ECONOMY AND FINANCE

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Protesters in Egypt wanted equality of opportunity

Rex

The real threat is not a fragile state but an over-mighty state, where the economy remains a closed system run by insiders for their own benefit

Beyond corporatism

Nobel laureate Edmund Phelps warns the Arab Spring countries not to follow the West's misguided lead into corporatism rather than true capitalism

WITH THE FALL and death of Gaddafi in Libya, Syria's repressive regime under pressure, and elections due in post-revolutionary Tunisia and Egypt, what are the chances that the positive political change of the Arab Spring will be followed by equally positive economic developments?

Many fear that these countries could slip into the category of so-called 'fragile states', in which social and religious tensions lead to continuing civil conflict and economic stagnation. But the real threat is not a fragile state but an over-mighty state, where the economy remains a closed system run by insiders for their own benefit.

The dictatorships of North Africa have been described as capitalist economies, but in reality they were 'corporatist' economies, where privileges and connections were the key to personal success, and where open competition and meritocracy were absent. In Tunisia the insiders were those well connected to the ruling family; in Egypt they were members of the military with a share in the ownership or management of privatised enterprises.

In corporatist economies, masses of ordinary citizens are denied the chance to achieve their potential. While demands for social justice lay behind the uprisings in Tunisia and Egypt, they were less concerned with inequalities of income or wealth as with inequality of opportunity. The young people protesting in Tunis and Cairo wanted to start businesses, enter industries, compete for places in companies and see an end to excessive licensing. But it is by no means clear they can achieve these aims even under new governments. The Egyptian army is reluctant to give up its powerful role in the economy. And, in Tunisia, foreign bankers are teaming up with local insiders to launch new infrastructure projects, including questionable initiatives in the desert. Such projects will not contribute to the advancement of young Tunisians, who are looking for careers not temporary construction work.

The system that would be most appropriate for Tunisia and Egypt is the basic capitalism developed by Britain and the US in the first half of the 19th century on the way to building their highly successful

economies. The foundations of this system are civil liberties, property rights, secure contracts, an independent judiciary able to restrain the government, local banks linked with local entrepreneurs, financial firms that supply venture capital and ease of market entry by new companies.

RIGID SYSTEMS

Today's Western economies are some distance from providing such a textbook model of capitalism. Indeed, continental Europe might still be accused of pursuing classic corporatism, in which the state takes whatever measures it deems desirable in the name of 'solidarity' and 'social protection', constrained only by the need to show efforts to restore growth whenever the economy flags. Certainly, Europe retains many examples of economic rigidity, a deficiency of entrepreneurialism and conspicuously high unemployment – all hallmarks of corporatism.

Meanwhile, in the US there are disquieting signs of growing rigidities – gridlock in Washington, a politically powerful financial sector able to circumvent fuzzy new regulations, and huge expenditures on lobbying by all sorts of interest groups seeking a champion in the nation's capital. When the US economy seemed to be dynamic and performing well, particularly during the glorious internet revolution, these problems could be ignored. But over the past decade, the US has undoubtedly passed into the land of corporatism.

The most obvious symptom of the present-day corporatist economies on both sides of the Atlantic is an excess of state borrowing and bank lending. In the US, fiscal discipline was thrown to the winds after the presidencies of Ronald Reagan, George HW Bush and Bill Clinton. With total federal outlay exploding since 2002 while federal revenue has declined steadily, there are now massive levels of public debt.

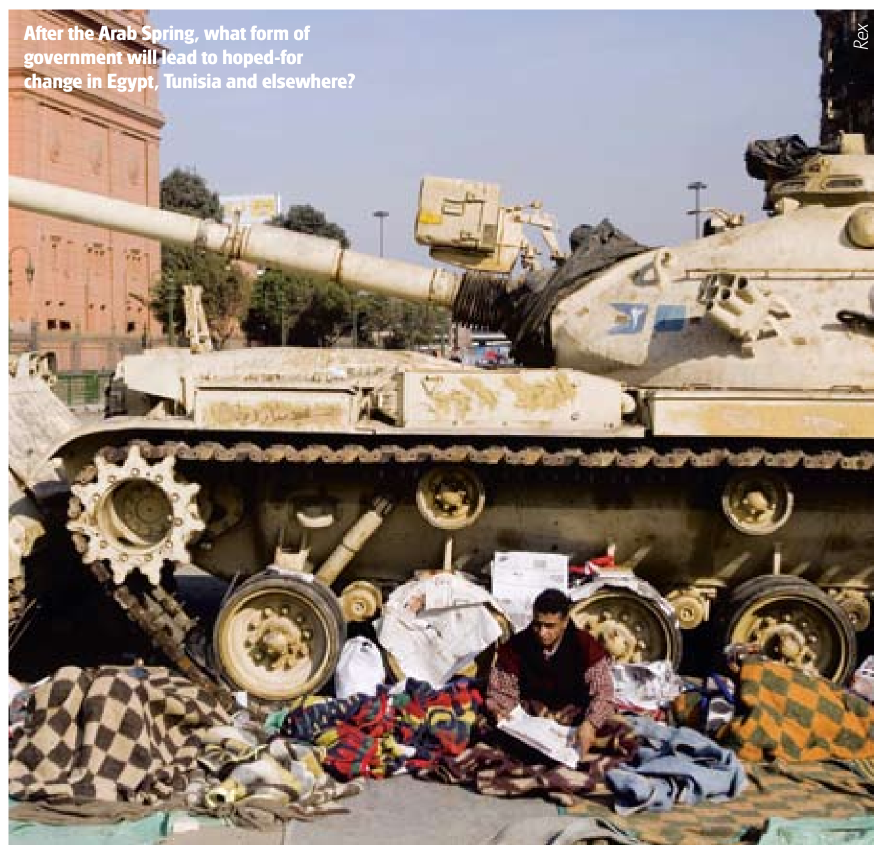
The only solution is to do everything possible to promote enterprise and innovation

