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Instinct or Analysis; are they Choices for Scotland?

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Foreword

It is always a great pleasure to provide a foreword for the David Hume Institute's Annual Lecture. It is an even greater pleasure than usual this time around, because our lecturer was Sir Ian Byatt who had for three years been our excellent and most supportive Chair of Trustees.

When we started the search for our lecturer for 2012 Sir Ian quietly suggested that he might be prepared to take this on and that he had 'some points that he wished to make'! Of course, along with all of our trustees, I jumped at this offer, knowing how much Sir Ian would have to say about being a practical and effective economist and applying hard-learned wisdom to the current Scottish economic scene.

This lecture took place on the 22nd October at the Royal Society of Edinburgh. It was very well attended by a packed audience who sat enthralled throughout and then launched into a set of fascinating and diverse questions – all of which Sir Ian answered quietly, thoroughly and most effectively.

As I said as soon as Sir Ian had completed his talk, this was a 'proper' lecture! The content was remarkable and thought-provoking as well as being relevant to present policy considerations; and the delivery was measured, allowing for full assimilation of the key points as they were made, one after the other.

Sir Ian started with appropriate references to Hume and Adam Smith, from whom he had drawn great inspiration throughout his long and distinguished career. He then warned that economic thinking had become too narrow in the recent centuries, casting doubts on undue reliance on sophisticated mathematical models – which had become increasingly lacking in resilience to changing circumstances. He preferred to rely upon a few key tools – more those of the micro than the macro economist.

He also stressed that the ‘practical economist’ – in whose ranks he must be numbered – had to accept that economics was never the only consideration in policy making. In the terms of his lecture ‘instinct’ informed decision-making as well as ‘analysis’.

On the basis of this foundation Sir Ian proceeded to discuss a number of key policy areas for Scotland, expressing his views in a characteristically robust manner, but always based upon sound foundations. He also stressed the need for both good data and sceptical conversations. We can all, I hope, agree to these priorities and the Institute is doing its utmost at least on the latter front.

All of us at the DHI are extremely grateful to Sir Ian for taking on this task. We are also grateful once more to the Royal Bank of Scotland for their continuing support of our Annual Lecture series. That continuity of support is much appreciated.

In closing I must add, as is traditional, that the views expressed in this paper are those of the author and not the Institute – even though Sir Ian was our excellent chairman until the end of 2011. We encourage open, informed, objective and sceptical debate. That is certainly what Sir Ian provided in this lecture.

Jeremy Peat
Director

The David Hume Institute

The Author

Ian Byatt was Chairman of the Trustees of the David Hume Institute from 2008 to 2011. He was Chairman of the Water Industry Commission for Scotland from 2005 to 2011 and Director General of Water Services (Ofwat) in England and Wales from the privatisation of the Water Authorities in 1989 to 2000. Before that he was Deputy Chief Economic Adviser in the Treasury. He is currently an Associate of Frontier Economics in London.

Instinct or Analysis; are they Choices for Scotland?

The legacy of David Hume, Adam Smith and the 18th Century: the importance of practical knowledge: & some implications for Scotland in the 21st Century

I was due to give this lecture on 23 April; St George's Day seemed appropriate for an Englishman to speak in Edinburgh. In the event, medical matters got in the way and I am now closer to St Andrew's Day.

Tonight, I start with Ivan Maisky, Ambassador of the Soviet Union to the Court of St James, who wrote a fascinating, and, by Soviet law illegal, diary, now retrieved from the Soviet archives. He writes of the State banquet, given by George VI, in 1938, to honour King Leopold of Belgium.

“One hundred & eighty guests, the entire royal family, members of government, ambassadors, and various British notables. We ate from gold plates with gold knives & forks. The dinner, unlike most English dinners was tasty (the King is said to have a French cook).

Two dozen Scottish pipers entered the hall during the dinner and slowly walked round the tables several times, filling the palace vaults with their semibarbarian music. I like this music. There is something of Scotland's mountains & woods in it, of the distance of bygone centuries, of man's primordial past.

