Unless growth is very strong, achieving deficit reduction at the speed that all political parties are promising will be painful – but with some the pain would be greater than others. By Simon Wren-Lewis
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s Britain’s political parties lay out their economic plans ahead of the general election, one key question is how fast should the deficit and debt fall? The Office for Budget Responsibility (OBR) forecasts headline public sector net borrowing (‘the deficit’) of 3.8 per cent of GDP for the financial year 2015/16. The OBR’s forecast for the debt-to-GDP ratio (‘the debt’) is just under 80 per cent. These are the numbers for the deficit and debt that any new government will inherit – but what are the paths by which they should be reduced?

Economic theory only really tells us one thing about the right speed for deficit reduction: if there is no danger of default, it should be fairly slow. So I have looked at four possible paths: in my ‘slow’ path, a target set in 2015 for the deficit five years ahead would be three per cent of GDP. On the assumption that long-run growth in nominal GDP is four per cent a year, then maintaining a three per cent deficit would stabilise debt at 75 per cent of GDP.

I think that is still too high, and for various reasons it is good to plan for a steady fall in the debt-to-GDP ratio over the next few decades. So the slow adjustment path involves a steady but slow reduction in deficits to one per cent of GDP by 2040, which, if maintained, would eventually stabilise debt at 25 per cent of GDP. The path of debt assumes four per cent nominal growth each year. This slow path is much slower than anyone is currently talking about, but I include it to make the point that it should be an option that is seriously considered. It gets debt down to a smaller share of GDP than at any time in Britain over the last 200 years.

FOLLOWING THE RIGHT PATH

My ‘medium’ path is more ambitious in two respects. First, the five-year target made in 2015 is a deficit of 2.4 per cent of GDP rather than three per cent, so the pace of deficit reduction from 2015 is more ambitious. Second, the target is an eventual debt-to-GDP ratio of 12.5 per cent so the deficit is steadily reduced to 0.5 per cent of GDP. But both of these paths fail to reduce debt noticeably by 2020 compared with 2015. (With four per cent nominal growth and starting with debt-to-GDP at 80 per cent, the deficit needs to be below 3.2 per cent for debt to start falling.)

My ‘quick’ path involves a deficit target of only 1.5 per cent by 2020, and further reductions so that the debt reaches its steady state level by 2025. But I assume for this path that the desired long-run debt level is the same 12.5 per cent of GDP as on the medium path. If public investment stays at around 1.5 per cent of GDP, then the OBR, then the 2020 figure for the deficit would correspond to achieving current balance by that date.

My final path, which I label ‘Osborne’, involves the OBR’s forecasts for the deficit under current plans for 2016 and 2017, and a zero deficit thereafter. This brings debt down much more rapidly – and with a zero deficit, the debt-to-GDP ratio steadily tends towards zero. I cannot see any logic to such rapid deficit and debt reduction, so it seems to be a political ruse to either label more reasonable adjustment paths as somehow spendthrift or to continue to squeeze the welfare state.

What it already seems to have done is to shift the opposition’s position towards the fast adjustment path. Labour’s current commitment is to achieve a current balance surplus as soon as possible, and certainly by 2020. If public investment stays at around 1.5 per cent of GDP, that would correspond to the fast path or even faster. The Liberal Democrats say their proposed path is somewhere between the plans of Labour and George Osborne.

So which path makes most sense? My work with Jonathan Portes of the National Institute of Economic and Social Research suggests that we should aim to bring debt down, which is why all of my possible paths do this. But economic theory also suggests that debt reduction should be slow unless the government is having difficulties in selling its debt. The British government has never had any such difficulty – and what is more, interest rates on debt remain pretty low so there is no urgency to reduce debt.

SHOCK WAVES

There is one further consideration that argues for slow rather than rapid debt correction, at least over the next five years. By 2015 or 2016, it seems likely that short-term interest rates set by the Bank of England will have finally risen from their ‘lower bound’ of 0.5 per cent as the recovery continues. But the Bank does not expect interest rates to rise rapidly, and in any case not to levels thought normal in the past. There is a direct relationship between how quickly rates rise and the speed of fiscal consolidation. The quicker the debt is reduced, the lower government spending will be (or the higher taxes will be), which will put downward pressure on demand and inflation. This in turn will keep interest rates low, as the Bank attempts to achieve its inflation target.
Now many commentators may say that is a good thing, although savers might have different views. But what if the British economy were to be hit by another significant negative shock – an economic collapse in the euro zone, for example? Monetary policy will have only limited scope to respond before interest rates again hit their lower bound. The faster is the path of fiscal consolidation, the lower interest rates will be and therefore the more vulnerable the economy would become to a large negative shock.

This is not just an academic concern, because we have been here before. In 2010, the OBR was forecasting a strong recovery in output and therefore expecting that the economy could cope with the austerity plans of the new government. Those forecasts proved much too optimistic. As a result, interest rates were stuck at their lower bound, the economic recovery of 2010 came to a halt and we had to wait until 2013 for the recovery to resume.

