsive to price, the amount of oil in the ground is finite. It is inconceivable that world oil output will match that of total output, and rise by seven times in the next 50 years and 50 times over the coming century.

How is the depletion of oil related to the earlier discussion about resource rents? The answer is that in the 21st century incomes based on 'economic rents' – incomes which are abnormally high relative to their economic justification – will expand relative to other types of income and the distribution of income will become increasingly politicised. As the world runs out of resources, the proportion of total income represented by resource rents will increase and governments will tax these rents more heavily in order to redistribute by handouts to their citizens. The post-handouts distribution of income will reflect market forces less than it does today, and will instead be greatly influenced by lobbying, bargaining and politicking. In the extreme the government may seize natural resources itself and try to capture all of the possible 'rents'. Individuals will be brushed to one side, as so much will depend not on the interplay of supply and demand, but on the interaction between companies and governments, between one government and another, and indeed between one bloc of governments and another bloc.

What about 'externalities'? Sometimes policy-makers can address the problem quickly and easily. If the size of the externality can be measured and it is small relative to the private sector's costs and benefits, and if the winners and losers are all citizens of the same nation, a government agency (or perhaps the law courts) can intervene to redistribute the appropriate amount between those who lose and those who gain. Prices and quantities are still determined mostly by market forces. However, the externality which dominates public discussion at the start of the 21st century is not small, local and measurable. It is the difference between private and social costs associated, or allegedly associated, with 'global warming'. A large body of scientific material claims that such warming is attributable to man-made carbon emissions. Some scientific authorities deny the consensus view, but – for the sake of argument – let us assume that human action (and mostly human action in the private sector) is to blame. The resulting externality is awkward in several ways.

The first point is that it is both very difficult to measure and potentially vast. Estimates of the size of the threat to future well-being from global warming depend on a number of imponderables. The much publicised analysis of the International Panel of Climate Change suggests that by the end of the 21st century the world's average temperature could be between 1.1 degrees centigrade and 6.4 degrees centigrade higher than today, depending on which model (in a so-called 'hierarchy of models') is correct. So the consequences of future global warming depend on where the temperature settles inside a band as wide as over 5 degrees centigrade! Another issue is how far societies should discount the future costs. Most observers accept that a cost of £100,000 to be incurred 80 or 90 years from now should be valued less highly today than a cost of £100,000 to be incurred over the next 12 months. (After all, most of us are unlikely to be alive at the start of the 22nd century.) But how much should that cost of £100,000 in 2097 be discounted? If commercial rates of interest (4 per cent or more) were to be used, we should worry as much about it as we worry about something costing £2,500 or less in the coming year. On the other hand, some political philosophers claim that the present generation should regard its utility and the utility of all future generations as equally valuable. If so, a zero (or very low) rate of discount should be adopted.

Secondly, the global warming externality is both an externality within nations (between those who emit large amounts of carbon and those who do not) and between nations (between nations which emit large amounts of carbon and those which do not.) The cross-border nature of the externality creates immense difficulties. The Stern Report has been widely criticized as exaggerating the problem of global warming, but its observations on cross-border externalities seem sensible. In its words, *"Collective action by independent sovereign nations is...challenging. In the area of climate change, there is no supranational authority to provide coercive sanctions."*

The political leaders of all the nations on earth may – somehow, somehow – reach a consensus that global warming over the next 50 years will amount to precisely 3.2 degrees centigrade, that the costs should be discounted at a rate of 2.6 per cent a year and so on. Yet that does not mean collective action will follow. If a group of nations decides not to incur the costs of curbing emissions, and yet all other nations do incur such costs, the delinquents benefit from the reduction in global warming just as much as the goody-goodies. The delinquents have had gain without pain. The resulting incentive to opt out of an international emissions-reducing agenda (or, in technical terms, 'to free ride' on the good behaviour of others) is obvious. It follows that the externality of global warming cannot be easily 'internalised'. Even if it were certain that anthropogenic carbon emissions caused global warming, an appropriate international agreement to curb emissions – an agreement with the right mix of energy-saving carrots and emission-deterring sticks – could not be easily designed.

In these circumstances there is an obvious danger that discussion becomes polarised between alarmists ('the end of the world is nigh') and sceptics ('there is no need for any early action at all'). The rhetoric of imperatives ('we must save the planet') overwhelms the language of common sense ('wind farms are *x* times as expensive in producing electricity as coal-fired power stations'). Many environmental NGOs will not listen to any kind of economic analysis, even an analysis which concedes that externalities qualify the case for the free market. They choose to be deaf not for any good reason, but because the argument is conducted with economic concepts. It will be decades before the determinants of global climate are properly understood and there is a good chance that warming (or, at any rate, most warming) is not due to carbon emissions. But – until scientific clarification comes – the supposed externality of global warming will cause a vast assortment of new regulations, taxes, fiscal incentives, government exhortations, laws, shifts in consumer preferences and so on, all with major economic effects. Market forces will be less efficient and successful than they would otherwise have been.

The argument of this essay should not be misunderstood. The free market economy remains the system most likely to bring the hundreds of millions of people in the world's under-developed continents (Asia and Africa, mostly) out of poverty. But defenders of the market system are naïve if they think that the debate on economic organisation will have the same contours in the 21st century as in the last 250 years. In his ***Reviving the Invisible Hand*** Lal says flatly, *"...the Green scares are without foundation. The world is not running out of resources."* But Lal is wrong, if he believes that someone born today can look forward to the same resource abundance as someone born in 1776, 1876 or even 1976. Humanity has used up a high fraction of the energy and mineral resources that were available to it at the start of the Industrial Revolution. The blunt truth is that the remaining stock of natural resources is significantly smaller than it was when ***The Wealth of Nations*** was published.

Resource depletion will intensify if the present extraordinarily high 4-per-cent-a-year trend rate of world output growth persists. The result will be an increase in the importance of resource rents in total income and a politicisation of distribution. The same sort of pessimism is justified by the emergence of global warming as a central issue of public policy. Many scientists and scientifically literate laypeople have persuaded themselves, rightly or wrongly, of the reality of anthropogenic global warming. A variety of anti-economic, high-cost and welfare-reducing policy initiatives are to be expected in what may ultimately prove to be a very dubious cause. Again, a politicisation of the economy is inevitable. The classical liberalism foreshadowed by John Locke and Adam Smith has achieved marvels since the start of the Industrial Revolution, but their arguments for market freedom have still not convinced everyone. The case for the free market may be opposed as strongly by environmentalists in the 21st century as it was by Marxists for much of the 20th century.