Piper's music has always had a strange, exciting effect on me, drawing me off somewhere far away, to broad fields and boundless steppes where there are neither people nor animals and where one feels oneself young & brave.”

For me, an urban Englishman and former Treasury official, a child of the bourgeoisie, a citizen of a free society and the market economy, the particular attraction of Scotland is the enlightenment of the 18th Century - Edinburgh as the Athens of the north, David Hume working in the Library of Advocates & Adam Smith, with his covert support for the colonies, and his intellectual dinner parties at Panmure House.

A particular attraction of their work was its focus on practice and practicability; on reform where sensible, and on existing practice where working well: no utopias, no paradigms.

So, two views of Scotland from the outside, or of two aspects of human life. More of this later; meanwhile more of the enlightenment tradition.

Adam Smith attacked the “whole commercial system” of Great Britain, “an immense haphazard and changing organisation of regulation & vexation”, but did so humanly & pragmatically. Emma Rothschild writes of him that, “In his comparison between the man of system and the man of humanity – between the public spirit which is inspired by the love of system, and the public spirit which is inspired by the love of humanity – he sees a certain charm in both principles”.

"But he takes a position, in general, in favour of the man of humanity, moderation, accommodation, “fellow feeling”, and respect for other individuals, including for their privileges & prejudices.”¹

David Hume, an admirer of Isaac Newton, hoped to discover the science of man. But as Stewart Sutherland showed in his Enlightenment Lecture a year ago, Hume was no friend of specific systems. And he was cautious about over-generalisation. As he says, “In all matters of opinion & science...the difference between men is...oftener to lie in generals than in particulars;”²

This enlightenment tradition and the emphasis on practical knowledge, goes back to classical times. Cicero, the advocate who spent a year as a Consul, wanted to encourage political participation and to present politics as a branch of knowledge.

Cicero discusses different forms of government from the perspective of the practitioner; saying, “the opportunity of rescuing the country ...does not come suddenly or when you wish it, but only when you are in a position which allows you to do so.”, and “even if it were true that the sage does not voluntarily deign to descend to the technicalities of statecraft, [he should] not shrink that duty if forced by circumstances.

¹ Emma Rothschild *Economic Sentiments: Adam Smith, Condorcet & the Enlightenment*. Harvard University Press 2001

² David Hume *Essays, Moral, Political & Literary* Ed Green & Grose 1875 “*Of the Standard of Taste*” 1757

"I should think it quite wrong for him to neglect the art of politics; he ought to have everything at his fingertips, for he never knows when he may have to use it."³

In our own age, Michael Oakeshott, the LSE political philosopher, made his attack on the “rationalist” in politics, who wants to build up everything from first principles.

Isaiah Berlin reminded us that “out of timber so crooked from which man is made, nothing entirely straight can be built”,⁴ extolling the virtue of the fox over that of the hedgehog.⁵

And here in Scotland, Neil MacCormick has built the case for practical reason in the law.⁶

The form and context of thinking can be as important as the thinking itself. Cicero wrote his *Republic* in dialogue form – using the symposium that Plato considered superior to the written text.⁷

“Writing, Phaedrus”, says Socrates, “has this strange quality, and is very like painting; for the creatures of painting stand like living beings, but if one asks them a question, they preserve a solemn silence. And so it is with written words; ... if you question them, wishing to know about their sayings, they always say only one and the same thing.”

³ M.T.Cicero *De Republica*. Book 1 Section 9 Translated Niall Rudd. Oxford 1998

⁴ Immanuel Kant, “Idee zu einer allgemeinen Geschichte in weltbürgerlicher Absicht” (1784) *Kant's gesammelte Schriften*, vol. 8 Berlin 1912

⁵ Isaiah Berlin *The Crooked Timber of Humanity: Chapters in the History of Ideas* Ed. Henry Hardy Fontana edition 1991

⁶ Neil MacCormick *Practical Reason in Law and Morality* OUP 2008

⁷ Plato *Phaedrus*, 275ff., specifically:

"Socrates: He who thinks, then, that he has left behind him any art in writing, and he who receives it in the belief that anything in writing will be clear and certain, would be an utterly simple person...if he thinks written words are of any use except to remind him who knows the matter about which they are written.

