A Vision of Prosperity

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The future is not a blank slate, and aspiration should be constrained by what it is possible to achieve. A competitive market economy, and a strong regulatory state will both persist. Technological change will continue to drive 'creative destruction'. Markets respond flexibly to incremental change, and competition drives the quest for solutions. Government also responds, by helping to contain risk. The probabilities of some risks (parenting, illness, old age) are known in the aggregate, but their timing is uncertain for the individual. Pooling them is efficient. Other risks affect everybody at the same time, e.g. economic disruption or war. It is possible to discern emerging outlines of large shocks that could stretch both markets and governance: oil depletion, climate change, ageing, immigration, globalization. Small perturbations could mutate into disaster: a health epidemic, financial collapse, some runaway technology, or violent outrage. Things could also turn out much better than expected, but that is no cause for concern. It is too early to be sure whether business as usual or crisis mode is the more relevant prognosis. The precautionary principle suggests more attention to the latter.

Whether continuity or crisis, for the UK the thrust of desirable policy strikes me as being largely the same. For those above the median, it suggests a moderation of consumption aspirations. Material abundance is not an end in itself: what we seek is well-being. In current public doctrines, well-being is defined in terms of the self-regarding individual. The ideal is self-actualization. This is problematic. It is also quite novel. The Western ethical tradition ranked obligation to others before personal entitlement. The utilitarian outlook of the recent past also took as its object the well-being of all. But in recent decades self-regard has been buffed up with scientific gloss as the motivational theory of 'rational choice', which asserts that people are driven, and ought to be driven, by nothing but their own gratification. As Hume expressed it (sarcastically I hope), 'It is not contrary to reason to prefer the destruction of the whole world to the scratching of my little finger'.

On this view, well-being is self-defined, and is identified through the lens of market choice. This implies consumer sovereignty, maximizing profit, and economic growth as the overriding objectives. This doctrine of self-regard is in accord with many people's intuitions, but is often out of line with reality. It can give rise to inconsistency, inefficiency, policy failure and disappointment. As Franklin Delano Roosevelt said, 'We have always known that heedless self-interest was bad morals; we know now that it is bad economics.'

The concept of rational choice imposes two requirements: 'consistency' requires a stable ranking of preferences. 'Completeness' requires that all options should be known. Neither is realistic. Psychological research reveals the self-regarding individual as having a craving for immediate arousal, and concern for long-run security. Inconsistency between these two horizons undermines rational choice. Tea or coffee? Immediate choice is trivial. Marry or walk away? The implications are uncertain. In technical terms, consistency requires that the present value of future payoffs should be discounted at a constant rate throughout, i.e. at 5% for every unit of delay. If we care more strongly about getting something now than about getting it later, then consistency is violated.

In his poem 'A Feaver' John Donne says to the woman, his lover,

> I had rather owner bee
> Of thee one houre, than all else ever

What makes his avowal credible is that a current passion can override our permanent interests. We have no objective method of choosing between 'one houre' of passion, and 'all else ever'. This is the problem of 'time-inconsistency'. Choice over time is also hard for other reasons. There seems to be an intrinsic myopic bias for immediate payoffs. 'Now has emotional power, and delay does not'.[1] The future is more inscrutable further out. Circumstances change. The calculating brain can be overridden by its emotional parts. Time-inconsistency is pervasive.[2]

The implications are radical: no algorithm or expert can work out the optimal choice. But choices still have to be made. It is difficult to make a sacrifice now for the sake of something better later. Call this the commitment problem. Take a degree or apply for a job? Stay up late, or get up early? Pay a dividend or build reserves? Go to war or keep the peace? When calculation is intractable, people fall back on ready-made solutions evolved by society: I call them 'commitment devices'. Conventions, norms, and institutions provide guidance in recurring situations. There are personal strategies of self-control, like willpower and personal rules ('no eating between meals'). Social commitment devices are more extensive, and rely on third-party monitoring. Numbers and time provide commitment devices. A weekly rest day controls the compulsion to work. Commitment devices evolve, develop, and decline. Paper money is efficient, but is tempting to print. The Victorian gold standard provided a commitment device. Private insurance and taxation mandatory prudential payments. Statutory law restricts choice. Constitutions bind legislators. As Edmund Burke said, 'The great use of Government is as a restraint'.[3] Commitment forms the fabric of civilization.