In Europe, a new kind of alliance has emerged. The politicians wanted sovereign bonds rated risk-free so they could borrow at very low interest rates, and the banks wanted sovereign debt to be rated so risk-free that no capital is required against bank holdings of these assets. This was accomplished through an implicit commitment to bail out a government in the event that it has serious difficulty servicing its sovereign debt.

This alliance may seem to benefit the insiders, both the politicians and the banks. But the implicit bond guarantees impose costs on the public, which have become very evident in the 'austerity measures' – tax rises and spending cuts – many governments are implementing in an effort to restore fiscal discipline. This is an example of when corporatism starts to lose public support.

The dissatisfied populations of North Africa eventually showed their feelings about overweening state controls in public protests. But such movements have not been confined to Arab dictatorships. On the other side of the Mediterranean, Greece and Spain in particular have had a series of demonstrations, not all peaceful, in response to austerity measures and high unemployment. The summer of 2011 also saw violent riots in some British cities, in part it seems a result of the thwarted ambitions of disillusioned youth. And perhaps ahead of their time in 2006, there was serious civil unrest among disadvantaged young people of North African origin in the 'banlieues' of several French cities.

The Arab countries can hardly look to the economies and societies of the West right now as an example of true capitalism. So what should be their way forward? It is certainly not Tunisia's 'cathedrals in the desert', the vast infrastructure projects promoted by the International Monetary Fund. Nor necessarily is it education: huge unemployment among educated Tunisians was one of the drivers of the revolution.



After the Arab Spring, what form of government will lead to hoped-for change in Egypt, Tunisia and elsewhere?

Rex

AN ENTERPRISING SOLUTION

The only solution is to do everything possible to promote enterprise and innovation. That means establishing the right for people to start up their own businesses, enabling new entry and entrepreneurship, and encouraging a more meritocratic way of hiring people in existing businesses. And it means ending support for sclerotic state-backed businesses and removing the blocks on people's initiative in pursuing even the humblest enterprise.

We understand, at least intellectually, what the solutions should be. But in the shadow of severe economic challenges in the West and political and religious tensions in North Africa, there are many obstacles in the way of helping the Arab countries move beyond corporatism to achieve a new liberal, capitalist economy.

But particularly at a time of global economic crisis, it is too easy to be pessimistic. The countries of the Arab Spring are undergoing dramatic political change. We must hope that their populations – especially the excluded younger generation – can experience economic change on a similar scale, bringing the opportunities for careers and personal development that they rightly demanded when they first took to the streets. ■

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The future of work in Europe

European job creation is inadequate in three key sectors

Alamy

EUROPEAN UNION TARGETS for employment, set in Lisbon in 2000, have not been met by all member states. The Mediterranean countries in particular are far from the objective of getting 70 per cent of the working age population into employment. And Europe's overall jobs performance continues to lag behind the US. To understand the future of work in Europe, it is worth comparing which sectors are creating jobs there and across the Atlantic. The US is the most advanced country technologically and a leader in developing new kinds of economic activity – think of Silicon Valley. And had Europe's performance followed the US more closely over the last 30 years, the EU's employment ambitions would have been met.

But since the early 1970s, employment in the two continents has been on different tracks. Consider their performance just before the Great Recession of 2008-09. In the first eight years of the 2000s, more than three quarters of Americans aged between 15 and 64 were in employment, compared to only two thirds of their European counterparts. Coupled with higher enrolment rates in higher education in the US, a lot more Americans were active outside the home.

Looking deeper into the transatlantic employment gap, three sectors account for most of the differences. First, services provided directly to the public, such as retailing. Second, business-to-business services, such as finance, insurance and commercial property. And third, services related to health and education.

In the late 1970s, the annual hours of work in each sector in the US exceeded those in Europe by about 70 for everyone aged between 15 and 64. By the early 2000s, the extra hours worked annually by Americans had jumped to 120 in health and education, 100 in business-to-business services and 80 in retail. Most of the US gains were in health, retailing and a range of business services, including accountancy and management consultancy.