"Phaedrus: very true.

"Socrates: Writing, Phaedrus, has this strange quality, and is very like painting; for the creatures of painting stand like living beings, but if one asks them a question, they preserve a solemn silence. And so it is with written words; you might think they spoke as if they had intelligence, but if you question them, wishing to know about their sayings, they always say only one and the same thing. And every word, when once it is written, is bandied about, alike among those who understand and those who have no interest in it, and it knows not to whom to speak or not to speak; when ill-treated or unjustly reviled it always needs its father to help it; for it has no power to protect or help itself."

In dialogue, Hume argues, perhaps rather optimistically, “An explanation of the terms commonly ends the controversy, and the disputants are surprised to find that they had been quarrelling, while at bottom they agreed in their judgement.”⁸

At the practical level, of course, economic, political and social **policies** are decided by groups of people, not by individuals. It is necessary to mobilise different interests to assemble objectives; and to interact with people with different experiences and skills to put them into effect.

Yet economics as an intellectual discipline has narrowed; political economy has been replaced by technical analysis.

Adam Smith’s “freedom” was political as well as economic. But in the fall-out from the French Revolution, economic freedom became separated from political freedom, which had become dangerous to established society. “Laissez-faire” became exclusively economic.⁹

Hume & Smith wrote primarily in terms of tendencies; but 19th Century economists wanted to be more precise. J-B Say wrote that the *Wealth of Nations* is a “confused assemblage...lacking in clarity in many places and in method almost everywhere”.¹⁰

He wanted to establish economics on “unshakable foundations...when the principles which serve as its basis are rigorous deductions from unquestionable facts”.

At much the same time, Jeremy Bentham argued that the aim of political economy should be the greatest happiness of the greatest number - “Nature has placed mankind under the governance of two sovereign masters, pain & pleasure. It is for them **alone** to point out what we **ought** to do, as well as to determine what we **shall** do.” He called these experiences of pain and pleasure, “utility”.

Compare this with Hume's much more subtle notion of "sympathy" or Smith's "fellow feeling". Sympathy extends to those with whom we have a human relationship - in whatever form; and the strength of the relationship varies. By contrast, utility is cold, abstract and impersonal.

⁸ Op. cit. 1757

⁹ Are there parallels with 21st century China?

¹⁰ J-B Say *Traite d'Economie Politique*

Economists, however, took Bentham's notion of utility as an “unshakeable foundation” of economic behaviour, while proceeded to define it in their **own** way. Many of them narrowed it by applying it to "rational" behaviour.¹¹

They used rationality differently from Hume. Hume argued that "reason is the slave of the passions”, they made reason the slave of utility.

They could then assume that human beings always acted according to **their** canons of rationality; or that the successful ones did, and that some combination of competitive forces and natural selection would do the rest.

Pinning human behaviour to utility theory made economics more amenable to mathematical methods. In the late 19th century, the Swiss economist, Walras, used mathematical methods that presumed perfect "rationality" and perfect knowledge.

These methods were very powerfully developed by Paul Samuelson and his followers in the second half of the 20th century. Typically they pursued equilibrium solutions, methodologically akin to those found in classical physics.¹²

The Keynesian revolution led to a further narrowing of the subject matter of economics to the point where, for much public policy analysis, economics is about the management of demand.

A whole industry of forecasters, economic consultants, and administrators in government departments and international agencies, now circulate in this narrow area, with an unhealthy focus on short-term forecasts and on the latest estimates of GDP.

In the last 25 years, other developments have taken place where the subject matter of economics is concerned.

¹¹ Starting with Philip Wicksteed's *Common Sense of Political Economy* in the 19th Century and maturing to work on crime, immigration, children and household production by the Chicago economist Gary Becker in the 20th century.