But it would be wrong to blame the OBR for this. Good macroeconomic policy should be designed to be robust to shocks, rather than only working when forecasts prove correct. The problem with the 2010 austerity programme was that it only worked if things went well. In the end, the pace of fiscal consolidation was eased in 2012 (‘Plan A’ became ‘Plan B’, although George Osborne does not like to admit this fact), but by then the damage had been done.

So the danger for 2015 and beyond is that history might repeat itself. If we attempt to bring the debt back down too fast, we leave the economy open to just the kind of negative shock we experienced from 2010 onwards. In this respect, none of the main political parties seems to have learned the lessons of the last five years – although for some this failing is greater than others.

Simon Wren-Lewis is Professor of Economic Policy at the Blavatnik School of Government, Oxford University and blogger at ‘mainly macro’
HOW ARE CENTRAL BANKS CREATING AN EFFECTIVE MONETARY POLICY?

IN THE WAKE OF the global financial crisis, the world’s central banks have been given the task of developing and deploying tools to limit the build-up of systemic risk and its potentially disastrous consequences of financial instability and economic distress. The hope is that the credibility acquired from conquering inflation in the 1980s and 1990s will rub off on the new agenda of ‘macroprudential policy’ – looking at the soundness of the financial system as a whole (as opposed to microprudential regulation, looking at the safety of individual financial institutions). We fear the opposite: that the fuzziness of the macroprudential agenda and the interplay of political pressures may undermine the reputation of central banks and threaten the effectiveness of monetary policy.

In fighting inflation, central banks have one explicit tool – interest rates. And an unambiguous and easily measured objective - inflation. There are no equivalents in macroprudential policy. Instead, policymakers have a collection of often conflicting tools and an even more baffling set of measures designed to capture systemic risk and financial instability. This makes it hard to build the political consensus for employing the macroprudential toolkit. The implementation of the policy inevitably involves a wide array of institutions, including the fiscal authority. This increases both the politicisation and access for divergent viewpoints, which permits any critic to use macroprudential ambiguity to argue that a different measure or different tool is more appropriate.

WHAT’S AT RISK?
The politicisation of macroprudential policy leads to countervailing pressures. Financial regulators may be biased towards non-intervention because they would face political pressure against tightening during a boom. It is often politically difficult to take measures that reduce short-term economic growth in the interests of fending off a bust that many think will not happen. This is a common problem in financial regulation, creating ‘pro-cyclicality’ – when the behaviour of market participants and policy authorities amplifies the volatility of the financial system. Regulators may also lean to premature intervention because they fear being criticised for failing to spot a bubble. But the desire to prevent future crises at all costs could put constraints on investment and the capacity for growth.

The macroprudential agenda is hard to disagree with: who can object to measures that prevent the build-up of imbalances that will cause significant economic harm? No wonder the macroprudential agenda currently enjoys much political support, especially as memories of the crisis are fresh and policies have only been implemented sparingly. But at some point in the future, this policy will have to be implemented more widely and receive political support in a more positive environment, where memories of the last crisis have faded and people are enjoying the short-term benefits of the bubble. Then this support is likely to be weaker than now.

As a practical matter, the macroprudential agenda seems set up for failure in many countries. The technical uncertainties and institutional designs give sufficient room for significant political objections to gain traction. Since any implementation is likely to run into strong political objections, anything that gives credence to those objections is problematic.

Having the central banks take the lead in implementing such a policy might seem sensible. But the success of the agenda depends on maintaining political consensus as well as the existence of a robust toolkit. Central bankers have fine-tuned the art of economic communication to steer inflation expectations. They must now become better political communicators, with sharp tools, to maintain consensus for managing systemic risk. If they fail, all the fury around the macroprudential agenda could signify nothing, risking both financial and price instability.

Central bankers have fine-tuned the art of economic communication to steer inflation expectations

Professor Jeffrey Chwieroth and Jon Danielsson

Professor Chwieroth is Professor of International Political Economy, Department of International Relations, LSE. Jon Danielsson is Reader in Finance, Department of Finance, LSE. Both are at the Systemic Risk Centre.

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**THE HOUSING MONEY-GO-ROUND**

What is the relationship between house prices, consumption and debt?

**THE PAST YEAR** has seen house prices grow at a fairly spectacular rate – by more than ten per cent across the UK as a whole and as much as 20 per cent in London. House prices and consumer spending typically move close together. The long boom in UK house prices to 2007 was associated with both rising consumption and household debt. But do rising house prices actually cause rising consumer spending? Daniel Chandler and Richard Disney, researchers at the Institute for Fiscal Studies, have been looking at whether rising house prices lead people to spend more and save less.

They find that the literature suggests a complex picture, with house prices having quite different effects on, for example, renters and homeowners and those who find it more or less easy to borrow. In summary, the limited impact of house prices on consumer spending arises from two factors. First, although we might expect rising house prices to encourage homeowners to spend more as their housing wealth increases, a number of studies suggest that most households do not respond to house price changes. In fact, the only group where rising house prices clearly affect spending is homeowners who have tight borrowing limits. Higher housing wealth acts as 'collateral' and rising house prices mean they can borrow more. This group is normally a small fraction of households.