THE COST OF SERVICE IN EUROPE

Why is Europe not creating enough jobs in these sectors? Take retailing. People who have been shopping in the US know that it is much easier to get assistance there than in European shops. Economists ascribe these differences to taxation and regulations that make employing assistants more expensive in Europe, combined with an alternative to employing more assistants: self-help.

Britain is not creating enough jobs in the retailing sector compared to in the US

There is a trade-off in shopping. Customers can go to shops with lots of assistants, but they are usually more expensive because their costs are higher. Or they can go to cheaper shops where they are likely to spend more time finding what they want themselves. Because the costs of employing assistants are higher than in the US, European shops keep their costs down by shifting part of the assistant's job to the customer. IKEA, the home products retailer, could not have emerged in the US.

Will taxes have to go up to subsidise jobs in the sector that will feel most pressure for job creation?

Something similar is happening in business services. US companies are using external specialist services much more frequently than European companies because it is cheaper and quicker to set up such services. Instead, European companies might go without the services or provide them internally.

The advantage of external services is not only in employment but also in efficiency. By specialising, independent providers can improve efficiency and provide better services for others. So Europe is losing out in both employment and productivity. But the biggest growth in the gap between the US and Europe is also the most controversial. Employment in health has grown much faster in the US, even though the European population is ageing faster than the US one. Why? The jobs in the US health sector are in medical services and social care, where costs have risen enormously. Is the reason that Europe is not creating enough jobs in healthcare services the fact that costs are not allowed to rise faster? I would like to think that this is not the reason.

Europe has a more caring social system supported by public policy, with much of the costs of education and healthcare borne by the state. Demand for these services, especially health, will increase – partly because of ageing populations, but also because with rising living standards people expect better healthcare.

COUNTING THE COST

How can governments meet the costs of these services? The US has shown one way: by allowing costs to increase and letting the private sector take the initiative. Sweden and other Scandinavian countries have shown another way: by increasing taxes and using the revenue to subsidise jobs in healthcare.

The hours of work devoted to jobs in health and education in Sweden exceed even those in the US, while hours worked in the eurozone countries fall well short of both. But the taxes needed to finance these jobs in Sweden are very high compared with those in other European countries. Swedish job creation in other sectors, such as retailing and home repairs, has suffered, which means that overall the country is behind the US. So even within Europe, it is no coincidence that IKEA is a Swedish company. It is also no coincidence that eating out in Sweden is much more expensive and less common than eating out in, say, Italy.

Is this the future of work in Europe? Will taxes have to go up to subsidise jobs in the sector that will feel most pressure for job creation? European citizens have a tough decision to make, but first they must sort out their public debt problems. Otherwise the social care system that is so deeply rooted in Europe's culture will become untenable. ■

econ.lse.ac.uk/staff/cap/index_own.html

PROFESSOR CHRISTOPHER PISSARIDES
Norman Sosnow Chair in Economics at the London School of Economics, and joint winner of the Nobel Prize for Economics in 2010

The rising cost of living

Trends in household inflation for the rich and poor differ

MEASURES OF INFLATION, such as the Retail Prices Index (RPI), are all indicators of how prices are changing for a 'typical household'. But how much variation is there in the inflation experiences of rich and poor households? And are any differences persistent or do they tend to cancel out over time? Research by the Institute for Fiscal Studies (IFS) is shedding light on these questions.

Official inflation measures are produced by first surveying the prices of different goods and services across the economy, and then weighting year-to-year price changes for individual goods according to how important they are in average household budgets. The inflation rates faced by individual households might differ from these average measures for two reasons: first, the prices of the same goods and services may rise faster or slower for them than for other households (for example, if they use different kinds of shops); and second, they may spend their budgets differently to the average. While the first issue may be significant, it is difficult to explore with the available data. But it is possible to look at differences in household spending by using the annual Living Costs and Food Survey (which is used to calculate the RPI). Using this, IFS researchers have calculated an inflation rate for every household.

Poorer households experienced higher inflation rates on average than richer households

Since we know that household spending patterns differ systematically across the income distribution, rich and poor households are likely to experience different inflation rates on average from year-to-year. For example, in years when domestic fuel prices rise faster than general prices, poorer households will, other things being equal, experience higher inflation rates than richer households – as the poor tend to devote more of their spending to heating. So how have inflation rates differed between different income groups over time?

The chart shows annual average inflation rates experienced in three parts of the income distribution from 2000-2010. There are differences but no single group consistently experienced higher inflation rates. In some years, poorer households faced higher average inflation, while in other years it was richer households.

One particularly interesting year is 2009, where there were large differences between rich and poor households. The poorest fifth of the population faced an average inflation rate of 3.1 per cent, while the richest fifth had an average inflation rate of just 0.9 per cent. The gap is partly explained by steep declines in mortgage interest rates, which benefit richer households more. Indeed, changes in housing costs play an important role in driving differences in inflation rates between households generally – not only between rich and poor but also between young and old.