¹² Physics has moved on; quantum physics is much more probabilistic than classical physics,

Starting with Milton Friedman's positive economics, economics has thrust its way into areas of study, which do not concern behaviour in what are traditionally regarded as economic activities, i.e. Adam Smith's "truck and barter", reaching into new areas, such as the economics of education, health, crime and punishment, and even sex, marriage and family life.

The key innovator was the Chicago economist, Gary Becker. What was thought to be somewhat quirky has now become main stream¹³. Applications are widespread, including many in the environmental field, such as trading permits for polluting activities.

But it represents the further penetration of a narrow, albeit powerful, utilitarian methodology, not the extension of a wider analysis over a wider area.¹⁴

Much has been lost. Analytic links between economics and politics have been downgraded. Concentration on "equilibrium" misses the essence of economic life; a world of rapid and continuing change – vividly described by Schumpeter as "a gale of creative destruction".

We have recently experienced the collapse of the macro-economic stability that rational expectations theorists **thought** they were celebrating. They had only taken recent events into account, failing to study the lessons of history and not recognising that much of economic life is a discovery process.

Practical analysts need to spend time on detective work and the collection of specific information. The canny and practical Scot, Sir Alec Cairncross, whom I used to work for in the Treasury, used to say that forecasting involves "niffing and sniffing".

"Niffing" meant paying attention to the Treasury's internal, model-based, national income forecast; "sniffing" meant keeping alert to such other kinds of relevant information that were available, such as monitoring reports from Scotland and other parts of the country.

¹³ Gary Becker *The Economic Approach to Human Behaviour* 1976.

¹⁴ See, e.g. Michael J Sandel *What money can't buy* 2012. Michael Sandel was the 2009 Reith lecturer.

It has long been established that human beings do not fit the model of rational economic man; but “irrationality” has been regarded as a limitation, a reason for slow responses or, a result of shortages of information.

A literature is now developing on the availability of, and access to, information. This is much to be welcomed. But it is not the whole story.

Work on behavioural economics is changing our perceptions. Richard Thaler, of “nudge” fame, distinguishes between “Humans” & “Econs”. Daniel Kahneman, in his recent book “Thinking, Fast & Slow”, starts, appropriately, with Hume and his writings on the association of ideas.

We learn from experience that ideas follow each other in our conscious minds in a fairly orderly way. Hume, in his Enquiry, set out three principles of association; **resemblance, contiguity in time and space**, and causality.

Nearly three centuries later, Kahneman uses these principles, backed by empirical research, to develop the notion that we have two systems of thinking, one instinctive and one analytic.

The first system is the mind in automatic mode. This comes out of our everyday experience through our **own** association of ideas; we become very sensitive to what has passed over our desks. It is a rapid response system that has served humans well over millennia.

The second system operates more slowly, requiring conceptual thinking and the conscious assembly and analysis of relevant information, including the views of others. It requires data, time, effort and reflection.

To illustrate, in a simple way, the difference between systems 1 & 2, Kahneman shows us, first the picture of an **angry woman** and, secondly, an **arithmetic problem**,

17x24=?

We know how to respond to the first, drawing immediately on past experience. The second, for most of us, involves a pencil & paper; we know that there is a solution but not instantly what it is.

Kahneman talks in metaphors; the two systems slide in and out of each other; system 1 learns from the practice of system 2. But while system 1 is automatic, to use system 2 requires time, effort and the conquest of inertia.

Both have their strengths and weaknesses. System 1 operates fast; we are always short of time and decisions have to be made. System 2 requires information, often complex information, that is not always readily available.

Unfortunately, research has shown that system 1 is subject to systematic bias; Kahneman identifies some of them.

System 1 activity tends to frame a question selectively, for example:-

- when asked about how much we would pay to avoid sea-birds being caught in oil slicks, we quickly think about what we saw on the TV.
- In making decisions, people give greater weight to the prospect of a loss than to the prospect of a gain.¹⁵
- People weigh pain & pleasure not just by duration and intensity, but by special and lasting memories, such as those of Proust's memory of Combray & the madeleine.
- The **order** of the drafting of a question – or, as public servants know, of a statement – affects the response obtained.
- People may know conceptually that by-gones are by-gones but they find it difficult to move on.