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1 David Laibson.

2 A. Offer, *The Challenge of Affluence* (2006), chs. 3-4. A valuable resource is Loewenstein, Read and Baumeister, *Time and Decision* (2003).

3 E. Burke, *On Scarcity* (1795).

Personality, class, family, culture, ideology, policy, national character all define priorities and obligations at different ranges of time. For the individual, society helps to achieve self-control. For society, the failure to commit is a nuisance. Defection does not only harm the defector, but also those who might have gained from his cooperation. The criminal, the truant, the latecomer impose costs ('externalities') on others. By analogy, a harmful myopic preference can be seen as 'internality', an inconsistency (e.g. addiction) which consumers inflict on themselves. People vary in their capacity for commitment, and also in their access to its tools. Those who have more education and more wealth, find self-control easier, and also more worthwhile.

Time-inconsistency means that what people end up choosing cannot be taken as a reliable measure of their welfare. Choice is fallible. There two other reasons. First, habituation—rewards provide diminishing satisfaction, and a rising dose is needed to maintain it. This 'hedonic treadmill' may be why surveys fail to detect rising satisfaction as income per head increases in affluent societies. Second, relativities—if everyone is improving equally, no one gets ahead. 'When everybody is somebody, then nobody is anybody.'[4] Losing status is more painful than gaining it is pleasurable, so economic growth with rising inequality can generate more pain than pleasure. Competition is compelling, and imparts a warm glow to the winner, but can be inimical to others.

Well-being is poorly measured by the metrics of economic activity. All experiences are ultimately in the mind. One notion of well-being is that of a comfortable bodily and mental state. Balance is the key: homeostasis, equilibrium, set-points. This means that the flow of inputs should match our capacity to absorb them. True prosperity is a good balance between short-term arousal, and long-term security.[5] One writer calls it 'flow', another calls it 'pacing'.[6] In economics, consumers are assumed to be insatiable. In reality, the flow of new rewards can swamp the capacity to enjoy them. The challenge is not to maximize consumption, but to pace it back to the level of optimal satisfaction. That means making space for a little slack. It means preferring quality (scarce by definition) over quantity. Creating such collective capacity is partly a task for government. For example, the legacy of high culture, theatre, visual arts, music, inherited from the past, requires constant re-investment, to sustain assets and create new ones, to educate people to appreciate their benefits, and to reproduce them.

Status is gratifying. Employment progressions which permit status to rise by means of periodic targets for authentic achievement are a source of real prosperity. This is one of the benefits of a competitive growing economy, in which most people rise gradually relative to the bottom.[7] The educational progression up the grades and degrees is a commitment device, which also delivers incremental credible rewards of status. Symbolic recognition of

[4] W. S. Gilbert, *The Mikado*.

[5] D. E. Berlyne, *Conflict, Arousal, and Curiosity* (New York, 1960); Tibor Scitovsky, *The Joyless Economy: The Psychology of Human Satisfaction*, (rev. edn. New York, 1992).

[6] Mihaly Csikszentmihalyi, *Flow : The Psychology of Happiness* (London, 1992); George Ainslie, *Picoeconomics: The Strategic Interaction of Successive Motivational States within the Person* (Cambridge, 1992).

[7] Offer, *Challenge of Affluence*, ch. 11.

achievement, if granted sparingly, does not need to be validated with large income inequalities. Knighthoods and membership of scientific academies are highly valued, but such incentives can be set (and are used) at other levels of achievement.

The unforced, authentic good opinion of others, their positive 'regard', is one of the highest of benefits.[8] A good way to get it is to endow them with our own. Reciprocal exchange is satisfying over and above the gains from trade. Experiments in diverse cultures have shown that most people are not exclusively self-regarding (although a minority are). 'Strong reciprocity'—a disposition to co-operate, and to punish defection, is pervasive. Goodwill is voluntary: when performance is explicitly incentivised, co-operation is often withdrawn.[9]

Elite institutions in Britain used to rely on reciprocal motivations of this kind: army regiments, inns of court, cathedral closes, Oxbridge colleges, learned societies, professional associations, academic and hospital departments, schools, football clubs, brass bands, pigeon racing. Face-to-face 'villages' provide the 'warm glow' of human interaction, and store up social capital and personal authority (no doubt some backbiting and exclusion as well). Since they tend to define the quality of their own product, one way to keep them honest is to discourage monopoly. The 'New Public Management' of the last two decades attempts to replace reciprocity with competition, setting providers against each other, and against the clients they are meant to serve. It is far from clear that this provides an adequate substitute.

