THE ABC OF ECONOMIC LITERACY

THE NEW ZEALAND INITIATIVE

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THE NEW ZEALAND INITIATIVE

The New Zealand Initiative is an independent public policy think tank supported by chief executives of major New Zealand businesses. We believe in evidence-based policy and are committed to developing policies that work for all New Zealanders.

Our mission is to help build a better, stronger New Zealand. We are taking the initiative to promote a prosperous, free and fair society with a competitive, open and dynamic economy. We develop and contribute bold ideas that will have a profound, positive, long-term impact.

FOREWORD

In early 2014, there were strong hints in the media that the next general election was likely to take place in September and so the team of The New Zealand Initiative was looking forward (well, sort of) to a very long, dragged out election campaign.

Contrary to what most people would think, election campaigns are not the best time for public policy think tanks. They are the times when open, constructive debates about policy issues become almost impossible as parties screen any ideas or proposals not on their merits but whether they fit into their manifestos.

How could we still be heard when the rest of the country was in campaign mode, my colleagues wondered.

Well, we decided to counter the political noise of the upcoming election campaign with our own campaign: The Campaign for Economic Literacy.

Every week, loosely coinciding with the real election campaign, we ran the readers of our *Insights* newsletter through the A to Z of economic literacy. And we did so quite literally, writing about issues from A (Adam Smith) to Z (Zero-Sum Game).

We discovered a few things in the process. Compressing fundamental economic concepts into bite-sized, 400-word pieces for an educated lay audience was at times a tricky exercise. There is no way one could do justice to the economic literature on, say, competition in such a small nutshell. However, that was not our real intention anyway. Rather, we wanted to introduce non-economists to some key economic ideas in an accessible way. If that triggered their interest, there is certainly no shortage of literature to satisfy their demand for further information.

The other thing we discovered was that there is no equality in the distribution of economic ideas across the alphabet. While some letters had multiple contenders to be covered in our A to Z of economic literacy, other letters would have almost lost out. M was perhaps one of the hardest letters to allocate as it could have stood for Marginalism, Markets, Marx, Money, Microeconomics, Mercantilism, Minimum Wages or Monopoly. In the end, we picked neither of those but went with Monetary Policy.

We tried to achieve a balance between different topics by making sure that the core ideas left out in some letters were covered in other places. Which still did not solve our final problem: There are no economics terms starting with X – other than X-efficiency, which we initially decided to cover more out of necessity than with enthusiasm. However, the author of that piece made sure that it still became an interesting piece.

Speaking of the authors, these pieces were shared among our team and written by different authors. If you are a regular reader of Insights, you will probably be able to guess who wrote what.

Finally, this compilation was edited by Mangai Pitchai and Eric Crampton. I thank them and the team for the job they have done in showing that even election times can produce good ideas.

Dr Oliver Hartwich
Executive Director, The New Zealand Initiative

A ADAM SMITH

Few economists are more famous than the Scotsman commonly regarded as the founder of economics, Adam Smith (1723–90). On the one hand, this is understandable and much deserved: Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776) is the book that established economics as an academic discipline. *The Wealth of Nations* also contains many important insights into economic logic.

On the other hand, it is also a little bit odd for two reasons. Before Smith appeared, there had already been centuries of economic discussions. Smith probably would not even have called himself an economist but a moral philosopher.

Smith did not start his intellectual life as an economist. To his contemporaries, he would have been better known as the author of *The Theory of Moral Sentiments* (1759). In this earlier work, Smith explained how society is held together by people caring for their neighbours. His vision was one shaped by virtues, conscience, moral rules, altruism and law.

The Wealth of Nations is the other side of the same coin in Smith's thinking. Here he showed how self-interested behaviour fits into his moral philosophy. It fitted surprisingly well.

Smith's critical insight was that competition harnesses self-interest for the greater good of society. "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own self-interest". It is as if 'an invisible hand' led people to do not just what is good for them but for their neighbours as well.

Smith's second-most important contribution to economics was understanding the division of labour. By observing how much more efficient a pin factory becomes if workers specialise in different tasks, Smith concluded that it is such specialisation which makes us more productive. This is true not only for companies but also for countries – which is why Smith was an advocate of free trade.

Few ideas presented in *The Wealth of Nations* were genuinely new but it was Smith who collected the economic wisdom of his time, gave it a new framework, and firmly established economics as a social science.

Two hundred and thirty eight years after *The Wealth of Nations*, Smith's timeless ideas are still relevant and inspirational – both for policymakers and for economists. Smith remains the best teacher for anyone aspiring to understand how altruism and self-interest belong together in society.

BANKING (CENTRAL)

It is a wonderful convenience to be able to buy almost anything we want, offering nothing in exchange but flimsy cash or an electronic claim on our bank. We experience this convenience every time we go to the supermarket and pay by cash, ATM, or credit card.

The entire system depends on the seller's confidence that the means of payment on offer is of real value. Counterfeit cash or fraudulent ATM or credit card transactions potentially undermine every honest person's ability to transact.

For most of human history, confidence has been greatest in coins made of gold and silver. Ancient rulers who secretly debased their coins cheated their people and eroded that confidence.

Today, we transact in a world of monopoly government paper money, backed only by trust in government. Today's governments can cheat their people by creating unanticipated inflation through issuing too much paper money.

The diversity of interest rates paid on borrowings by banks and governments illustrate how confidence varies in the value of each issuer's promise to pay future interest and principal. Higher interest rates mean higher risk.

The modern government-controlled central bank is banker to the major commercial banks. It accepts their deposits (which count as banking system reserves), and may lend them money or buy some of their assets when they need more cash. The perceived soundness of a commercial bank depends in part on its perceived central bank support.

The soundness of a commercial bank also depends on the quality of its loans, the degree to which it matches deposit and lending risks, the level and quality of its reserves, and the financial strength of its major shareholders.

In contrast, the soundness of a central bank is dominated by the government's ability to inject more taxpayer money into it when needed.

Governments may oblige central banks to lend unwisely, perhaps by forcing them to fund government deficits, or perhaps to support institutions that have made bad loans in a politically 'worthy' cause, such as housing loans to uncreditworthy borrowers.

Such situations can easily induce booms and crashes, banking crises, and prolonged unemployment.

These roles and pressures place heavy responsibilities on central bankers. They stand at the apex of the confidence pyramid and play a pivotal role, for better or for worse, during any general banking crisis.

Central banking has mystique but no magic wand. It cannot insulate the public from the consequences of collective fiscal and financial follies.

C COMPETITION

To understand competition, you should visit a tropical rainforest. To most visitors, rainforests with their impressive fauna and flora may look like places of abundance. The truth is quite different: The quality of the soil is often poor, and hardly any sunlight reaches the ground – scarcely the best conditions for opulent vegetation.