We also have difficulties with proportions. We are fazed by visual illusions. Mention a percentage and many people switch off. Death in a traffic accident is much more likely than death by terrorism; but the headlines respond differently.

¹⁵ Extensive research indicates that people do not follow the Bernoulli expected value rules when making decisions under uncertainty. See the discussion of the point in Kahneman.

When I worked for another Scot, Sir Donald MacDougall, again in the Treasury, he always had a slide-rule tucked into his jacket pocket. This he learnt from Lord Cherwell, “the Prof”, Churchill’s statistical adviser in the war. Its use helped him, and others, to put issues into perspective.

Do computers help us to take better account of numbers? Sometimes yes, but not always. The use of computer models, especially large and complex ones, can lead to what I call "educated non-thinking". Unless we engage and interact with models, and the information that they do, or do not, contain, and are ready to bring **new** information into play, models can obscure rather than reveal and promise more than they deliver.

I vividly remember the crucial IMF visit in 1976, when the British economy was in deep trouble with the financial markets, and when we were alone in the degree of our reliance on a Keynesian economic model, and wondered **why** the world did not understand that we were doing the right thing.

I remember sitting in the Treasury, looking with senior colleagues, and with the IMF staff, at a table of forecasting numbers produced by the Treasury model. These numbers were received with scepticism.

What was at issue was not the workings of the model, but the **appropriateness** of the model to deal with the situation. This had **not** been adequately addressed in Whitehall - although it had been questioned outside the inner circle.

The bigger the model the less resilience it has to changing circumstances and the greater the resistance of its guardians to override it with different perceptions or new facts. Indeed, where people are encouraged to feed their own numbers into an on-line computer model, things have got worse.

In this way, the use of models can become a form of system 1 activity. giving quick answers to issues based on a pre-determined, but not always appropriate, selection of past events.

So where are we? Assuming Humans behave like Econs distorts both policy analysis & policy recommendations. Humans act instinctively; analytic thinking is inherently difficult and information is scarce.

Keynes argued that economics is not a difficult discipline but a set of analytic tools that are difficult to **apply**.

Economics gives us the tools of opportunity cost: the importance of changes at the margin: the necessity of looking at both supply **and** demand: the recognition that by-gones should not affect our decisions: the importance of incentives, financial, social and psychological.

I would emphasise the understanding of data, both **where** they come from and **how** they should be properly used, rather than manipulated to produce a particular result: the need to identify the relevant information and to monitor consequences: and the need constantly to scan the horizon for the emergence of “black swans” and “unknown unknowns”.

The skill comes in applying these tools to a particular issue. Professional expertise remains important. In his 1985 Reith Lectures¹⁶ and later writings, David Henderson warns us against what he calls do it yourself economics (DIYE) – economic ideas, beliefs and presumptions which owe little or nothing to economics as a recognised discipline.

No practical problem can be solved by economics alone. Politics is clearly relevant, as is administration, the law, presentation, and the impacts on particular groups.

This cannot be done in isolation. We bring all kinds of baggage to a problem - our past experiences, our long-held objectives, our concerns about what we see as the mistakes of the past, our emotions. We find it very difficult to be disinterested.

So issues often need to be discussed, challenged and refined at a **basic** as well as at a technical level.

Everything that I did in Whitehall: from Nationalised Industries to Corporation Tax: from Pensions to Selective Employment: from Housing to Higher Education had political, administrative and distributive dimensions.

¹⁶ *Innocence and Design: The Influence of Economic Ideas on Policy* Blackwell 1986

There were never overriding solutions. The direction of policy depended on melding together different objectives, different forms of expertise and different perspectives on the evidence.

Internal debate was crucial. Typically, we quickly found ourselves at the frontiers of what was known.