Second, in the case of renters who wish to buy a house, and homeowners who intend to ‘upsize’ their property, higher house prices act as an incentive to save more and a deterrent to spending. Hence the small wealth effect for homeowners is offset by the saving effect for would-be house purchasers. As a consequence, the literature typically finds relatively small net effects of changing house prices on spending.

A related concern is whether rising house prices lead households into excessive debt – a concern for policymakers if it causes difficulties for households in the event of, say, a sudden drop in income. If, for example, a typical household borrowed up to its credit limit – a view held by some economists – then rising housing wealth in the UK would have led to a great increase in household debt-to-income ratios. In practice, UK households did increase their debt: income ratios as house prices increased in the run up to the recession, but they did not borrow up to their credit limits and tended to limit the cost of this increased debt by using debt secured on housing to reduce their unsecured debt such as credit cards.

Households with debt problems in the UK are not typically those with greatly increased housing wealth – indeed a lack of wealth is usually the cause of household indebtedness.

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**TAX AVOIDANCE**

**WHAT A WRITE OFF**

Peer pressure ensures people comply with tax obligations

**IN RESPONSE TO** public outcry over tax avoidance and evasion over the last years, the government has pledged a number of measures, such as closing down tax avoidance schemes and recovering tax debt. While the delivery of the core is under way, we turn our attention to prevention – what stops people from considering noncompliance in the first place?

Peer and societal pressure can prevent individuals from evading taxes. If societal norms are strongly opposed to evasion and avoidance, taxpayers will fear losing their reputation, as well as experience guilt or shame, if they evaded tax. Researchers at the independent Tax Administration Research Centre at the University of Exeter, funded by the Economic and Social Research Council, HM Revenue & Customs, and HM Treasury, investigate the role of social norms in tax compliance from a range of disciplines.

One little understood aspect of social norms is the way they are communicated through social networks, the focus of a recent study by Dr Diana Onu and Professor Lynne Oats.

**DON’T DO IT, MATE!**

To understand how communication can affect tax compliance intentions, Onu and Oats collected and analysed hundreds of publicly-available online discussions about tax. Using discourse analysis, they reveal how people manage to influence and persuade others to comply with their tax obligations with persuasive messages like: ‘It really sounds like you are asking to go to jail’ or ‘What do you mean by writing off income? That’s just tax evasion’. The analysis also suggests that threatening messages may backfire and produce defiance, while ‘softer’ persuasive techniques may be more effective.

Insights about persuasive messaging are particularly useful in designing effective public communication campaigns. Internationally, experts from the OECD and the EU are increasingly calling for public communication campaigns that reinforce taxpayers’ norms – since they aim to prevent evasion, such measures may prove more cost-effective and sustainable than efforts to recover tax debt after evasion has occurred.

www.ifs.org.uk/publications/7198

tarc.exeter.ac.uk/publications/discussionpapers
OUT OF THE LOOP

People do not psychologically benefit from economic expansions nearly as much as they suffer from recessions

How do macroeconomic changes affect people’s wellbeing? The psychological impact of economic expansion and recession is particularly salient given the massive swings of recent decades – see-sawing from boom to bust and back again. Research by the Centre for Economic Performance (CEP) reveals an important asymmetry in the way that individuals experience positive and negative fluctuations of the business cycle. Jan-Emmanuel De Neve and his colleagues find evidence that the life satisfaction of individuals is between two and eight times more sensitive to periods when the economy is shrinking than at times of economic growth. People do not psychologically benefit from expansions nearly as much as they suffer from recessions. These results suggest that policymakers seeking to maximise wellbeing should focus more on preventing busts than promoting booms. They also help to explain why increases in GDP do not always pay off in increases in happiness: the modest happiness gains accrued over years of growth can be wiped out by just a single year of contraction. To explore how individuals react to positive and negative growth, the researchers analyse wellbeing measures from three large datasets: the Gallup World Poll of 151 countries; a representative sample of 2.5 million Americans; and Eurobarometer, a twice-yearly opinion survey conducted by the European Commission.

In general, they find that growth is significantly associated with wellbeing. But when split across positive and negative growth, this result is mostly driven by the negative growth years. Recession years are significantly associated with losses in wellbeing, but there is not an immediate relationship between positive growth years and wellbeing.

So why is it that people experience macroeconomic losses in a more negative way than they experience equivalent gains positively? A deep-rooted mechanism could be that individuals simply react more strongly to negative developments. People’s disproportionate sensitivity to negative stimuli and the general finding that ‘bad is stronger than good’ may have an explanation rooted in evolutionary biology, since in terms of survival the avoidance of threats is more important than a missed opportunity.

Periods of economic contraction not only involve a loss of national income but also an increase in uncertainty, which is arguably intensified by the disproportionate coverage of negative news about macroeconomic trends compared with positive trends. Volatile business cycles and the resulting uncertainty are also attention-seeking stimuli. Other research has highlighted the role of economic insecurity in increasing angst and stress by showing that the subjective wellbeing of employed individuals working in the public sector – who in general enjoy more job protection – is less acutely affected by economic shocks than comparable workers in the private sector.