The reason rainforests are nevertheless impressive ecosystems is the competition they promote. The trees only grow so tall because they are competing for precious sunshine. Thousands of highly specialised plants, birds and insects compete for nutrients. The result is a thriving place of biodiversity.

In many ways, markets are like rainforests. Markets bring together scarce resources and virtually unlimited wants. It is through competition between these different wants, and competition between different ways of satisfying them, that markets create prosperity out of scarcity.

In economic thinking, competition has two main functions. First, it spurs companies to try harder and be better than their rivals. They do so, of course, to make a bigger profit. As a most welcome by-product for society, products get better, new ones get invented, and prices fall – thanks to competition for customers' business.

The second function of competition is its disciplining effect. In a competitive world, you can never be too sure of your position. If a rival has a better idea or a better product, your days as a market leader are numbered. Competition is the best antidote to complacency, arrogance and laziness.

Competition is always both a discovery procedure and a tool of disempowerment. Both these functions are crucial for a market economy – but not only there.

Competition is equally desirable in many other places. Where cities compete for residents and their taxes, people will get better public services. Where teachers compete for promotion based on performance, their students will get a better education.

Unfortunately, many economists have trouble distinguishing between the results of competition and competition itself. However, the distinction should be quite easy: Competition is always the rivalrous behaviour of competitors, not the number of competitors nor the prices they charge.

To promote competition, the most important thing regulators can do is to let it evolve. Competition does not need encouragement, nor does it need to be mandated. It is what happens naturally when scarce resources meet unlimited demands.

Rainforests do not need gardeners, either.

DEBT

D

In Shakespeare's *Hamlet*, Polonius' sage advice to his son about friendship was:

Neither a borrower nor a lender be
For loan oft loses both itself and friend

In contrast, borrowing and lending between complete strangers makes the world a better place.

People can deposit savings in institutions that on-lend the funds to people who need to borrow to buy a house or expand their business. Globally, banks and other such intermediaries shift savings from countries that have a surplus of savings over investment opportunities, such as China in recent decades, to deficit countries.

Under such a system, people with surpluses are better off than if their opportunities to invest were narrower, and people with deficits are better off than if their opportunities to borrow were fewer.

These transfers of savings may take the form of debt or equity. This article is about debt.

Unlike equity, debt involves no ownership control of the borrower's enterprise. Instead, the borrower typically agrees to pay the lender interest and principal according to a pre-determined schedule, as for term deposits or payments on government bonds.

The lender is risking that the borrower will default, and needs to take care as a result. Higher interest rates can compensate for greater risk, but not if the borrower defaults.

Conversely, borrowers who borrow too much can inflict severe future distress on themselves and their associates.

Borrowers have less incentive to be prudent when they are merely the agent of the person who is really liable. For example, when large companies or governments borrow, they are putting their shareholders and taxpayers at risk rather than the managers, politicians, or officials signing the borrowing contracts.

Unless such agents are well controlled, they may borrow imprudently.

Similarly, lenders have less incentive to be prudent when they are merely someone's agent, or when someone else, such as the government, is assuming the risk. Government-backed lenders Fannie Mae and Freddie Mac were major underwriters of the recent US housing bubble.

Misplaced confidence in financial soundness is a dangerous thing, particularly for taxpayers. Unsurprisingly, research has found evidence that government guarantees for bank deposits increase the risk of bank failure.

Peace-time debt crises of national significance commonly reflect government mismanagement of fiscal, exchange rate, monetary, industry and/or prudential policies. But they can also have climatic and international causes. The costs in unemployment and lost output can be serious indeed.

E ENTREPRENEUR

As George W. Bush allegedly once said, "The problem with the French is that they don't have a word for entrepreneur". That may not be entirely correct as the French may be short of business sense but certainly not of words. What is clear though is that most people have no idea what entrepreneurship really means.

So let's take the word 'entrepreneur' and dissect it a little. It was actually coined by (*quelle surprise!*) a Frenchman (of Irish origin): Richard Cantillon (1680–1734). Quite literally, 'entrepreneur' means 'undertaker' and this is how it translates into many other languages (e.g. 'unternehmer' in German or 'imprenditore' in Italian).

Unfortunately, the connotation with funerals and gravediggers prevented a similar English translation. It might have helped elucidate what entrepreneurs do because, well, they undertake things.

Undertaking itself is a word with many potential meanings. It is about committing oneself to a task, taking charge, and obligating oneself to a project, often while bearing risks. In a nutshell, this is how most economists would describe entrepreneurs.

There are two definitions of entrepreneurship often found in economics textbooks. One focuses on the risk aspect inherent in entrepreneurial activity. While employees do not bear any residual risk for the company they work for, entrepreneurs stand to lose some or all of their investment if things go wrong. Seen from this angle, an entrepreneur is the bearer of insecurity relating to his income. Therefore, a small shareholder is an entrepreneur while a highly paid employee like a CEO is not.

The second way of looking at entrepreneurs focuses not so much on their responsibilities but on their activities. For Austrian economist Joseph Schumpeter, entrepreneurs are people who are always on the lookout for new and better ways of doing things: inventing new products, conquering new markets, and finding more efficient production methods. In this way, their actions promote a process of 'creative destruction'.

US economist Israel M. Kirzner, meanwhile, emphasises that an entrepreneur's core function is spotting hitherto unexploited opportunities. In a way, this is also what Schumpeter's entrepreneur does but Kirzner takes it a step further: We all behave as entrepreneurs in this sense, even in our roles as consumers.

So the next time you are looking for a better bargain or a new job, you may feel a little like Gordon Gekko, Citizen Kane or Mr Burns: We are all entrepreneurs now ... even the French.

FREEDOM F

Trying to explain economic freedom to someone living in an economically free country is like trying to explain to a fish what water is. Like a fish in water, when we are free we rarely stop to consider what freedom is, why it is important to our livelihood, and what would happen if it was ever taken away.

Fortunately, New Zealand consistently ranks near the top of international indices measuring economic freedom. But this also means that we might take it too much for granted.

In its broadest sense, economic freedom is the ability for individuals to autonomously arrange their economic affairs and pursue greater prosperity. More specifically, it is the ability to exercise personal choice, participate in voluntary exchange, compete in markets, and enjoy the use of one's property.

The choice to start a new business in any given field is an example of economic freedom. As is the ability to choose from 10 different brands of bread at the supermarket. The ability to sell your bike on Trade Me at the highest price a buyer is willing to offer is also an example of economic freedom.

There is a role for government to play in economic affairs, but that role is limited. For the most part, it is to provide the legal structure to protect property rights and enforce contracts.

Of course, very few governments stick to those core functions. There are many other tasks that governments have taken on, such as the provision of roads and infrastructure, education and health, to name a few.

But the more the government's role is extended, the more economic freedom is threatened and diminished. The government harms economic freedom through corruption, over-regulation, taxation and restrictions on voluntary exchanges.