Sometimes the issue was a new one: sometimes the external environment had changed: sometimes mistakes needed to be rectified.

Policies will never be pursued unless a number of interests are engaged - all of whom have their own objectives. This both complicates implementation and increases the risk of unintended consequences.

In a complex and imperfectly-understood environment, unexpected consequences of policy measures – i.e. the things we **did not** consider often dominate over expected consequences, i.e. the ones we **did** consider.¹⁷

This increases the importance of monitoring policy and learning from both successes and failures.

Sufficient transparency is crucial. At Ofwat, where I was subject to uncomfortable challenge, developing better communication with stakeholders was a key issue; listening and explaining: explaining and listening: keeping issues strategic and not lost in detail: keeping them simple without, you hoped, distorting them.

This helped us to know when it was necessary to adjust, to trim our sails or to change course. Good recommendations are often in the form of a direction of change rather than a rigid prescription - in the spirit of Smith and Hume.

How might this relate to Scotland today? Important decisions need to be made, and should be based on evidence rather than on instinct.

David Hume was a defender of the Union, on characteristically pragmatic grounds - "The Scottish nation, though they had never been subject to the arbitrary power of their prince, had but very imperfect

¹⁷ Recent events in the field of climate change provide an example. The UK, and Scottish governments are committed to reduction in CO₂ emissions. This is happening in the US where increased use of natural gas is displacing coal. But in the UK, and in the EU generally, there is considerable reluctance to extraction of gas by fracking. Coal prices are falling as a consequence of the exploitation of natural gas in the US. At the same time the collapse in the carbon price in the ETS provides a further financial incentive to increase the use of coal.

notions of law and liberty, and in scarcely any age had they enjoyed an administration, which had confined itself within the proper boundaries.”

"By their final union alone with England, their once hated adversary, they have happily attained the experience of a government perfectly regular, and exempt from all violence and injustice."¹⁸

Daniel Defoe, writing a few years earlier than Hume, drew attention to the advantages of the Union in opening up the Atlantic trade, especially to Glasgow, and recommended the building of a Clyde:Forth canal so that Edinburgh could also enjoy them.

Much water has passed under the bridge since then. Greater devolution, indeed independence, is in the air, in London as well as in Edinburgh.

What might Hume have thought? His comments on Hobbes reveal that he would have been sceptical of any unique solution:-

"Hobbes's, ... though an enemy to religion, partakes nothing of the spirit of scepticism; but is as positive and dogmatical as if human reason, and **his** reason in particular, could attain a thorough conviction in these subjects."¹⁹

I like to think that Hume would agree that for greater devolution to bring widespread benefits, it needs to be accompanied by more analytic (i.e. system 2) activity - particularly if, through the widening of experience, it **enhances** instinctive (system 1) activity.

Such analytic work should involve:-

- enriching the economics beyond the narrow confines of macro-economic demand management,
- recognising that while the events of the past may shape aspirations, moving on is critical to future success,
- giving Scotland's economy an environment favourable to opportunity and creativity,

¹⁸ David Hume *The History of England* Vol. VI p. 223 Liberty Fund, Indianapolis 1983, based on the Edition of 1778 with the author's last corrections and improvements.

¹⁹ *ibid*, p.153

- understanding the aspirations of other citizens of the UK who are also facing opportunities and challenges,
- avoiding fashionable blind alleys, such as exports of renewable energy and water,
- testing ideas in interdisciplinary and lay fora, using Socratic or Humean dialogue.

The difficulties of the Euro show the folly of putting aspirations before capability and relying on “political will”; unless our leaders are hard-headed they soon need hard hats. The direction of change may not be forecastable; but scenarios could be developed, often scenarios about how to respond to unexpected turns of fortune.

This should be done, I believe in the spirit of Hume and Smith, not in that of Say and Samuelson, **without** forcing everything into an economic model.

A key issue is whether an independent Scotland should stay in the sterling area, join the Euro or operate a separate currency, as does Sweden. The Scottish Government may find the fiscal rules of the UK Treasury irksome, but there can be no guarantee that those set for new entrants to the Eurozone would be any more relaxed.