Economic growth and wellbeing

The central findings of the new study provide an opportunity to revisit the longstanding debate on the relationship between economic growth and wellbeing. When considering longer-term data, which covers entire business cycles, it appears that reported wellbeing has not risen in most of the world’s economically developed nations despite real GDP having almost doubled over the past four decades.

Based on a quote by Martin Seligman, Director of the Positive Psychology Center, University of Pennsylvania

* In a world that was a vale of tears, public policy was centred on the relief of misery. As education and abundance increase and suffering decreases, a new definition of prosperity is called for, where wellbeing stands shoulder to shoulder with relief of misery as the twin aims of public policy.*

Source: cep.lse.ac.uk

WHAT IS well-being?

David Cameron’s battle cry for a Big Society in 2010 made the wellbeing of the nation a major governmental aim for the future. What should a ‘wellbeing policy’ incorporate?

* Be part of something bigger
* Be comfortable with who you are
* Take a positive approach
* Find ways to bounce back
* Have goals to look forward to
* Keep learning new things
* Connect with people
* Do things for others

(keys to happier living)

Easterlin, the pioneer of research on happiness economics. Easterlin’s ‘paradox’ highlights the role of economic insecurity in increasing angst and stress by showing that the subjective wellbeing of employed individuals working in the public sector – who in general enjoy more job protection – is less acutely affected by economic shocks than comparable workers in the private sector.

The experience of Greece is illustrative. This result echoes work by Richard Layard is a co-founder of Action for Happiness. Layard is a co-founder of Action for Happiness. Layard is a co-founder of Action for Happiness. Layard is a co-founder of Action for Happiness.
This result echoes work by Richard Easterlin, the pioneer of research on happiness economics. Easterlin’s ‘paradox’ resulting from the conflicting findings in the short-term (using annual growth data, which incorporates both positive and negative growth years) versus long-term (real GDP data that covers one or more business cycles) can perhaps be better understood in light of CEP’s results on macroeconomic ‘loss aversion’. Recessions can rapidly undo the wellbeing gains from longer expansionary periods and lead to an insignificant relationship between national income and average wellbeing when considered in the long run.

The experience of Greece is illustrative. The country’s real GDP grew by more than 50 per cent between 1981 and 2008, while life satisfaction edged up by about 5-10 per cent overall (with most of the gains made over the decade of stable growth to 2008). But the recession that began that year led to a decrease in average wellbeing that erased all prior gains. Average wellbeing in Greece now stands at a level below historical records, despite real GDP remaining at a level well above historical figures. The psychological costs of the recession cut even deeper than the negative growth numbers would indicate.

A better understanding of this asymmetric sensitivity has macroeconomic policy implications. On the one hand, a typical reading of the income-happiness paradox suggests that further growth in the developed world is a futile means to the end of improving wellbeing. On the other hand, researchers who find evidence of a positive relationship between wellbeing and GDP typically take from this that further economic growth is good for society.

CEP’s new findings suggest a more nuanced perspective: policy that is designed to engineer booms but which risks even relatively short busts is unlikely to improve wellbeing in the long run. Steady positive growth that minimises the risk of contraction seems the most likely route to improving general wellbeing.

www.youtube.com/watch?v=c0sWih8B3v8

**ACTION FOR HAPPINESS**

Richard Layard is a co-founder of a new movement called Action for Happiness, which was launched in spring 2011. Members from all backgrounds pledge to live so as to create as much happiness as they can and as little misery. The movement already has more than 20,000 members from over 120 countries. Surveys in Britain and the US show that people are no happier now than in the 1950s – despite massive economic growth. But if we ask ‘How is our society doing?’ we should ask how people feel about their lives. That is the proper measure of the quality of life. What matters ultimately is people’s experience of life. Experience is subjective, which is precisely why it matters. Pain is subjective and so is contentment. Here are Richard’s ten keys to happier living:

- Do things for others
- Connect with people
- Take care of your body
- Notice the world around you
- Keep learning new things
- Have goals to look forward to
- Find ways to bounce back
- Take a positive approach
- Be comfortable with who you are
- Be part of something bigger

Source: www.actionforhappiness.org
THE FUNDING FALLOUT

We will have to wait a generation to see if the recent rise in tuition fees has saved the government any money

IN 2012, THE government made significant changes to the way that higher education is funded in England, including the controversial increase in the tuition fee cap to £9,000 a year. Although students can borrow from the government to cover these fees, they will leave university with substantially higher debts than earlier generations, and mid-to-higher earning graduates will repay substantially more over their lifetimes. Yet the reform now looks set to save the government relatively little money: how can this be? Research by Claire Crawford, Rowena Crawford and Wenchao Jin at the Institute for Fiscal Studies (IFS) sheds light on this question. They find that universities have been the main beneficiaries of the reform, with an increase in funding of around £6,000 in today's money on average per student over their course. Lower-earning graduates will also repay less over their lifetimes, as the threshold above which loan repayments are made has been raised. This makes the new system more progressive than its predecessor.