While tax policies, subsidies, restrictions on foreign investment, or regulatory reforms by themselves may be undertaken with the best intentions, they all limit economic freedom. This has real material consequences. One only needs to observe the difference between North Korea and South Korea.

According to empirical research, high degrees of economic freedom are positively correlated with greater economic growth, higher average incomes, greater gender equality, higher life expectancy, and less poverty.

The value of economic freedom over crowd-pleasing government policies is only truly appreciated when it is gone. We should never take it for granted. Eternal vigilance is the price of liberty.

G GOVERNMENT

When searching for quotations about government, one thing quickly becomes clear: very few of them are positive. Thomas Jefferson, for example, put it this way: “History, in general, only informs us of what bad government is”. Or take Thomas Paine: “Government, even in its best state, is but a necessary evil; in its worst state, an intolerable one”. And these two quotes are some of the nicer ones you can find.

Maybe government gets a bad rep because governing well is inherently difficult. On the one hand, government by its very nature reduces our freedom and so we are rightly watching its actions with scepticism. On the other hand, expectations on government are enormous and many people want it to solve all the world’s ills.

In political theory, the main justification for having a government is to prevent a “war of all against all” (Thomas Hobbes) and to guarantee peace, freedom and property rights (John Locke). This is the minimalist state, where the government’s role is to provide the basic legal machinery of the state.

Many economists would regard this as the core function of the state. To finance it properly, maybe 5 to 10 per cent of GDP would suffice for these tasks. This was also the size of government in most Western countries until the eve of World War I.

What we have seen since is a rapid expansion of government in which the state often controls almost half of all economic activity. At such levels, government does not guarantee freedom and property anymore. It becomes their greatest threat. This has consequences for economic performance.

An empirical study conducted by the Fraser Institute in Canada found that in advanced economies (such as New Zealand), the greatest factor that has increased the growth of government is the welfare state, or more precisely, the redistributive state.

Rather than performing the core functions of administering law and justice, maintaining defence and public order, and providing public goods, nowadays, government growth is due to transfers between taxpayers, or between taxpayers and non-taxpayers.

Economists are highly sceptical about such transfers because they do not create wealth, they only redistribute it – and in doing so, they destroy incentives to work hard.

Which leads us to another classic quotation on what government is: “Government is the great fiction through which everybody endeavours to live at the expense of everybody else” (Frédéric Bastiat).

HISTORY OF ECONOMIC THOUGHT

H

Studying economics these days, it is quite possible to get a degree without ever coming across the name of a single economist. That is because economics is taught as a set body of knowledge without illuminating its insights by reference to the works, minds and times of the great economists.

This is a pity and it is not really appropriate to a social science. In mathematics, one may well learn the Pythagorean Theorem without knowing anything about the life of Pythagoras. In physics, it is possible to explain how a Faraday Cage works without mentioning Michael Faraday.

But understanding Keynesian economics without any reference to John Maynard Keynes and the historical background of the Great Depression? Making sense of Karl Marx without knowing much about industrialisation? Or figuring out what Milton Friedman's Monetarist Counter-Revolution was all about without knowing anything about Friedman, or in fact, what made it a *counter*-revolution?

Economic ideas do not grow in a vacuum. They are not designed in sterile laboratories, either. Economic thinking develops in the real world by observing real people and their behaviour – and drawing conclusions from it.

The history of economic thought is full of economists who were driven to their most important insights by circumstances. Adam Smith, frustrated by the protectionism around him, developed a theory of the benefits of free trade. Friedrich Hayek analysed how markets oscillate between booms and busts, and attempted an explanation of these swings in his business cycle theory.

Studying economics through the lives of great economists has many benefits.

For a start, with a knowledge of history economists would not be too surprised by current developments. The financial crisis of 2007–08, for example, came as a shock to many economists because such crises did not happen in their textbooks. But they happened in history. As Kenneth Rogoff and Carmen Reinhart's *This Time is Different* showed clearly, financial booms and busts have been a regular occurrence for (at least) eight centuries.

Knowing something about the development of economics can also save you from reinventing the wheel. As Hayek once said, "In economics you can never establish a truth once and for all but have always to convince every generation anew". Economic knowledge easily gets forgotten if one is unaware of its history.

And there is a final reason why economics courses should include some history: Contrary to common prejudice, most famous economists were not dour number-crunchers but quite colourful figures. Studying their stories is not just enlightening – it is fun.

INCENTIVES

Incentives are the little magnets that guide human activity. But that doesn't mean things always go according to plan.

Take the 'cobra effect': an anecdote set in the time of British rule in colonial India. To decrease the number of venomous cobras, the British government offered a financial incentive to the public for every dead cobra.

The problem was that the government underestimated the enterprising and creative nature of the Indians. People started purposely breeding cobras to receive the bounty.

The problem wasn't that the public did not respond to the incentive. It was that they responded too enthusiastically.

Such is the nature of incentive schemes. Those who offer incentives must be aware of what motivates people, where their self-interest lies, and the unintended consequences of trying to direct human behaviour.

Incentives are the reason we wake up in the morning, go to bed at night, and do everything in between.

In their simplest form, incentives are costs or benefits that motivate consumer, business or individual decision-making. In economic terms, incentives are a market mechanism for producing mutually beneficial results.

The most common example of how incentives produce mutually beneficial results is price. Sellers have an incentive to maximise their profits – it is in their self-interest to do so. However, buyers have an incentive to get value for their dollar and to maximise their utility.

Basic trade economics stipulates that the buyer and seller will arrive at a mutually agreeable price when both respond to incentives and pursue self-interest.

Of course, this is only a simplistic account. In the real world, people may continue to buy certain goods even as the price rises exorbitantly. Petrol is one example.

However, incentives are not simply the decision to buy or not to buy. In fact, people can be very creative with their response to incentives. On an individual level, they can also encourage creativity and innovation. The rising price of petrol could provide the incentive to take fewer frivolous trips, drive more sensibly, plan journeys that cover multiple errands, or car pool.

On a business level too, rising prices provide incentives for competitors to enter the market, seek alternative fuel sources, or for current petrol retailers to improve their service or reduce their prices in other areas.

Because of human creativity and innovation, predicting responses to incentives is never easy. As economics professor Glen Whitman argues, "What distinguishes good economic thinking from bad is recognition of the subtle, creative, and often unforeseen ways that people respond to incentives".

JOBS

J

During the last American presidential election, Mitt Romney bragged that he had created around 100,000 jobs. The Obama campaign claimed Romney had actually destroyed jobs. Which statement was true is irrelevant: Both fed into a common mistake in voters' understanding of economics – the belief that government should create jobs.

Jobs in this case refer specifically to job creation as opposed to productive employment and the labour market. Jobs are, and always have been, a critical concern across the globe. Whether young or old, skilled or unskilled, for billions of people jobs are essential for their economic and social development.

It is perhaps not surprising then that job creation is often touted as the main impetus behind myriad government policy initiatives.