Spending on heating varies in rich and poor households, which affects a household's inflation experience

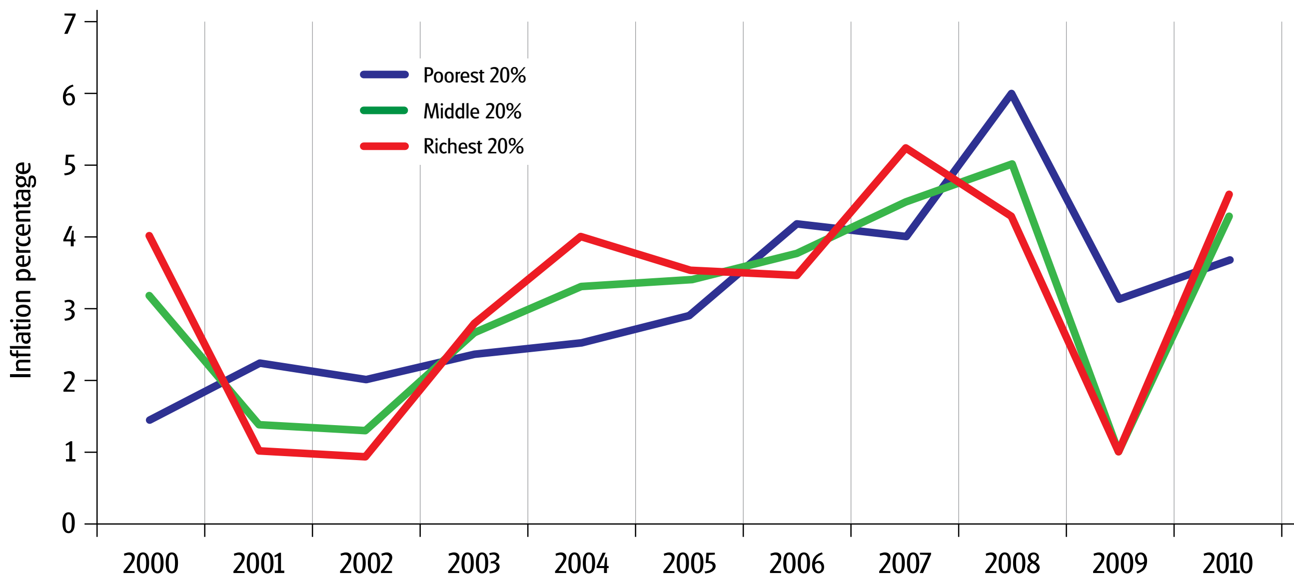

Figure 1: Average inflation rates experienced by three income groups 2000-2010 *Source: IFS*

Alamy

Despite substantial variation from year to year, poorer households experienced higher inflation rates on average than richer households. The average inflation rate for the poorest fifth was 3.3 per cent compared with 2.9 per cent for the richest fifth. This suggests that 'real' income inequality may have increased by more than is shown by conventional inequality measures (which don't account for differential inflation rates).

During the recession, the difference in average inflation rates was particularly large: 4.3 per cent for the poorest fifth and 2.7 per cent for the richest fifth. In part this was because mortgage interest rates fell and domestic fuel prices rose. Whether this is likely to be an issue over the next ten years will depend on how relative prices change in the future, something that is difficult to predict. It is quite possible that the pattern of the recent past will not repeat itself in the years ahead. ■

www.ifs.org.uk/pr/inflation_0611.pdf

The ins and outs of unemployment

In hard times when unemployment rates are high, should policymakers do more to help?

PEOPLE WHO ARE thrown out of work in Britain find new jobs much more slowly than in the United States. According to research by Professor Jennifer Smith of the University of Warwick, not much more than one in every ten unemployed British workers find new jobs within a month, compared with one in every two unemployed Americans.

The comparatively slow transitions from unemployment to work in Britain mean that significant changes in the labour market, often driven by a recession, have lingering effects. This helps to explain why Britain has suffered from persistently high unemployment in the past. It also suggests that policies to help people find jobs – such as Jobcentre Plus and rationalisation of the benefits system – could play a critical role in speeding the fall in unemployment as the economy recovers.

Policies to help people find jobs could play a critical role in speeding the fall in unemployment

In the Great Recession of 2008-09, unemployment in Britain rose by over 850,000: from 1.6 to 2.5 million. Although this increase was less than many had feared on the basis of past recessions and the severe six per cent drop in output, the end of recession has not brought a significant fall in unemployment. Instead, the unemployment rate has fluctuated around eight per cent, having risen from a pre-recession low of 5.2 per cent in April 2008.

Professor Smith's study analyses 20 years of labour market history for more than 5,000 people interviewed each year by the British Household Panel Survey to investigate what drives inflows into and outflows from unemployment.

She finds that while British workers lose their jobs at a slower rate than their US counterparts, rises in unemployment are mainly driven by sharp increases in the job loss rate. Inflows into unemployment account for 60 per cent of unemployment changes in Britain. This contrasts with claims made on the basis of US data that all changes in unemployment arise from variations in the job finding rate not the job loss rate.