The waters have been muddied by the recent hegemony of rational choice theory, a normative doctrine which makes individual desire the sole measure of value. Even the progressive egalitarian John Rawls justifies his ethical model entirely in terms of maximizing personal advantage. The 'self-sufficiency' of the rational actor (and its associated 'American Dream') has its admirers among British politicians. This 'dream' can be defined as sufficient wealth to allow complete freedom of any social dependency or obligation. In an unequal society, such aspiration is delusive, since wealth of this magnitude is relative, and only a few can have it. The costs of a good education are large, the costs of illness, job loss, or divorce potentially heavy. Hence the urgency with which Americans pursue this dream. Only wealth can guarantee economic security, health care, education and housing. But the 'dream' signifies an ability to exact servitude without reciprocating it. Only a minority can ever attain such coercive dominance.

Without some reciprocal provision of welfare services, there is no security for all, and the role of the many is to service the few. This is also why American primacy in income and wealth does not buy a good position in the indices of life expectancy, health, trust, economic security, and happiness. As a bonus, the fantasy of self-sufficiency also serves to legitimize American plutocracy. The notion of 'freedom' as a personal ideal, which ranks so high in American discourse, has its distant origins in revulsion from European tyrannies. Autonomy, the freedom

8 Avner Offer, 'Between the Gift and the Market: The Economy of Regard', *Economic History Review*, 50, 3 (1997).
9 Herbert Gintis et al. (eds.), *Moral Sentiments and Material Interests : The Foundations of Cooperation in Economic Life* (Cambridge, Mass. 2004), esp. chs. 1-2.

from excessive control in the workplace in particular, is a source of emotional and physical well-being, and the most powerful of aspirations.[10] The urge to replace the shackles of authority and circumstance with total 'freedom' is understandable but naïve. No man is an island. Total solitude is intolerable. So autonomy is tempered with obligation, even though obligation restricts autonomy. Rabbi Hillel said, 'if I am not for myself, who will be?—and I by myself, what am I?' In fact, the American rhetoric of freedom is empty. Americans accept the legitimacy of subordination in the workplace, where it matters most, and restrict 'freedom' to the political sphere, where access is controlled by wealth.

Measured in dollars, less than half of our welfare comes from the market. Home production is unwaged: keeping house and raising of children is delivered by non-market exchange (the shadow cost is about a quarter of GDP). Leisure is a sacrifice of income. Voters have chosen democratically to obtain a growing share of welfare outside the market. In affluent countries between a third and one half of output is allocated by government or non-profits. Since 1900 public-sector allocation in the economy has grown about fourfold. It peaked in the 1970s, but has not declined since then.

A reciprocal conception of well-being remains individualistic: we seek the well-being of others, in order to achieve our own. Psychological and emotional well-being (which alone matters in affluent societies) relies on the economic division of labour. Not only on markets, but on the good faith and reciprocity that are necessary for markets to work. This resource underpins our expectations of civility and security. It is currently acknowledged in the concept of 'social capital', but the term excludes the most important of commitment resources, the social-democratic state.

Prosperity is defined by how it is measured. Sustaining economic growth has been used by Gordon Brown as a measure of his success as Chancellor. This is to confuse the speed on the dial with the well-being of the passenger. 'Economic growth' is an artifact of the way we measure the economy, the product of a form of book-keeping called 'national accounts' which in its modern form is of fairly recent origin. It has immense practical use in government, business, and research, of being able to monitor economic activity precisely on a regular basis. It was not designed to measure well-being, which is the real end of economic activity.