However, contrary to such popular opinion, job creation is not – and should not – be the goal of government policy.

This is a critical fallacy, a misunderstanding that government should be responsible for job creation and that job creation should be pursued as primary evidence of 'economic growth'.

In *The Myth of the Rational Voter: Why Democracies Choose Bad Policies,* prominent economist Bryan Caplan identifies the 'rational irrationality' of this 'make-work' bias. There is, indeed, a tendency to underestimate the economic benefits of conserving labour rather than creating more jobs for the sake of more jobs.

In the early 1930s, the Soviet Union proudly declared itself the world's first country to put an end to all unemployment. While the Bolsheviks ardently claimed unemployment was a disgraceful product of capitalism, what they failed to divulge was how they attained their zero-unemployment figure. Everyone was given some job or function, no matter how mundane or unproductive. The Soviet Union may have succeeded in eliminating unemployment, but it came at the cost of reduced efficiency and productivity.

Ironically, the public often believe labour is better used than conserved – that producing more with less labour is a danger rather than progress. This is a very real belief among the majority of non-economists, who interpret efficiency gains as the destruction of jobs, while economists see real growth manifested through the production of more with less.

Government policy should focus primarily on achieving real economic growth by increasing labour productivity. The creation of jobs should not be the overarching goal of fiscal expenditure, but rather a by-product of stimulating economic growth.

Government may not be good at creating good jobs; however, it is certainly capable of destroying them.

But that is an entirely different matter.

K KEYNESIAN ECONOMICS

Keynesian economics owes its name to a problematic economic theory put forward in the late 1930s by Lord John Maynard Keynes, a brilliant but mercurial English economist with a genius for advocacy and rhetoric.

Keynes took so many positions on so many issues during his career that Winston Churchill is said to have observed that if you asked two economists for a view you would get three opinions, two of them from Mr Keynes. More reliably, one of Keynes' eminent contemporaries, Sir Alex Cairncross, once remarked that Keynes would be "longest remembered for his ideas" but who "never said the same thing for long".

Keynesian theory contentiously proposes that slumps and recessions are caused by a slump in total spending in the economy. A recession allegedly occurs because producers respond by reducing output and employment rather than prices and wages. This is because it is hard to reduce money wage rates in the short term.

The posited drop in output reduces real incomes, which further reduces spending, aggravating the recession. Adherents of this theory, Keynesians, call this additional decline a multiplier effect.

The original slump in spending may occur because consumers started saving too much and spending too little. Keynesian economics refers to slumps due to under-consumption as 'the paradox of thrift'.

Alternatively, investment spending may slump because investors irrationally lose confidence, or, in other words, because of 'animal spirits'.

Keynes' remedy was for governments to increase government spending and/or to print money to lower interest rates and stimulate investment spending. The spending boost would have a multiplier effect on national income.

Politicians would not even have to worry much about the quality of spending. Paying people to dig holes and fill them again was good enough. Keynes himself suggested burying gold bars at the bottom of a disused mine. Money spent excavating the useless mine would boost national income.

This theory is popular with governments because it supports government deficit spending and printing money in economic downturns, while not imposing any real offsetting fiscal discipline during upturns.

Keynes' impatience to alleviate today's slump by such means meant discounting the risk of causing more or bigger future slumps from public debt crises and/or the need to curb inflation. His "in the long run we are all dead" riposte to those who pointed out that slumps were self-correcting in time came to epitomise his side of that debate.

Keynes is dead, but public debt crises live on.

LABOUR MARKET

The labour market refers to all the places where firms look for people to hire and where workers look for job opportunities.

It exists because firms need workers and workers need jobs.

Employers need workers who will do the work at an affordable wage, while workers need jobs that pay an acceptable wage to meet their needs.

So both sides need to seek what they want, and employers have to compete with other employers while workers have to compete with other workers.

The employment contract is a deal between a willing employer and a willing worker about what the worker will do for the employer and what the employer will do for the employee. The agreed wage is part of the deal, but as with any market, the outcomes of labour markets offend some notions of virtue and fairness.

The scarcer a worker's skills relative to society's willingness to pay, the bigger the pay cheque. Luck also plays a big role, particularly in one's country of birth. The lower the quality of a country's economic institutions, the poorer the job opportunities.

To illustrate, according to ESPN, Kobe Bryant's salary for the 2013–14 season with the LA Lakers is US$30 million. Yet, the United Nations reports that 1.2 billion people, about 20% of the world's population, live on less than the equivalent of US$1 per day.

Views about the labour market are often intensely ideological. Marxists believe that government involvement is necessary to stop fat cat capitalists from exploiting workers. Firms are rich and powerful, while the worker is weak – and regulation is necessary to offset this imbalance.

This view ignores the power that competition between employers confers on workers. Would anyone pay Bryant $30 million otherwise? Johnny Paycheck's 1977 country classic: "Take this job and shove it, I ain't working here no more" epitomises the liberating power of choice.

The problem with much of the labour market regulation is that it says 'we', meaning those with jobs, would rather see others unemployed and on welfare rather than in a job that we think is not up to standard.

In New Zealand, we have tolerated high youth unemployment because governments preferred to see young people without work than in a job paying less than the adult minimum wage. How does that make sense?

A deeper concern with labour market regulation at the expense of the most vulnerable, such as those with few skills trying to get their first job, is that it violates their very being. It is an awful thing to be unable to find a job, to feel that society puts no value on what you have to offer.

Adam Smith expressed this non-Marxist view over 200 years ago:

The property which every man has in his own labour; as it is the original foundation of all other property, so it is the most sacred and inviolable … To hinder him from employing this strength and dexterity in what manner he thinks proper without injury to his neighbour is a plain violation of this most sacred property.

M MONETARY POLICY

Money is the modern economy's essential lubricant. But for money, there is only barter trade – and poverty.

Money is anything that is widely accepted as a means of settling a debt or paying for a good or service, simply because it can be similarly passed on. Even unopened packets of cigarettes or bags of sweets have been used as money *in extremis.*

An unexpected shortage of money can cause recessions or depressions, yet too much money can cause inflationary booms that end painfully. Even modest inflation is a stealth tax on money holdings.

Governments, having monopolised the printing of money, must decide how much to print. That can be a difficult choice, particularly in times of financial stress.

Governments tend to print too much money, unless constrained by non-inflationary arrangements backed by public opinion. Printing more money creates the illusion of greater prosperity. Shrinking the amount of money in circulation is seldom an attractive political option.

Governments found it hard to generate inflation when money had to be backed by gold. Britain adopted the gold standard in 1717, and the US sustained the value of its dollar at US$20.67 per ounce of gold between 1834 and 1934.

But neither country could sustain the gold standard when spending pressures got too great. Britain abandoned the gold standard in 1914 with the onset of World War I, taking Australia and New Zealand with it. The United States devalued its dollar to US$35 per ounce of gold in 1934, amid the Great Depression, and suspended convertibility entirely in 1970, amid big fiscal problems. Both New Zealand's Consumer Price Index (the CPI), and the price of gold, have increased more than sixty-times over since then.