This suggests that in a recession, the government could go further in alleviating rises in unemployment through policies that encourage employers to hang on to workers. Germany's 'Kurzarbeit' policy, where the state subsidised jobs to allow reductions in hours during the recent recession, is an example. Other policies that might have similar effects include pro-cyclical employment taxes: lowering employers' National Insurance contributions in a recession would reduce labour costs and encourage employers to retain their workers. ■

papers.ssrn.com/sol3/papers.cfm?abstract_id=1840217

Alamy

Jobcentre Plus can help get people back to work, but more initiatives are needed

Rex

Fixing fragile states

Fragile states are a central focus of Britain's international development policy. Professor Tim Besley talks to Romesh Vaitilingam about his research on state capacity

RV: What is the idea of state capacity, which you believe should be at the heart of the development policy debate?

TB: We use the term as a catch-all for those things that the state invests in to become an effective organisation. These are similar to what the development community talks about in discussions of so-called 'fragile states'. We focus on two dimensions: the effectiveness of the state's ability to raise tax revenues; and the legal capacity, which is the ability of the state to become an enforcer of property rights, a registrar of personal property and land, and an overseer and regulator of financial markets.

RV: Tax revenues are clearly essential for investing in infrastructure and education, but how does a country start generating taxes effectively?

TB: You have to understand how governments have historically made their decisions to build tax systems. We say 'build tax systems' rather than 'raise taxes' because you need to make investments in infrastructure to support the system. You need monitoring and collection, and you need compliance tools to make sure that people actually deliver on their taxes.

If you think of it as an investment, then what are the motives that will make it worthwhile? There are factors about the economy. For example, it's easier to tax transactions if you have a more market-based economy rather than a large informal economy. But over time, you get more formality and therefore tax systems develop.

The international community should do whatever it can to reform local institutions

Then there are demand-side factors for what the state produces. Historically, war was one of them. Governments needed revenues to fight wars. What was exceptional about Western Europe was the extent to which warfare became a key focus of state activity and the driving force behind fiscal systems.

Finally, there's the ability of the state to respond to demand-side factors, which lies in the nature of political institutions. The core argument is that if you raise a lot of revenue, you want to think about the control that taxpayers have over how that revenue is dispersed. You need strong representatives from local institutions. We use the term 'cohesive institutions' to describe when there's a fair amount of citizen control.

Putting these ingredients together – the economy, demand and institutions – gives you a conceptual framework for thinking about investing in fiscal capacity.

RV: You mentioned external wars as a driver for establishing fiscal institutions. But what about countries experiencing civil war and people violently contesting control of state institutions?

TB: One of the key functions of the state is the need to establish law and order and peace within a jurisdiction. And one feature of many countries is sadly that they've singularly failed to deliver peace and security for their citizens. Even if they do, there are two ways to do it. One is by having a genuine peace supported by cohesive institutions. The other is by having one force repressing the will of the citizens, which is not much of a solution. Repressive states are also problematic in the sense of not really having established what you would want to achieve in the form of a stable and peaceful state.

RV: Your research quotes Adam Smith calling for peace, taxes and justice as the three elements

One of the key functions of a state is to establish law and order

of a successful economy. You've talked about peace and taxes: what about justice?

TB: The justice part of Adam Smith's famous remark is what we call legal capacity, and the fact that a prosperous economy relies on all manner of inputs from an effective legal system – contract enforcement, property rights, and so on. We're not talking about justice writ large – human rights, and so on – although those ideas do link to our agenda. We're talking about justice in a relatively narrow sphere of how people are able to contract freely with one another and engage in commerce without fear of predation.

RV: What does your framework offer for thinking about what happens next in the potentially fragile states of the Arab Spring and how the international community can help these countries develop?

TB: Being of an optimistic nature, this is a great opportunity to realise the virtues of building cohesive institutions. So the international community should do whatever it can to reform local institutions so that these countries move onto the path of common interests and not the path of fragility. It's clearly a country-by-country judgement, but ultimately the answer has to be about building cohesive institutions. Doing that is complicated – and researchers and policymakers still have much to learn. ■

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Professor Tim Besley *is Kuwait Professor of Economics and Political Science, and Director of STICERD at the London School of Economics*

The South Sea Bubble

Stock market crises are not a new phenomenon

THE SOUTH SEA Bubble of 1720 was one of the world's first stock market crises. But was it the result of gambling mania among investors and fraud by the South Sea Company, as historians have traditionally argued? In a new book, economic historian Dr Helen Paul of the University of Southampton shows that this explanation is wrong.

Of course, she says, some investors were naive and paid large amounts for a variety of company shares. Others took advantage, expecting share prices to keep rising at least in the short term and planning to sell out before the bubble burst. But there were underlying reasons why people were interested in shares in the first place. Shares in joint stock companies were easier to sell on than other forms of investment. Two major wars were coming to an end, and people were optimistic about the future of trade.