The focus on growth as a target provides a cognitive economy for policy makers. It makes a good polemical point. But what if well-being is more complicated to achieve? In that case, policy makers are economizing their cognitive effort, but externalizing larger costs on to the public: another example of myopic choice. For example, the policy focus on finance as the economy's leading sector has sustained economic growth, but has piled up unmeasured costs in rising inequality, housing strain, transport congestion, de-industrialization, and rising debt

[10] Michael G. Marmot, *Status Syndrome: How Your Social Standing Directly Affects Your Health and Life Expectancy* (London, 2004); Peter Warr, 'Well-Being and the Workplace', in D. Kahneman, et al. (eds.), *Well-Being: The Foundations of Hedonic Psychology* (New York, 1999). That is also the proper interpretation of the findings from the World Values Survey reported in Paolo Verme, 'Happiness & Freedom', unpublished paper University of Torino, 2007.

and insecurity. It may still be a desirable trade-off— but nobody counts. Nor is it even sound economics. Inequality generates excess financial liquidity, which has driven up house prices and consumer lending. To secure housing, cars, and holidays, borrowers pile up debts they may not be able to service, and if the revenue flows falter, finance will falter too.

The inadequate coverage of modern national accounting was understood by its founder, Simon Kuznets, more clearly than by his successors. In 1933 (and later), he warned about using economic growth as a measure of the state of the human condition.[11] Some of the massive omissions from national income have been taken up in a sequence of extended and alternative accounts: the value of leisure, of unpaid housekeeping and childcare, and the counting of bads (prisons, road congestion) as if they were good.[12] But other omissions have not been rectified. Kuznets pointed out an inconsistency in national accounting: investment in material capital is measured, and its amortization is estimated. Depletion of natural resources is not. Building up the capacity of the human mind and the stock of human capital, and the atrophy and maintenance costs of human capabilities, are left out, though physical capital is measured carefully, both gross and net. Since Kuzents's time we have learned that the main source of growth is not fixed capital, but human ability. This is created and nurtured unpaid within the household. The product of social effort is impoverished by restricting it to the choice on the market stall.

Adam Smith's 'invisible hand' is supposed to convert selfish private choice into the common good. In current economics, this good is minimal, namely Pareto optimality (no economic slack: you cannot benefit one person without harming another). But (except in the austerely abstract Arrow-Debreu general equilibrium) the theorem of the invisible hand remains unproven, despite more than two centuries of trying. This is almost a falsification.[13] An earlier Arrow result, his impossibility theorem, suggests that the invisible hand is unavailable. Prisoner's dilemma shows how rational choice can fail to deliver the social good. Advocates of markets claim that they economize on information, but rational choice actually requires impossible resources of foresight, calculation and analysis. In practice, such requirements are waived even by proponents of the doctrine. [14] Markets deliver reliably. But they are not failsafe, universal social coordination devices. The case for markets is a pragmatic policy one, and that is how it is often actually treated. To worship markets is a mystification.

The individualism of Ayn Rand, of 'what I have, I hold', is contrary to many people's ethical intuitions, and is inconsistent with their demonstrated willingness (in experiments) to make a sacrifice for the benefit of others. Decisiveness is an attractive quality, and it is only a short step to admire the rough virtues of manliness. In American culture in particular, 'toughness' is

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[11] Simon Kuznets, 'National Income', in Edwin Seligman and Alvin Johnson (eds.), *Encyclopaedia of the Social Sciences*, vol. 11(1933).

[12] E.g. T. Jackson et al., *Sustainable Economic Welfare in the UK, 1950-1996* (London, 1997).

[13] See e.g. Kenneth Arrow, 'Economic Theory and the Hypothesis of Rationality', *New Palgrave Dictionary of Economics* (London, 1987).

[14] See e.g. Kenneth Arrow, 'Economic Theory and the Hypothesis of Rationality', *New Palgrave Dictionary of Economics* (London, 1987).

regarded as a virtue (in British culture, it is not the control of others that is traditionally admired, but control of the self). Toughness is admirable when it signifies the ability to *endure* pain. In the policy language of the last two decades, toughness has been transmuted into the willingness to *inflict* pain. In contrast, Adam Smith approved of self-interest, but also appreciated social obligation and reciprocal regard. This was the role of 'the impartial spectator', the inner voice that upholds the norms of decent society. #