New Zealand was slower to curb inflation than the United Kingdom (under Prime Minister Margaret Thatcher) and the US (under President Ronald Reagan). But New Zealand led the world in 1989 in obliging its central bank to focus monetary policy on price stability. The result to date is encouraging. New Zealand's average annual rate of CPI inflation was 11.5% in the 20 years to March 1989 and 2.3% in the 20 years to March 2014.

We should not be too eager to abandon the successes of our inflation-targeting regime in hopes of achieving higher employment. Theory and evidence suggest any employment gains would only be temporary. But the costs of abandoning price stability would last a very long time indeed.

NATIONALISATION

N

Try to envisage a world in which you wake up every morning from your bed manufactured by Kiwibed, prepare your breakfast of Kiwibread and Kiwicoffee, and put on your clothes made by Kiwiclothes, no less.

This may sound like a nightmare to some – a situation where practically all goods and services are produced by nationalised and monopolised industries, and shielded from the price-reducing effects of private competition.

And yet, this was the reality under Soviet-style communism, and also in many major OECD countries up until the early 1970s.

Nationalisation refers to the purchase of privately owned corporations, industries and resources by a government. Often, it occurs with the intention of maintaining wealth-generating assets in public control, preventing labour exploitation and large-scale layoffs, or trying to ensure the fair distribution of income generated by a country's national resources. Whether this always worked in practice is an entirely different question.

In New Zealand, there have been a number of high profile nationalisations, including the purchase of the Bank of New Zealand in 1945, Tranz Rail in 2001, Air New Zealand in 2003, and the remaining rail network in 2004. Most recently was the 2008 purchase of the rolling stock and ferries from Toll New Zealand.

Historically and globally, the industries that have commonly been subject to nationalisation have been in the transport, communications, energy, banking, utilities and natural resources sectors.

Nationalised industries are meant to operate in the public interest. Unfortunately, the consequences of nationalisation have, in practice, often resulted in greater inefficiency, reduced productivity, limited consumer choice, poor service, and higher consumer prices. Remember the exorbitant costs of a long-distance call under the state-run model in the 1980s.

Privatisation on the other hand – the opposite of nationalisation – opens a company to private competition, encouraging the offer of better service, more choice, and lower prices – all the while realising a sustainable profit margin. However, not all privatisations are entirely successful on all counts.

A notable case was the nationalisation of British Rail between 1994 and 1997, which did not reduce ticket prices as predicted, instead creating one of the most expensive train systems in the world. It did, however, result in improved safety, better punctuality, and increased patronage.

Nationalisation and privatisation will always elicit vigorous public debate on whether one or the other is right or wrong. However, at the very least when it comes to where we sleep, what we eat, and what we wear, we'd all rather have more and better choices at lower, more competitive prices.

O OPPORTUNITY COST

'Opportunity cost' is one of the most fundamental concepts in economics. When choices have to be made, the opportunity cost of the preferred choice is measured by the net benefits that could have been secured by choosing the best of the rejected alternatives.

The concept is straightforward common sense; applying it is the tricky bit.

Imagine you have won a free ticket (which has no resale value) to see an Eric Clapton concert. Bob Dylan is performing on the same night and is your next-best alternative activity. Tickets to see Dylan cost $40. You would be willing to pay up to $50 to see Dylan.

Would the opportunity cost of going to the Clapton concert be $0, $10, $40 or $50?

This question was posed in an article by Paul J. Ferraro and Laura O. Taylor: *Do Economists Recognise an Opportunity Cost When They See One? A Dismal Performance from the Dismal Science*. In the survey of approximately 200 economics graduates – many of them with PhDs – only 21.6 per cent gave the correct answer. Of the economists who answered incorrectly, their responses were almost evenly distributed between the three wrong answers.

The correct answer, by the way, is $10, being the benefit of $50 less the ticket cost of $40. If you are embarrassed, you are in good company.

Put most simply, a forgone net benefit (e.g. of $10) represents the opportunity cost of the preferred choice, and a forgone net cost is a benefit.

Opportunity cost is fundamental to cost-benefit analysis. If the net benefit from the preferred course of action does not exceed its opportunity cost, why is it the preferred course of action?

In their survey, Ferraro and Taylor also asked what the minimum net benefit from listening to Clapton would have to be to justify forgoing listening to Dylan. That's right, the answer is $10. If it were $5, the opportunity cost of listening to Dylan would be $5, half the $10 benefit.

People understand these things intuitively in their private lives, but when they vote in general elections they might hope to secure a benefit at someone else's expense. This incentivises political parties to stress the benefits from 'free' this or that, neglecting opportunity cost. Yet a dollar spent on, say, education is a dollar less spent on something else.

When choices have to be made, there is no free lunch; there is only opportunity cost.

PRICE

From an engineering perspective at least, a good case can be made to use silver for all electric wiring. Silver just makes more sense than, say, copper, steel or aluminium. That is because silver's specific electrical resistance is the lowest of all metals.

That we are nevertheless not using silver for overhead power lines has a lot to do with economics and the role that prices play.

To most non-economists, prices are just what we pay for the goods and services we buy. To economists, however, prices are much more than that. To them, prices are a marvel, a work of art – or a little less poetically, a very condensed piece of information.

Think about it this way: if the last coffee crop was bad, or if suddenly millions of Chinese developed a craze for double espressos after every meal, the resulting global shortage of coffee beans would not result in rationing. Nor would it require a central planner to tell people to drink more tea instead. What it would do, however, is increase the price of coffee so that coffee drinkers would adjust their consumption accordingly.

Prices bring together everything we know about the supply and demand of any given good. In this way, they help us decide what to use resources for.

This, then, explains why we do not use silver for all electrical wiring. It is a rare metal with many other potential uses (such as in jewellery, medicine and optics). The high price of silver is therefore guiding it towards its highest value use, leaving the job of conducting electricity to other, slightly less suited but much cheaper metals.

In an economy without a functioning price system, we would not be able to make such decisions. We simply would not know which good could be used for what without resorting to trial and error, planning, rationing and waste.

Prices are absolutely crucial for the functioning of the economy. They bring order into a chaotic world of countless goods, services, uses, consumers, suppliers and intermediaries. Without prices, nothing can coordinate all of these.

Politicians play with the price system at their peril. Yet there are minimum wage laws, rent controls, price controls, and other ways of distorting prices. Usually introduced with the best intentions, these measures prevent markets from working properly.

The price for such interference will be paid by all of us. But that is a price not worth paying.

Q QUANTITATIVE EASING

Those who read the business pages may have come across the term quantitative easing (QE), an apparently magical potion for reviving debt-ridden economies – almost like a shot of adrenaline in the arm of a dying patient.