The story of the South Sea Bubble needs to be told with both financial theory and social history

The South Sea Company had monopoly rights to trade slaves to Spanish-held America. Ordinarily, Spain tried to keep foreign merchants out of its US colonies. Slave traders were the exception because the colonies were dependent on slave labour and, struggling to maintain its large empire, Spain could not provide slaves itself.

The South Sea Company could have been the first step to establishing a new British colony in the Spanish Americas. Even if that was a remote possibility, many people wished to stake a small claim in the company just in case. The company's records show that it took the slave trade seriously, working with a major slaving company, the Royal African Company, and the Royal Navy. It survived stoppages in the trade and continued slaving even after 1720. Yet drawing on evidence from contemporary sources, some historians continue to claim that the trading arm of the company was weak and that only fools would invest in it.

But while these sources tell us much about social history, they reveal little about financial history. Many express the views of a male, Anglican, landowning elite, and blame outsiders such as Jews.

Tellingly, commentators like Daniel Defoe criticised financiers but not the trade in human beings. They lacked the financial theory to explain stock market bubbles. As Dr Paul concludes, the story of the South Sea Bubble needs to be told with both financial theory and social history. ■

The South Sea Bubble: An Economic History of its Origins and Consequences *by Helen Paul, published by Routledge*

Thinkstock

The South Sea Company continued trading slaves even after 1720

Food purchases have dropped significantly since the onset of the recession

Alamy

Household expenditure in a recession

Younger people have cut back their spending the most

ANALYSIS BY ESRC Centre researchers at the Institute for Fiscal Studies (IFS) throws light on the nature of the recent recession and its impact on households. It shows that the 2008-09 recession was different from the recessions of the 1980s and 1990s in the scale of the falls in household expenditure, in how long those falls have persisted and in the ways in which households have adjusted their spending.

Looking at the scale and persistence of the falls, the research, which was co-funded by the IFS Retirement Saving Consortium, finds that household spending fell by almost five per cent in real terms between the first quarter of 2008 and the second quarter of 2009. This compares with falls of just three per cent during the recessions of the early 1980s and early 1990s. More recently, even by the first quarter of 2011 spending was still 4.4 per cent below its peak – by this stage of previous cycles spending had already returned to its pre-recession peak.

From official forecasts made alongside the March Budget Britain won't reach pre-recession levels of household spending until the first quarter of 2013. Although now widely seen as optimistic, even these forecasts imply almost twice as long a period of expenditure below pre-recession levels as occurred in previous recessions.

The pattern of household expenditure is crucial to understanding the path of the economy

In terms of how households have changed their spending the researchers found that two big differences stand out by comparison with previous experience. First, unlike previous recessions, food purchases fell significantly and this may reflect sharp food price increases over the period. Second, purchases of 'consumer durables' fell relatively little, in stark contrast to previous recessions when this spending has taken the biggest hit. This may reflect the effects of the temporary cut to the main rate of VAT and the vehicle scrappage scheme – both implemented by the previous government – as well as other factors.

Other categories of expenditure that have seen substantial falls both in this recession and in previous ones include holidays, alcohol and eating out.

The research also highlights the different experiences in the recent recession of different types of households. The oldest households (those containing someone over 65) reduced their spending by substantially less than younger households. Average annual expenditure growth in 2008 and 2009 was seven percentage points below its non-recessionary trend value for households where the oldest person was younger than 35 and it was five percentage points below the trend for those where the oldest person was aged between 35 and 64. The research found no statistically significant fall in expenditure growth for older households.

Those paying off mortgages reduced their expenditure, on average, by substantially more than those who own their property outright or are renting. This implies that those households who have seen their mortgage interest payments fall have, on average, tended to save rather than spend this windfall.

Cormac O'Dea, a senior research economist at the IFS, said: "The pattern of household expenditure is crucial to understanding the path of the economy as it accounts for about 65 per cent of GDP. Continued economic weakness has gone hand-in-hand with continued low levels of household spending and the drop in spending since 2008 has been unprecedented in recent history both in its scale and its persistence." ■

www.ifs.org.uk/publications

Punishing price-fixing

A more rigorous approach needs to be adopted to deter cartel behaviour

DISQUALIFYING PEOPLE FROM being company directors for periods of up to 15 years would be a far more effective way of discouraging cartels than corporate fines. That is the conclusion of research by the ESRC Centre for Competition Policy (CCP) at the University of East Anglia. But while there is legislation to impose so-called 'Competition Disqualification Orders' (CDOs), to date it has never been used.

Practices such as price-fixing, market sharing and bid-rigging allow firms that appear to be competitors to act as monopolies, hiking prices and ripping off their customers. Products subject to this theft have included car glass, long-haul flights, replica football kits, bathroom fittings and construction. Price fixing typically occurs between small numbers of employees from competing firms, communicating in secret. They generally know that cartel practices are wrong but engage in them anyway in pursuit of higher profits. In the European Union, such behaviour is currently punished by enormous corporate fines, for example, one of £790 million imposed on a French car glass manufacturer in 2008.