However, the true public cost of higher education depends on loan repayments made by graduates many years into the future, which are highly uncertain. Whether the new system will save any money will therefore not be known for decades to come.

In 2012, ‘teaching grants’ – funding given directly to universities to teach undergraduates – were withdrawn for most subjects and substantially reduced for others. Instead, universities are allowed to charge substantially higher tuition fees: the cap has been raised from £3,375 a year in 2011 to £9,000 a year from 2012. But students are not required to pay these fees upfront; they can borrow money from the government to cover them and repay their loans once they graduate and earn more than £21,000 a year.

BIGGER DEBTS?
Unsurprisingly, students will graduate with much higher debts as a result of this reform, averaging more than £44,000 (about £20,000 more than before). On average, they are expected to repay around £7,800 more in today's money over their lifetimes. But graduates who do less well in the labour market will pay back less because the threshold above which repayments are made has been increased. This also means that the amount graduates repay each year will be lower, so it will take them longer to clear their debt. In fact, the IFS team estimates that almost three-quarters of graduates will not have repaid their loans in full by the end of the 30-year repayment period.

Meanwhile, the reform looks likely to do little to reduce the public cost of higher education. While the amount spent on teaching grants has been slashed, the cost of providing student loans has risen substantially. Based on current forecasts of earnings over the next 30 years – which affect how much of their loans graduates will repay – the IFS study estimates that the government will spend only five per cent less (around £1,250 per student) than it would have done under the old system.

But that estimate is hugely uncertain – and is liable to change substantially according to shifting economic circumstances. This is exactly what has happened in recent years: as the prospects for graduate earnings have fallen, the estimated cost of student loans has risen. If the IFS researchers had used the more optimistic earnings forecasts produced in March 2012 – just 18 months earlier – then the new system would have looked to save the government 15 per cent compared with the old system.

Replacing the certain cost of teaching grants with the uncertain costs of larger student loans means we will have to wait a generation before we know whether the 2012 reform has saved the government any money.

www.ifs.org.uk/publications/7165
www.ifs.org.uk/publications/7175

Warm welcome

How pro-immigration attitudes in Scotland should affect the decisions of policymakers

MIGRANTS ARE SEEN AS filling important skills and labour gaps in the Scottish economy, according to an online survey of more than 700 Scottish employers. The research, carried out by Dr David McCollum and colleagues from the ESRC Centre for Population Change at the universities of St Andrews and Stirling, was supplemented by 80 in-depth interviews with Scottish businesses, recruitment agencies and other groups. The results highlight the importance that is attached to migration by employers in Scotland.

Two-thirds of Scottish employers responded that EU status and visa and immigration laws were issues of high importance to them, and one-third of employers said that they would like to see issues around immigration and visas receive more policy attention. Many employers and industry representatives claimed that they were actively lobbying the Scottish and UK governments on immigration policy matters. This research feeds into one of the biggest challenges facing policymakers in recent years: the task of reconciling pro-economic growth/pro-immigration stances with public pressure to be seen to be ‘in control’ of immigration flows.

But, while employer views are nearly universally in favour of immigration, most businesses did not advocate a drastic liberalisation of immigration. This is because they recognise that such moves would encounter significant opposition from parts of the existing population and could place strains on public expenditure and community cohesion. This suggests that the general public and the business community may not be as far apart in terms of policy preferences as is sometimes assumed.

NUANCED IMMIGRATION POLICIES

The research also highlights the widespread feeling among employers that Scotland’s immigration policy needs are different from London and South East England. It is equally the case that Scotland’s migration needs resemble those of other regions of England outside the South East. To contrast Scotland and England as being ‘different’ in terms of their experiences and needs with regard to immigration may therefore be false. This study raises questions about such a simplistic division and suggests that it is London that needs a different immigration policy from that of the rest of the country.

“This is significant because immigration policy can be critiqued as being determined by the experiences and needs of the South East rather than the UK as a whole,” says Dr McCollum. “For example, if more restrictive immigration policies are brought in, developed in response to ‘overheating’ in the South East, these may be detrimental to other parts of the UK, including Scotland, where immigration is seen as a benefit to businesses. Our findings highlight the opportunities for Scotland, and the rest of the UK, to work towards more nuanced immigration policies that better suit local needs.”

www.cpc.ac.uk/publications/cpc_briefing_papers.php

Behavioural economics can promote effective competition in the interests of consumers

IN AN ATTEMPT to understand how consumers make decisions the UK’s new financial watchdog, the Financial Conduct Authority (FCA), has turned to the use of behavioural economics. This rise in the use of this system not only marks a new approach to financial regulation but also suggests that consumers are far from rational.

This is a significant departure from the previous assumption of the rational consumer with findings from behaviour economists and psychologists suggesting that several psychological undercurrents, or biases, can lead to poor decision-making. In addition, research by Dr Desponia Mantzari from the ESRC Centre for Competition Policy at the University of East Anglia shows that this increased use of behavioural economics can not only be used in influencing the agency’s consumer protection work, but can also promote effective competition in the interests of consumers. This means that competition can be based on product price and quality and not on firms manipulating consumers’ behavioural biases.