Before resorting to QE, the orthodox medicine for monetary authorities to stimulate the economy is to lower interest rates on some form of official debt, such as the interest rate the central bank pays on overnight deposits, and/or increase liquidity in the banking system by buying back government term debt. The latter technique is called an open-market operation (OMO). In addition to its liquidity effect OMO will raise prices of term debt, lowering its yield. By either measure, the authorities can hope to make private credit cheaper, stimulating investment in businesses, housing and consumer durables.

QE's most striking point of distinction from an OMO arises when it involves buying back privately issued paper instead of government paper. (Note that some define QE to include buying longer-term government paper than is usually bought in the US in an OMO.)

Why would the authorities buy private paper, particularly paper of dubious value held by injudicious private banks, when there is no shortage of medium- and long-term government debt to buy? Why, indeed.

In deciding what private securities to buy, government is favouring some issuers (e.g. those issuing mortgage-backed bonds) and some holders (e.g. banks) at the expense of others. It is also shifting private risks to taxpayers. The government could easily pay too much for those assets since its buying power is likely to bid up their prices. An unwanted effect might be to make imprudent banks stronger and taxpayers weaker (via government) through hidden subsidies.

Moreover, what happens when the monetary authorities subsequently decide that the additional liquidity needs to be reduced? Reversing the process by selling the accumulated private paper in large amounts could undesirably disrupt the primary issuance market (e.g. for mortgage lending).

One argument in the US in favour of QE (focused on buying private mortgage-related debt) is that the US suffered such disruption to this market in the 2007–08 global financial crisis that special assistance is desirable to 'unfreeze' it. This argument may be more political than economic.

In conclusion, heavy recourse to QE is a sign of desperation – a bit like reaching for unproven, fringe medical remedies in the belief that proven mainstream treatments can do no more. Such options can be worth considering when the Reserve Bank has already lowered interest rates to zero. Talk of QE in New Zealand was wholly inappropriate.

REGULATION

R

Regulations govern conduct – and a well-regulated society is a well-ordered and civil society. But bring up the topic of government regulation and expect passionately polarised responses for more rules or less red tape.

Government regulation can be particularly controversial when the community is deeply divided over some regulatory choice that must be made, such as the rules affecting abortion, compulsory military service during the Vietnam War, or whether to allow or ban the Springbok tour in 1981. Government then might seek to find a response that best preserves community peace and cohesion.

More generally, government laws and regulations can displace, for better or worse, rules in privately agreed arrangements for regulating conduct, such as employment agreements, school rules, and rules governing gated communities. They can similarly displace long-accepted common law rules.

Government regulations are sometimes categorised as social (e.g. abortion laws), environmental or economic. Views about their desirability differ, particularly over time. A major change in recent decades in New Zealand, and elsewhere, has been a rise in restrictive environmental regulation offset by major economic deregulation.

Today, much government economic regulation is ostensibly aimed at stopping businesses from exploiting or misleading suppliers, employees, customers and investors. Yet economic research finds that businesses may support some of this regulation, perhaps judging that it most hurts competitors. For example, the regulation of quality can raise costs disproportionately for small and medium-sized Enterprises (SMEs), hurting consumers overall. Economists call this the capture theory of regulation. However, the theory may not explain regulations that are opposed by business.

Another proposition is that governments care not one fig about interest group pressures or contributions to political campaigns, but regulate solely for the benefit of the wider community. This is called the public interest theory of regulation. A major regulatory textbook dryly observes that a large amount of evidence refutes this naïve proposition.

In contrast, the mainstream economic theory of regulation proposes that interest groups lobby for changes in regulations that will particularly benefit them, and politicians respond rationally to this demand since they want to get re-elected. Political parties merely differ with respect to their favoured constituencies and ideologies. Outcomes can be difficult to predict since they depend on the voting balance between contending considerations, but the national interest is not centre stage.

Whether a particular regulation best serves the overall community can be difficult to determine. Economists use cost-benefit analysis for this purpose, but it has well-known limitations. Any analysis should anticipate the Law of Unintended Consequences – the adage that intervention in a complex system commonly creates unanticipated and often undesirable outcomes.

S SIGNALLING

If you have ever bought a used car, you will be familiar with this problem. The seller, of course, knows whether the car is reliable, may know the previous owners, and is aware of any hidden flaws.

For you as the buyer, the situation is a bit more complicated. At first sight, a gem is difficult to differentiate from a lemon. With a bit of polish and some new car scent spray, you can put a nice gloss even on a dud.

In such situations, which economists describe as 'asymmetric information', markets do not work well. Buyers, not knowing whether they will get good or bad quality, have a reduced willingness to pay. But for the price buyers are prepared to pay, the owners of good quality cars would not be willing to sell them. As a result, we end up with a market where poor quality cars trade at low prices.

This is the dilemma described in George Akerlof's classic paper, 'The Market for Lemons', and it is here where 'signalling' comes into play. To overcome the problem of asymmetric information, the sellers of higher quality goods, whose quality is difficult to ascertain before use, need to find ways of showing their quality.

In the case of used car markets, a credible signal for the quality of the car would be a warranty. If the buyer is confident that the car is not a lemon, he could promise to cover all repairs for the next couple of years. In doing so, he could justify charging a higher price.

Such quality signals are far more widespread than you may first think, as economist Daniel Klein points out in his book *Reputation*. Where market failure theorists predict that we should not be able to trade used cars, real-world entrepreneurs bridge the gap between buyers and sellers to provide credible signals of product quality.

Advertising, surprisingly, provides another example.

If you have ever wondered why companies hire celebrities to endorse their products, think about it this way: The reason actress Andie MacDowell promotes L'Oreal is not because the product stopped her from ageing but because she is worth it. Paying her handsomely signalled to buyers that L'Oreal was serious about the quality of its products. For the same signal, the company could have publicly burned $100 notes as well (but it would not have looked as good).

Academic titles fall in the same category. Some of us get them because we are interested in learning and knowledge. The real value of a PhD lies elsewhere, however. It signals that you are capable of achieving things that require a sustained effort. That's why people get PhDs – and that's why companies hire PhDs.

Doctorates, warranties and Andie MacDowell may differ in many ways. One thing they have in common: They are strong signals.

TAX

T

Taxes are one of the most tangible links between government and civil society. We all pay taxes in some form, and in exchange, we expect government to provide certain goods and services: roads, infrastructure, the courts, law enforcement, education, and support for society's most vulnerable.

From this perspective, the oft-quoted declaration "Taxes are the price we pay for a civilised society", widely attributed to Oliver Wendell Holmes, rings true.

However, it is a common misconception that a dollar taxed is a dollar that can be spent by government on goods and services. In reality, a dollar taxed is a dollar that must be spent on collecting tax, ensuring tax compliance, public administration of policy, and of course, the actual public policy.