The CCP research suggests that fines do little to deter future cartel behaviour

But the CCP research suggests that fines do little to deter future cartel behaviour. The problem is that the average length of time between cartels being operated and the imposition of a fine is more than ten years. By this time, the individuals responsible may have moved to another firm, retired or even died.

As things stand, it is firms who bear the risk of their employees' misbehaviour and those intent on fixing prices know it. Since 2003, price-fixing has been a criminal offence in Britain, punishable with up to five years in prison and/or an unlimited fine. But company executives have only been imprisoned in one case. The failed trial of four British Airways executives in 2010 highlights the difficulty of proving guilt, when fixing prices may only involve some quick phone calls or emails.

CDOs provide an alternative punishment that can be used by the Office of Fair Trading (OFT), the body responsible for enforcing competition law. Under the 2002 Enterprise Act, when the law has been breached, directors can be disqualified if they have contributed to misbehaviour, if they had reasonable grounds to suspect it or if they *ought* to have known. Ignorance is no defence.

CDOs are for a fixed period, during which individuals would be committing a criminal offence if they get involved in managing a company in any way. CDOs do have some shortcomings – they only apply to directors and may be difficult to monitor to ensure compliance. Yet in a 2007 report for the OFT, British firms viewed the threat of CDOs as a stronger motivator for good behaviour than high corporate fines.

A LENIENT APPROACH

But despite the OFT having completed numerous cartel investigations resulting in corporate fines, not one CDO has been imposed. The main reason is that the OFT refuses to impose them if firms under investigation (and their employees) fully co-operate with investigations.

Indeed, a defining feature of cartel-busting is a leniency programme. As cartel practices are hard to catch, the OFT offers complete immunity to the first firm to blow the whistle. And while there is only one immunity deal and that goes to the first firm through the door, discounts on fines are available to subsequent firms who co-operate.

The OFT fears that imposing CDOs would discourage firms from co-operating. But as the CCP researchers point out, co-operation can be reflected in the length of disqualification sought and key evidence will normally come from the whistleblower. They conclude that CDOs are the most straightforward way of ensuring justice is served by directly punishing those responsible for cartels. ■

competitionpolicy.ac.uk/publications/working-papers-2011

Cartel-busting isn't currently effective and the responsible directors need to be penalised more directly

Thinkstock

Managing natural resources effectively

Professor Paul Collier talks to Romesh Vaitilingam about how low-income countries, rich in natural resources, can harness the opportunity for development to benefit all their citizens

RV: What are the key decisions for resource-rich economies?

PC: In the past, many resource-rich countries haven't managed to harness their potential. And if we drill down, that's because the chain of decisions that has to go right is long and complicated. We can split the decision chain into five links. The first is managing the discovery process. After all, these natural resources are hidden. Discovery is all about generating information. What's discovered is, in economic terms, a lot of rents under the ground. So the next step is to capture those rents for society rather than for the people digging the stuff out of the ground. Those people are entitled to a return on their labour and capital and the risks they're taking. But with natural resources, that leaves a lot of rents that need to be captured for society, which requires a set of tax instruments. This link often goes horribly wrong.

The third link is that resource extraction happens in some locality, and it's important to manage that localisation. At one extreme, you get local communities of indigenous people who lose everything. Towards the other extreme, you get the statement, 'this belongs to us, not all citizens'. Managing the legitimate interests of the local without saying the local is entitled to full ownership is essential.

So we've discovered our natural assets, we've taxed them and we've managed the local. Then we turn to the downstream, the revenues that come into the government. What happens to them?

The next key link is the decision between consumption and investment. The revenues are generated by depleting a natural asset, so they're clearly not sustainable. But some are more sustainable than others. A lot of the discoveries we're seeing now, especially of oil, are rather small discoveries and so will last only 20 years, perhaps. So that's at the end of the spectrum where you need a high savings rate from these revenues.

It's important not to have a 'race to the bottom' in governance

Having decided to save a lot of the revenues, the final link is deciding how to invest those savings. The model that has all the glamour is the Norwegian one: 'save the money abroad'. But the lower-income, resource-rich countries are very short of capital, so they should be investing at home. To do that, they need to build the capacity to invest properly. So that final link is building the capacity to invest productively – 'investing in investing'.

RV: Your decision chain is advice for the governments of poor countries that have a wealth of natural resources. What's the role of the international community in encouraging them to follow this agenda?

PC: First, we have to recognise that this decision chain is the responsibility of the resource-rich societies themselves. Governments need to build rules that are supported by a critical mass of citizens.

RV: What can the international community do?

PC: One is help the information process. There's a lot of knowledge out there, which can accelerate 'social learning'. The international community can adopt voluntary guidelines, against which resource-rich societies can benchmark themselves. The second thing the international community can do relates to the major actors in the decision chain, the resource-extraction companies. Very few low-income, resource-rich countries have their own resource extraction companies. They don't have the technology, the skilled labour or the finance. So inevitably international companies are centrally involved, and it's important that we don't have a 'race to the bottom' in governance.