One example of how the FCA has used behavioural economics can be seen in its first market study on the General Insurance Add-On market, whereby insurance is sold alongside goods and services. This behavioural experiment, launched by the authority, reviewed the experiences of consumers who buy insurance online with the aim to understand whether different sales tactics affected the consumer’s decision.

This is a completely new remit for the FCA that has the potential to be very promising. In this ‘brave new world’ of financial regulation, firms will be required to do more than simply comply with conduct rules. Greater scrutiny will be applied to value for money, innovation and pricing in the market.

www.competitionpolicy.ac.uk
How an economic theorist helped the Bank of England deal with the financial crisis

AS THE FINANCIAL CRISIS took hold in Britain following the collapse of Northern Rock in 2007, the Bank of England urgently needed to get large amounts of cash to the commercial banks and building societies to prevent the collapse of the financial system. Mervyn King, then governor of the Bank, turned to Paul Klemperer of Oxford University to work out the best way. The challenge was to design an auction that could rapidly deliver the most efficient allocation of money to the right bidders.

Successful auction design involves mathematical modelling, data analysis and a good understanding of the bidders’ and the auctioneer’s objectives. The rules that govern an auction will affect whether bidders participate, how they bid and whether they will try to manipulate or undermine the auction. The process of designing the auction therefore involved specifying what kinds of bids were possible, how the winners would be determined, what the winners would get and what they would pay.

The Bank of England’s situation was particularly challenging because different bidders were asking for loans of funds on different terms, specifically offering different collateral as security for these loans, and the Bank wanted to be able to charge winners different interest rates accordingly. Making things even harder, the Bank wanted the amount of funds linked to each different type of collateral to depend on the bidding, because the Bank neither had enough information to specify these amounts in advance, nor did it want publicly to reveal its own view of the severity of the crisis. Furthermore, bidders might want to make ‘either/or’ bids – for example, a bidder might like to win A or B but not both; or would be willing to pay £x more to receive A than to receive B.

Klemperer had previously developed auctions designed to generate multiple prices for multiple goods, including Britain’s 3G mobile phone licence auction, which sold five licences of three different sizes and famously netted the government the unexpectedly large sum of £22.5 billion in 2000. But that auction required 150 rounds of bidding over seven weeks. Since financial markets move fast, the Bank of England’s auction had to run instantaneously, so new techniques were required. Permitting the amounts of funds loaned to vary in response to the bidding was also an innovation.

MULTI-PURPOSE AUCTIONS
Klemperer came up with a solution he christened the ‘product-mix auction’, a single auction for multiple types of funds that would allow borrowers to submit combinations of bids simultaneously, and would also allow the Bank to avoid specifying the proportions of different types of funds it allocates until after the bidding. Crucially, this design is much quicker, simpler to use and less vulnerable to collusion than previous multi-price auctions. Mervyn King called it “a marvellous application of theoretical economics to a practical problem of vital importance”.

With funding from the ESRC, Klemperer is now developing his design further using the new technique of ‘tropical geometry’, devised by mathematicians in the last 15 years. In February 2014, he advised the Bank of England on the implementation of an enhanced version of his original design. A similar approach could also have important applications elsewhere, such as the purchase of electricity generated in different locations. It might also be used as a mechanism for trading biodiversity, for example, by allowing developers to trade off development in one place against greater conservation elsewhere.

“Many people think auctions are just about raising money,” Klemperer says. “It’s nice to demonstrate that they can also help with more important problems, such as making the financial system safer and conserving the environment.”

www.economics.ox.ac.uk
UNEMPLOYMENT, FISCAL. Austerity and instability in financial markets have posed serious challenges over the past few years, not least for the economic researchers to whom policymakers have turned for advice on how to combat the crisis. In Britain, the response of the profession is being co-ordinated through the ESRC’s Centre for Macroeconomics (CFM) – a partnership between the London School of Economics, University College London, the University of Cambridge, the National Institute of Economic and Social Research and the Bank of England.

One of the CFM’s initiatives, launched in 2014, has been a monthly survey to inform the public about the views of leading UK-based economists on important questions about macroeconomics and public policy. The profession has long been chided for its apparent inability to reach a consensus view, and the results of the first few surveys are revealing on the policy areas where there is strong agreement – and where there is not.

The first survey invited opinions on whether the financial crisis will have a significant negative impact on economic growth in Britain. A majority thought that it would not damage long-term prospects. Moreover, the respondents were generally optimistic about the country’s immediate capacity for higher growth. In particular, roughly half were partially optimistic about the facility to deliver the most which was to design an auction that could rapidly deliver the most collateral to depend on the ‘product-mix auction’, a single auction of three different sizes and famously netted the government the unexpectedly large sum of £22.5 billion in 2000. But that auction required the ‘product-mix auction’ to avoid specifying the proportions of different types of funds it allocates until after the bidding.