Besides, increases in tax rates do not automatically lead to an increase in tax revenue, as illustrated by the Laffer Curve. Named after Arthur Laffer, this curve popularised the notion that higher tax rates, when taxes are high enough, may actually cause the tax base to shrink so much that tax revenues decline. Conversely, a cut in tax rates may increase the tax base so much that tax revenues increase.

How so?

Taxes distort behaviour by influencing the personal decisions people make about their work and consumption. For instance, people who would prefer to work longer hours or at a higher pay may work less or refuse a pay rise to avoid being taxed at a higher rate. Higher personal income taxes encourage workers to substitute their preference for work to economic activities they would otherwise not prefer.

This is known as the deadweight loss of taxation, where the tax system causes individuals to pursue actions they would otherwise not prefer. To gain maximum tax revenue, there must be a careful balance between low rates with a greater tax base, and high rates with a smaller tax base. Although few taxes are high enough that governments could increase revenue by reducing tax rates, the principle is more general: the economic cost of a dollar's worth of tax revenue is more than a dollar.

There is also the issue of tax incidence, which describes who bears the cost of the tax. For example, in most markets, buyers and sellers share the cost of the GST, even if it is the retailer who sends the cheque to Inland Revenue: taxes do not pass through perfectly to consumers. This is worth bearing in mind when we consider compulsory employer Kiwisaver contributions: some increases in employer Kiwisaver contributions will come at the expense of lower raises in future.

Taxes are not the price we pay for a civilised society. At best, they are the price we pay for a civilised government. But they are also the price of overly bureaucratic procedures, unpredictable outcomes, and the loss of freedom to make our own decisions.

U UTILITY

Economist John Stuart Mill saw utility as “the feelings of pain and pleasure”. The utility, or usefulness, of something depends on how much it satisfies a person’s needs or wants. Positive utility might be thought of as ‘pleasure’, negative utility as ‘pain’.

While utility is subjective (some people may hate music that others love), people reveal the utility of something to them by how much they are willing to pay for it.

The utility of water is high because it is necessary for survival. So why is water cheap while diamonds, which are dispensable, are dear? This water-diamond paradox puzzled economists of the 18th Century.

The Labour Theory of Value proposed that the price of something is determined by the ‘toil and trouble’ of the labour: Water commands a lower price than a diamond because it embodies less labour. But would an ugly stone requiring more labour be even more valuable? The nervous young man slipping a diamond ring onto his true love’s finger would not have improved his chances by having chosen a less beautiful and more labour-intensive stone. The Labour Theory of Value began its quest to explain value from the wrong side of the process.

But the Theory of Marginal Utility was revolutionary in resolving the water-diamond paradox.

Marginal utility is the additional utility to the same person from a tiny bit more of the same thing. If you only have access to 1 litre of water per day, you would likely drink it. With 10 litres, you might prepare food. With 100 litres, you could bathe your family. And with 1,000 litres, you might fill your swimming pool.

Each of these activities – drinking, cooking, bathing and swimming for pleasure – is of less value than the preceding activity. The law of diminishing marginal utility proposes that the more we have of something, the less value we put on having a little bit more of it.

When water is plentiful, the value of another litre (i.e. the marginal utility) is low. Conversely, diamonds are scarce and coveted, even at the margin. Water is cheap because its marginal utility is low; diamonds are dear because their marginal utility is high.

That diamond rings are so highly desired brings us back to the subjective nature of utility. Studies show that when people are tricked by cheap wine in a fancy bottle, they perceive that it tastes better than the same wine served in a plain bottle. Brain scanning technology shows that when participants drink the supposed fancy wine, “the parts of the brain associated with reward and pleasure light up like a Christmas tree”.

Diamonds are expensive because people value their rare beauty. They consequently can serve as credible signals of a young man’s commitment to the relationship: diamonds came to serve as a bond paid by a suitor as guarantee that he would not abandon his fiancé.

Since he so highly values her commitment to him, the diamond provides utility that is worth the price.

VOLATILITY V

Economics would be a pale imitation of itself without volatility, or at the very least about as stimulating as watching paint dry. Luckily the world is a complicated place, where prices fluctuate for various reasons, and this, for the most part, is a good thing.

On a microeconomic level, producers wouldn’t be able to discover demand if there were no volatility. Or, rather, a world without volatility is a world in which there is never any change in consumer demand, in technology, or in production. It is a world that can only exist in a blackboard economist’s model. Because the world is more exciting than that, technology, and supply and demand, are in constant flux, resulting in price volatility. Entrepreneurs then respond, engaging in a process of arbitrage between the price at which they buy inputs and the price at which they sell output. Without these volatile price movements telling entrepreneurs about changing underlying conditions, there would be no way of allocating scare resources to their most efficient use.

Price changes are also needed to encourage investment in a particular sector. Long-term trends in commodity prices, such as Asia’s growing demand for protein, tell farmers that the investment needed to convert their land to dairy pasture is likely to pay off in the end (though not guaranteed).

Although price fluctuations usefully steer production and investment, this doesn’t mean all types of volatility (or lack thereof) are equally desirable. Volatility induced by political uncertainty is entirely different from price changes caused by changes in fundamental supply and demand conditions.

International debt markets are a good example. The yield on five-year Greek government bonds has been trading at a fairly consistent level of just over 4 per cent for some time. Meanwhile, Argentinian four-year bonds (the closest comparable security) are trading at 7.6 per cent. The difference has almost nothing to do with economic fundamentals, since both countries are in major financial strife.

An investor, who knows nothing about the political support being lent by the European Union, might conclude from the yields that Greece is responsible with its public finances compared to Argentina. In fact, Greece’s public debt to GDP stands at 161 per cent, whereas Argentina’s is equivalent to 42 per cent of GDP.

The opposite can also be true. Investors in New Zealand’s listed electricity sector know only too well how volatile share prices have been due to the Labour and Green’s proposal to restructure the market, when in fact the fundamentals of the industry haven’t changed.

Change, or volatility, is a good thing in economics, provided it is based on market fundamentals and not political hot air.

W WELFARE

The biographies of top economists indicate that they were often motivated to study economics to be better able to contribute to the common good.

But what is meant by the common good and what policies contribute to it? After all, in general elections, voters are commonly confronted with at least one party advocating higher taxes to make New Zealand a better place for New Zealanders – and at least one other party advocating lower taxes in the same cause.

Welfare economics is a branch of economics that explores what might be meant by the common good, and seeks to evaluate economic policies on the basis of their effects on the well-being of the members of a community.

As explained previously in A for Adam Smith, competition, in conjunction with security in person and property, induces even solely self-interested butchers and bakers to serve their customers' interests. Otherwise, we freely take our business elsewhere.

During the 20th century, welfare economics formalised this insight into the proposition that stylised competitive processes will produce a zero-waste welfare outcome. It is optimal in the sense that no one person's (self-perceived) welfare can be increased by reducing that of at least one other person. (Whether such a change is worth doing regardless remains a moot point.) When economists talk about welfare economics, they typically refer to this kind of analysis rather than to the analysis of income-support policies.