When a government agency deliberates well-being, the purpose is to find out how government can promote it. It is first necessary to clear the ground by asking what government is for. The theory of public goods regards its main task as correcting market failure. Markets are seen as the norm. Its critics say that government failure is as pervasive as that of markets. UK technocrats have largely embraced this notion, which is really rooted more in the ingrained individualism of American culture, than in robust analysis. It is true in some sectors but not in others. In the United States, private medicine is in a mess, the airports and airways are clogged. In Britain the privatized railways and airports are likewise unreliable, and privatization has had a mixed record, with modest successes offset by large failures.[15]

The welfare state in America continues to expand, most recently with prescription drug entitlements, and an entitlement to health insurance in the offing. In development policy, the 'Washington Consensus' has suffered setbacks in Eastern Europe, Africa, and Latin America, while the great development successes (Japan, Korea, Taiwan, China, India) disregarded many of its free-market principles. The ideological attack on government since the 1970s, and the persistence of pro-market parties in government has not been able to roll back the state, although it holds it at bay.

From the aspect of time-inconsistency, the role of government is to act as a commitment agent for society. This role endures in a hostile climate because government performs it more efficiently than markets. Affluent consumers face difficult commitment problems, and turn, as voters, to government for help. The welfare state is not primarily about re-distribution or redressing indigence. Controlling the future by means of a private contract is uncertain and costly. Uncertainty grows exponentially. Government is the solution that society has evolved. In most countries, it provides education, health, and the foundations of social insurance, as well as physical network infrastructures. Forms of private provision that operate tolerably well, like mortgages, life insurance and private pensions, and energy and water infrastructures, increasingly depend on government regulation to resolve inherent conflicts of interests between provider and public.

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15 Massimo Florio, *The Great Divestiture : Evaluating the Welfare Impact of the British Privatizations, 1979-1997* (Cambridge, Mass, 2004).; Christian Wolmar, *Broken Rails : How Privatisation Wrecked Britain's Railways*, 2nd, rev. edn. (London, 2001), David M. G.Newbery, *Privatization, Restructuring, and Regulation of Network Utilities* (Cambridge, MA, 2000).

Provision suggests a hoarding metaphor, in which assets are accumulated for later use. For a house or a factory this metaphor is apt. But the problem is often not to lock in the future, but to honour entitlements inherited from the past. It is how to transfer resources from those who have them to those who need them. Private savers for old age build up contractual entitlements, which they cash in when they retire. But these entitlements still require workers to hand over current output, on terms which the original contract could not anticipate or control. In private contracts, management fees can eat up twenty to forty percent of the sums contributed. A stock of financial assets needs costly management. It is subject to currency and inflation risks, the risks of fraud, default and contract ambiguity, and the systemic risk of unanticipated circumstances.

Pay-as-you-go finance does not require a long-term contract. Current taxpayers pay current beneficiaries. The terms represent a self-regulating equilibrium: a political bargain, reflecting the current social and political leverage of recipients, of old people, students, the sick, single parents and the unemployed on the one hand, and of workers on the other. These communities are fluid and overlapping. Most people will be recipients one day. This forms the basis of mutual obligation, which depends on the enduring norms and institutions of inclusive national communities. The pay-as-you go bargain may be more or less generous to one side, but it is not as brittle as private contracts. Because there is no contract to monitor or assets to manage, it is cheaper. That is why I think there is no reason to be alarmed about open-ended obligations which are supposed to threaten European or American public pension systems. Unaffordable obligations will not be paid— they will be re-negotiated. Revisions actually take place from time to time. Pay-as-you-go is democratic, realistic, efficient, and does not require long bets on inscrutable futures.

It is a commitment technology that works. If it withers, the alternatives are potentially worse. In the same vein, fixed capital infrastructure only pays off over the long term, and is difficult for markets to provide. Education, the formation of human capital, is almost impossible to provide for profit. The exception proves the rule: education for profit is only undertaken in poor countries which have not yet managed to construct reliable states, and then only at the primary level. Healthcare for profit in the United States is s costly social failure.