Since financial markets move fast, the Bank of England’s auction had to run instantaneously, so new techniques were required. Permitting the borrowers to submit combinations of bids to the right bidders. The rules that govern an auction will to the right bidders.

Klemperer had previously developed a similar approach could also be used as a mechanism for trading biodiversity, for example, by allowing developers to trade off development in one place for trading in different places. It might also be used as a mechanism to a practical problem of vital importance”.

Crucially, this design is much quicker, simpler to implement than designing the ‘product-mix auction’, a single auction with funding from the ESRC, Klemperer is much more than making money for trading in different places. The auction therefore involved specifying what money and business news.

With funding from the ESRC, Klemperer is much more than making money for trading in different places. The auction therefore involved specifying what money and business news.

Nearly two-thirds thought that sustained eurozone deflation would pose a threat to Britain’s recovery.

The predictions of the other half were in line with those of the OBR.

DIVIDED OPINIONS
Opinions were more negative on the likelihood of deflation in the eurozone – only a small majority replied that there is not a significant risk over the next two years – and nearly two-thirds thought that sustained eurozone deflation would pose a threat to Britain’s recovery. In a later survey, a similar-sized majority saw a further risk to the recovery from rising house prices and argued for the deployment of ‘macroprudential’ tools rather than traditional interest rate policy to deal with this risk.

Two policy areas in which the surveyed economists have been most strongly in agreement are those where public opinion is most polarised. One is whether Scotland would be better off in economic terms as an independent country. An overwhelming majority of respondents said ‘no’ – while a smaller majority agreed that Britain would be acting in its own economic interests to rule out monetary union with an independent Scotland.

The second area of agreement was the economic impact of migration and the effectiveness of the government’s migration policies. There was overwhelming support for the view that migration will increase the average income of the current inhabitants of Britain. Moreover, the panel agreed, current government policies are not effective in attracting the ‘best and brightest’ – indeed, they may be doing the opposite.

www.centreformacroeconomics.ac.uk
SUCCESSFUL TOWN CENTRES ARE WORKING ALONGSIDE ONLINE SHOPPING, NOT AGAINST IT

BRITAIN’S TOWN CENTRES and high streets have experienced a period of profound and disruptive change since the global financial crisis reshaped the economic landscape. But it was not simply the collapse in consumer confidence from late 2008 that led to the country’s much-touted ‘high street crisis’. Longer-term forces of change, which were masked during the ‘growth’ years of the early to mid-2000s, have also been at work.

Three have been particularly important. First, the progressive rise of online shopping and the digital economy more generally. Second, the cumulative impacts of competition from out-of-town ‘one-stop’ retail developments, albeit modified by more than a decade of wide-ranging support for a ‘town centres first’ policy. And, third, wider shifts in consumer behaviour around what really constitutes a ‘convenience culture’.

While each of these forces was powerful in its own right, they also interacted in complex ways that considerably strengthened their individual impacts. Indeed, as the ‘high street crisis’ developed, it became increasingly clear that the way these forces were combining had become unpredictable. Technology was clearly at the heart of these shifts. The retail industry more generally had entered a period of unprecedented structural change in which incumbent market leaders with significant legacy costs were being challenged with increasing effectiveness by firms whose market presence was being established with a much lower cost base as a result of the internet. But what the commercial property company Colliers International describes as ‘the quantum shift in shopping habits’ reflected not only consumer adjustment to online shopping, but also a wider shift in prevailing cultures of consumption. There seems to have been an implicit reconsideration of the balance of costs and benefits of out-of-town facilities – and a growing search for convenience at the local level.

NEW CONFIGURATIONS

Local shopping becomes particularly attractive when businesses can supply either a ‘choice-edited’ neighbourhood version of the range and quality of the out-of-town offer – or if they provide something specialist and/or rooted in the local community. Consumers seem to have adapted their behaviour in response to tougher economic times by using more frequent top-up shopping at a greater number of local stores to balance their household demands against supply more effectively.

The outcome is some surprising winners and losers. In its projection of the likely configuration of Britain’s grocery market in 2019, IGD Retail Analysis expects the overall size of the market to grow strongly but with major shifts in the structure of the market. As might be expected, online and discounter grocery channels are estimated to more than double their sales. More surprising are forecasts that the convenience store-grocery sector will add more sales than any other sector and by 2019 will account for almost a quarter of total grocery sales; and that the market share of the once dominant one-stop ‘superstores and hypermarkets’ sector will fall significantly.

Given the locational characteristics of the large majority of stores in these two sectors, it is not so much a case of out-of-town retail causing the death of the high street but rather the reverse.

Britain’s town centres and high streets have always been dynamic and adaptive, constantly reshaped by periodic economic, technological and competitive shocks. And while it is clear that the crisis has had significant effects and that urban centres subjected to powerful reconfiguration pressures will not simply revert back to pre-crisis forms (particularly nostalgic images of those forms), they have proved remarkably resilient.

Successful high streets of the future will be those that promote new forms of complementary relationships – between online retail and the traditional store; between corporate retailers and small specialist independent stores and services; and between high streets as retail spaces and high streets as spaces for leisure (including bars and cafés), services (such as health and beauty) and social interactions.