Welfare economics has clarified the many situations in which the same competitive processes will potentially fail to maximise welfare in this sense. These include problems of monopoly, public goods (such as national security and communicable diseases), environmental pollution, income distribution, poverty, malleable preferences, and distortion of taxes. Economists have formally shown in many of these cases how a well-motivated government might ideally use taxes or regulations to improve general well-being.

Nevertheless, related branches of economics have also illuminated many difficulties that confront government action, including problems of voting behaviour, inadequate information, and political and bureaucratic incentives. The UK TV series *Yes, Minister* brilliantly depicts these difficulties. 'Doing good' in government is subject to the Law of Unintended Consequences.

What about the welfare state? One of the earliest uses of this term was in the 1942 Beveridge Report, which ideologically proposed that the state was responsible for individual welfare 'from the cradle to the grave'. What followed was a dramatic increase in taxes and social service spending in member countries of the Organisation for Economic Co-operation and Development (OECD), albeit with significant national variations. Whether the welfare state's provision of comprehensive and mandatory income insurance protection is welfare-improving, in the economists' sense of the term, remains a matter of no small contention.

X-EFFICIENCY X

It would have been a stretch for us to relate X-rays or xylophones to economics. Lucky for the ABC of economic literacy that Harvey Liebenstein prefixed the word efficiency with a big X when proposing the concept of X-efficiency in the 1960s. It is the only economic concept in MIT's *Dictionary of Modern Economics* listed under X.

X-inefficiency arises when firms fail to achieve the maximum possible level of output from given inputs. It contrasts with allocative inefficiency, which is the failure to produce the optimal mix of outputs, even if each output is produced at least cost.

X-inefficiency represents a forgone opportunity to increase profits, wages or both. A textbook monopolist would not fail to maximise profits but, in practice, some firms might.

The *New Palgrave Dictionary of Economics* cites, as evidence for the existence of X-inefficiency, a study in 1981 of a Ford plant in Germany that was producing 50 per cent more automobiles with 22 per cent less labour than an identically designed plant in the United Kingdom. (Presumably, the German workers were getting paid commensurately more, reflecting their greater productivity.)

Differences in labour market laws, entrenched labour market practices, cultural attitudes to work, performance, and pay may make it hard for even a profit-maximising owner to raise the productivity of the UK plant to the German level. But if wages were sufficiently lower in the United Kingdom, a profit-maximising owner might be able to make enough profit out of the UK plant to justify not closing it and shifting all production to Germany.

Managerial slack is a related source of X-inefficiency. Employee managers are likely less motivated than owner-managers to maximise profits. Owners may be unable to fully overcome this problem. Diffuse ownership may be one reason owners might fail in this manner.

Laws that make it unduly difficult to hire or fire managers or workers or to target incentives at top performers (performance pay) may contribute to X-inefficiency. For example, anti-takeover laws may protect underperforming management teams.

Performance measures across firms and countries, such as in the Ford factory above, can help identify egregious cases of X-inefficiency, but eliminating its causes may be too hard if they are entrenched.

The theory is controversial because if people prefer not to work as hard and as productively as they could, and consider the lower wage to be a price worth paying, they are actually optimising. Their lower productivity is efficient.

Y YIELD CURVE

Imagine you are at a speed dating event, circling a room filled with people who, like yourself, are looking for love. The problem is that besides a clutch of banal questions and answers, you have very little information to go on in deciding who is worth asking out on a longer date.

You could, for example, be looking for a steady long-term relationship, and have no indication whether the person sitting across you is likely to kidnap your cat and key your car, or is the future mother or father of your yet-to-be-born children.

The example above goes some way to explain the tortuous nature of the human courtship process, and why financial markets have developed a tool to sidestep this uncertainty and quickly size up a prospective investment.

A yield curve is a graphical representation of interest rates of the same type of debt security across different maturities. So in the case of New Zealand government bonds, a yield curve would depict interest rates ranging from three months to 30 years, with the varying interest rates forming a typical curve.

Under normal economic circumstances, New Zealand short-term interest rates would be lower than long-term rates. The yield curve would be upward sloping, suggesting that investors expect short-term interest rates to rise. This may anticipate higher future inflation in a growing economy.

An inverted, or downward-sloping, yield curve is where short-term interest rates are higher than long-term interest rates. This is a signal to investors that short-term interest rates are expected to decrease, which may suggest the economy is slowing.

The slope of the curve also conveys information about the pace of the economy, and the steeper it is, the faster investors may expect an economy to grow or contract.

Yield curves are not limited to government bonds, but can be applied to any set of debt instruments that bear the same risk profile, such as all the bonds issued by a single firm (albeit without the effects on a national currency).

Of course, this being economics, you can get flat and lumpy yield curves too, and all the curves are subject to change at any moment based on the economic fundamentals of the issuer. Ultimately, it is a useful tool (among many) that investors can use to size up the risk of a prospective or existing investment.

Now if only we could develop a curve that could help us tell bunny boilers from the homemakers, and the stalkers from the Romeos.

ZERO-SUM GAME Z

Once upon a time, when we were hunter-gatherers, life was poor, nasty, brutish and short (to quote Thomas Hobbes). But life was also very simple: Whatever had been hunted or gathered by a tribe had to be divided among its members. The berry you received could not be eaten by somebody else; the piece of meat between your teeth was no longer available to the others.

In such situations, whatever was your gain was another person’s loss, and you could only become richer by making someone else poorer by the same amount. The total wealth effect on society from your own increasing affluence was precisely zero. Wealth was a zero-sum game.

Fortunately, we have long left the days of hunting and gathering behind. Our economy looks quite different now – and we are all much better off than our Stone Age ancestors. However, because humanity used to live rather primitive lifestyles for so long, thinking about wealth as a zero-sum game seems to be deeply wired in our DNA.

Thus, when we see people who have made fortunes in business, our instinct is to believe they must have stolen their wealth from someone else. We have even coined a term for this alleged class of people: ‘robber barons’.

Such thinking ignores what really happens in our economy today. Far from just moving wealth around, modern economies are all about creating wealth. This should be fairly obvious by just comparing, say, a shopping mall to a Stone Age cave. It does not come intuitively, though.

Modern economies create wealth by trade and division of labour. In this way, whenever two parties engage in mutual voluntary exchange (of goods, services, land or whatever), they must both anticipate to be better off by the exchange. A jacket may be bought for $200 because it is worth at least $200 to the buyer and at most $200 to the seller. The point is that both the buyer and the seller will be better off thanks to the transaction.

In this way, an entrepreneur like Bill Gates did not get rich by ripping anyone off. On the contrary, he made us all a bit better off by providing us with an operating system and office software we wanted to buy.

Economics is about creating wealth. It has nothing to do with the zero-sum games of times past. The only zeroes we have added over the centuries are the ones to average per capita incomes.

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