In my own vision of prosperity, the market competes to divine our wants. Firms can charge a premium for novelty, and will keep up its flow. So maximizing innovation is not a top policy priority. Under 'business as usual', the challenge of prosperity is not to privilege the market further, but for individuals to cope with its abundance, and for governments to look after long-term needs. The challenge for government is how to combine competition with restraint. Nordic countries achieve material prosperity, social equity, and prudence. Despite high taxation and regulation, they rank among the highest in economic performance. The rhetoric of market reform is resisted in continental Europe, with some cost in employment. In contrast, Britain has prioritized growth: that means rising inequality, deteriorating environments, insecure and low-paid jobs, unaffordable housing, more costly health, education and infrastructure, and outbreaks of alienation: alcohol and gambling, out-of-wedlock births, low educational attainment, obesity. The payoffs are disproportionately at the top. Rising life expectation is often credited to rising economic growth, but the richest country, the USA, ranks low among rich nations in life expectation, and several countries have matched it on as little as one-fifth of the income.

Let us aim for what is genuinely possible. Government needs to understand its primary role as a commitment agent, as the trustee of those dimensions of prosperity which pay off over long periods of time. If circumstances allow for 'business as usual', then government should strive not merely to maximize short-term growth, but to make sure that prosperity is sustainable, that it does not privilege money because it is easy to count. These are difficult tasks, because they require governments to restrict consumer discretion. Voters, like consumers, tend to be myopic, and politicians are prone to myopia themselves, as individuals and as policy makers. If however things take a serious turn for the worse – oil depletion, climate change, financial collapse, then does politics have the capacity to anticipate and to cope? The main task will be similar: to inhibit current consumption in favour of adaptation and mitigation. When people are reasonable, then long-term interests count. The problem is co-ordination: each person alone cannot affect social outcomes, so the rational thing is to ignore them. But cooperation is often achieved. Debating the issues is a way to co-ordinate and mobilize the support that such policies require.

Enough of generalities. Prosperity depends on resolving conflicts between immediate growth and long-term commitment. In several policy domains the doctrines of maximizing growth and of prudence imply different priorities.

- Pensions. The challenge here is to sacrifice some level of competitiveness for employers, and some current individual consumption, in order to provide for a longer old age.

- Education. Human capital is the most important determinant of economic competitiveness, and justifies resource allocation in those terms alone. But education also inculcates the capacity for prudence, and the skills to enjoy it. It underpins stable personal lives and a higher quality of cognitive and cultural consumption.

- Health. The rising cost of addiction and obesity highlights the risks of self-indulgence. Experience with smoking suggests that it can be overcome.

- Robust pay as you go. PFI is an expression of faith in the superiority of private management, and also in the ability to control the future by means of contracts. Neither of these is self-evident from first principles, and recent experience is not always good. It is easy enough to lose the virtues on which public services depend, by displacing them with private incentives.

- Gambling, drink, drugs. Each of these presents a choice between a short-term gratification and potential long-term damage. The concept of consumer sovereignty clashes explicitly with that of self-control.

- Parenting, especially motherhood, is critical to the capacity for a good life. In affluent societies, it is not rewarded by the market. Public policy can do a more to make it attractive and effective. For example, getting single mothers out to work may restrict their capacity to parent. High housing costs force parents to work for longer, at the expense of parenting.

- Youth: Challenging post-school activity can compete with alcohol and pubs. Opportunities to cultivate self-control can offset the pressures of consumerism. e.g. musical training as against musical consumption; outdoor recreation versus air travel.

- Urban layout and planning. The market return of land use is in conflict with the intangible benefits of open space. Hence the current neglect of public parks and the challenge to Green Belts.

- Markets are not omniscient: their vision is bounded by the myopia of high discount rates. In the face of oil and other resource depletion, market response is likely to be sudden and harsh, though this will stimulate the quest for substitutes. For the environment more generally, and particularly for climate change, individual rationality drives a 'race to the bottom' and 'the tragedy of the commons'. The private interest is to anticipate restrictions by means of immediate indulgence, in conflict with social objectives of a sustainable habitat. Market simulations (e.g. carbon trading) can be used as instruments of policy, but environmental challenges pose social co-ordination problems that markets by themselves are poorly fitted to solve.

Future prosperity depends on the performance of competitive markets. It also requires social commitment (both voluntary and state-led) to achieve quality of life and long-term security. Not to privilege commodities and market services because they are easier to count, or because they have powerful self-interested advocates. Not to privilege the present over the future—because the future is certain to become the present.