NEIL Wrigley, Michelle Lowe and Dionysia Lambiri

Professor Wrigley (head of team), Professor Lowe and Dr Lambiri are part of a research team at the University of Southampton

Source: Student Money Survey 2014, www.savethestudent.org *For more details see www.savetthestudent.org

EARN MONEY?

HOW DO STUDENTS MAKE EXTRA DOSH

STUDENTS FEEL additionally worried about repaying their studies when compared to 2013

WON’T YOU PLEASE, PLEASE, HELP ME!

Webcam girl, and her dad pretend I was dating a girl, and her dad once had to garden paid me for it

HOW CONCERNED

Parents and friends

SAVINGS

HOW DO STUDENTS

monthly, so where are students finding the extra £458 of living costs outside of London) only covers £277 a month.

The average student in 2014 spends £9,000 of income to supplement their spending?

BRITAIN IN 2015

50
WON’T YOU PLEASE, PLEASE, HELP ME!
How does a student in 2014 piece together the financing jigsaw puzzle?

STUDENT FINANCE FACTS IN FIGURES
Since new charging structures were implemented in 2012, there are important changes in student financing*

- £9,000: The maximum universities can charge for tuition fees in 2014 - a three-fold increase on 2011
- £5,500: How much full-time students can apply for as a maintenance loan (more if in London)
- £43,500: The average university graduate student debt
- £21,000: When you have a job you pay back 9% of everything you earn over £21,000 per annum

HOW CONCERNED ARE STUDENTS ABOUT MONEY?

- 4/5 constantly worry about money
- 46% find this affects their studies
- 58% find this affects their diet
- 1/3 students have never budgeted

HOW DO STUDENTS SPEND THEIR MONEY?

- Travel: £24
- Clothes: £44
- Books: £64
- Food: £105
- Rent: £365
- Other: £24
- Drugs: £23
- Mobile Phone: £23
- Bills: £58
- Social: £6

HOW DO STUDENTS FEEL ABOUT STUDENT LOANS?

- 50% worry about repaying a student loan
- 55% don’t understand loan repayment conditions
- 80% worry about life after university

HOW MUCH DO STUDENTS HAVE IN SAVINGS?

- £350 on average
- £1,000 - £2,500
- £500 - £1,000
- £100 - £500
- £100 - £500
- £5 - £100
- NOTHING

INTERESTING WAYS STUDENTS MAKE EXTRA DOSH

- Selling used soap online
- I once had to pretend I was dating a girl, and her dad paid me for it
- Selling plums grown in my garden
- I’ve taken trolleys back to Sainsbury’s so I can have the pound in them
- Webcam girl during college
- Butler in the buff

Sources: Student Money Survey 2014, www.savethestudent.org **For more details see www.savethestudent.org**

OVERDRAFT: 12%
CREDIT CARD: 9%
FRIENDS: 4%
GRANTS: 11%
INTERNET: 18%
PARENTS: 16%
PART-TIME JOB: 10%
PAYDAY LOAN: 1%
SAVINGS: 1%
YOUR BODY: 1%
OTHER: 1%
Higher wages. But the effects are not large: a deduced from the changes in the travel times reductions in road travel times as a result of new whether places that experienced potential employment is the observed wage increases in firms already operating in the area shed workers. £1 billion of road improvements could create a similar size to the effects on employment: a 3-4 per cent rise in plants and employment. Our back-of-the-envelope calculations suggest that a 2.5-3 per cent. an increase in labour productivity and average with improvements in productivity (output per average and painful process of administration.

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PROFESSOR STEVE GIBBONS

Research by the Spatial Economics

are frequently proposed as a strategy for growth, generating 'agglomeration economies' and improving access to markets, fostering cutting the costs of moving goods and people, transport system bring a number of benefits: to any subsequent evaluation to work out road-building projects have rarely been subject likely environmental impact. But, surprisingly, gains exceed the costs of construction and the potential impacts of transport improvements are routinely subject to investment appraisal, to improved economic performance? Proposed BRITAIN'S ROAD-BUILDING OPINION |

DO NEW ROADS CREATE NEW JOBS?

road to economic recovery? Overall, the economic government to conduct an independent review of the high street with The Portas Review, recently highlighted five key areas of dissatisfaction from shoppers and their requirements for greater levels of satisfaction from the high street:

1 Free parking (60%)
2 Choice of stores (59%)
3 Independent stores (57%)
4 Specialist shops eg, butcher (50%)
5 Parking spaces (48%)

While hoping to see fewer:
1 Charity shops (31%)
2 Betting shops (52%)

HOPE STREET

It’s not all doom and gloom on the high street. Entrepreneurial hotspots are lighting up the UK to offer promise of growth. And if businesses adapt to public needs, a brighter future awaits...

526,446 businesses were registered with Companies House as of January 2014, compared to 484,224 recorded in 2012 and 440,600 in 2011.

136,939 No surprise that in Greater London 135,000+ businesses were registered, but Birmingham and Manchester are also areas to head for if you’re a would-be entrepreneur.

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