RV: How optimistic are you that in the coming years we'll see some of these countries follow your recommended path successfully?

PC: Certainly around Africa, there's a burning sense of 'never again' – an awareness that the past is a history of plunder, of the few expropriating from the many and of the present expropriating from the future. To date, they've not built on that successfully. Ghana, which was probably the best managed economy in Africa, discovered oil in 2007 and, very rapidly, the quality of public spending decisions deteriorated.

This is what inspired our work on the Natural Resource Charter, an alliance between academics and civil society in developing countries, trying to put detail on the decision chain that I've described. We've found a lot of take-up for the charter, for example from the economic arm of the African Union and the African Development Bank. But managing natural resources for development is a struggle: whether it will go better than last time, let's hope so. People do learn from the past. ■

www.naturalresourcecharter.org

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A country with rich natural resources must learn to manage and not waste its opportunities

Rex

Household incomes: what the future holds

There's delayed pain to come from the Great Recession

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Household incomes continued to grow through the recession and into 2009/10

BRITAIN'S NATIONAL INCOME fell by over six per cent between the first quarter of 2008 and the third quarter of 2009, making it the deepest recession since the Second World War. GDP remains well below its pre-recession peak, and the latest estimates suggest that growth is going to be slow for some time to come. You would expect a huge economic shock like this to have a direct impact on people's living standards. Researchers at the Institute for Fiscal Studies have tried to piece together the effects of the recession – and subsequent government policy – on household incomes. The results are rather surprising, but not comforting for the future.

Perhaps the biggest surprise is the fact that household incomes continued to grow through the recession and into 2009/10. Deep recessions are generally associated with simultaneous falls in people's living standards. For example, between 1979 and 1982, household incomes fell by nearly three per cent after inflation. Incomes were more protected this time around, largely by government actions to increase benefits and reduce taxes temporarily.

The second surprise is a remarkable increase in the incomes of those right at the top of the distribution between 2008/09 and 2009/10. While overall incomes grew by about 1.6 per cent, the incomes of the richest one per cent grew by an extraordinary 13 per cent. This appears to be correlated with a rebound in the stock market, but it more than makes up for the two per cent fall this group experienced in the previous year. In fact, the outperformance of the large majority of households by those right at the top of the distribution has been a feature of the past decade. Incomes at the top percentile have grown more than twice as fast as those in the middle of the income distribution.

The third surprise comes from looking a little further back in time. The economy grew fairly steadily in the years prior to the recession, at around two per cent a year between 2002/03 and 2007/08. But in each of those years, average incomes grew less quickly than the economy, and in most years, incomes in the middle of the distribution grew by less than average (mean) incomes. As a result we went into the recession following several years of very weak income growth across most of the distribution – much weaker than you'd expect given how well the economy as a whole was doing.

A final surprise has been the remarkably robust picture in the labour market. Employment levels are only about two per cent below their 2008 peak, while GDP remains four per cent below its peak. Despite the depth of this recession, unemployment has risen much less sharply than in previous recessions. This has meant that fewer households have seen substantial falls in their living standards as a result of losing their jobs.

So what does the future hold? We can understand what happened up to the start of 2010 by analysing official figures. We can also use our own forecasting models, official assumptions and some more up-to-date data to say something about what has happened more recently, as well as what is likely to happen going forward. Based on what we know about changes to the tax and benefit system and changes in the labour market, the immediate story is of a sharp drop in incomes in 2010/11. Going further forward things look even bleaker. Tax and benefit changes implemented and planned from January 2011 through to April 2014 will reduce household incomes by an average of about five per cent.

The pain will be shared through lower wages, higher taxes and lower benefits

Many changes have been announced. The biggest include the increase in VAT that came into effect in January 2011, increased rates of National Insurance that took effect from April 2011, and a change to the indexation of benefits, which means that most benefits will rise in line with the consumer prices index rather than the retail price index. This last change is expected to be saving the government £5 billion a year by 2015.

In addition the prognosis for earnings does not look good. The Office for Budgetary Responsibility and the Bank of England are both expecting real earnings to fall this year, and the Bank's governor, Mervyn King, has repeatedly warned that living standards are likely to fall over the next few years.

THE PAIN THRESHOLD

Our best estimates are that real household incomes in 2014/15 will still be lower than they were in 2008 and probably no higher than they were in 2002. To see no real income growth over such a long period is historically most unusual – certainly since the start of our household data in 1961 and almost certainly since the Second World War. What we experienced in 2008 and 2009 was a relatively painless but extraordinarily deep recession. What we look to be experiencing now and for the next few years is a slow recovery and the delayed pain from the recession. The impact on households will be severe, but very different from that of previous recessions.

The pain will be shared through lower wages, higher taxes and lower benefits. That perhaps feels like a more socially just recession than that of the early 1980s, which saw a minority become unemployed and take a big hit to their incomes while many saw their incomes rise quite fast. But it can't be reassuring to a government looking to go to the polls in 2015.■

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PAUL JOHNSON
Director of the Institute for Fiscal Studies

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