If Scotland were to have its own currency, it would need to establish an expanded political and economic credibility in world currency markets; this would require demonstration of the requisite skills.

It will be interesting to hear what Patrick Honohan, the Governor of the Central Bank of Ireland might say on these issues when he comes to the DHI in November. Ireland has experience of being in the sterling area: running its own currency, the Irish punt: and now being a member of the Eurozone.

In these situations, how would the development of public infrastructure be financed? Investment in the water environment has been cut,²⁰ treating Scottish Water as an agency of government rather than as a business. Abolition of the tolls for the Forth bridge coincided with the need for a new crossing.

²⁰ See my article in the Scotsman in August 2011

If Scotland were to borrow on world markets, within the fiscal constraints of the pound, or those of the Euro, or outside them - would its credit rating be in the category of Spain or Italy, or that of the UK and Sweden? Where is the evidence that it would quickly command the confidence of world investment markets?

Another issue, less often mentioned, is the political economy of income distribution, trying to understand the current widening of the distribution. In the United States the incomes of most people are stagnating while there are substantial increases among certain professional classes, not only bankers and CEOs; such changes seem linked with changes in world trade.

I suspect, that there may be similar trends in the UK and in Scotland. What implications might this have for taxation in Scotland, both for corporates and individuals, and for the provision, and financing, of public services? And what effect would Scottish taxation and public expenditure policies have on migration in and out of Scotland?

Despite Scotland's achievements in higher education, differing policies in London & Edinburgh on fees and public support are already providing an incentive to reduce access by Scottish students to the best institutions²¹ – to the detriment of Scotland's human infrastructure, and its capability for strategic thinking. I am delighted to see the interest that this Institute has taken in these issues.

And what of policy on social security, crucial to employment and income distribution? Would a more devolved Scotland leave this to the UK, or want to evolve a policy of its own? And if so, how would UK policy develop? Who is going to set out the whole picture?

Would different policies on social security risk fragmenting the UK labour market, and so making macro-economic adjustments more difficult by reducing the mobility of labour between Scotland and other parts of the UK?

Scotland has some very successful industries; oil, whisky and tourism all make good use of Scotland's natural assets. What policies will best

²¹ Only a third of undergraduates at St Andrews are Scottish & present arrangements present powerful incentives to students from non-UK EU member States and incentives to Universities to recruit non-EU students.

provide industries such as these with opportunities to continue to be innovative and creative?

What kinds of institutions are required to support good decisions on economic and social policy? Two developments seem particularly important. One is building the right economic, political and social research bodies, where much remains to be done.

The other is the development of institutions that can question, inform, and guide the intellectual culture of Scotland.

Greater home-based analytic capability, arising from both these developments would provide Scotland with more sustained political power than does rhetoric on macro-economic plans.

Some of the right institutions are already in place. Where infrastructure is concerned, the Scottish Futures Trust has proved to be a useful innovation, although it needs more assets, perhaps including those of Scottish Water, to realise its full potential.²²

There is an urgent need for a Treasury function within the Scottish Government, widening out beyond the allocation of inflows from the Barnett formula to analysis of economic, and social policies. It needs to cover micro- as well as macro-economic issues including corporate & individual taxation.²³

And it needs to earn the respect of Treasuries & Ministries of Finance in other jurisdictions, both within the UK and outside it.

Linking planning to monitoring is essential to the operation of a good system. An enhanced Treasury function within the Scottish government would complement the capability, and excellent work, of Audit Scotland, presented to the DHI by the former Auditor-General, Robert Black, earlier this month.

The Scottish Parliament should play an important role in challenging the Scottish government, using the right economic and social tools, and recruiting such expertise as it requires to do the job.

²² If Scottish Water were to be refocused as a public interest company, it could fulfil that function. See SFT website for model of a Scottish water as a public interest company. See my August 2011 article in the Scotsman.

²³ See my article in the Scotsman in August 2011 for a fuller account of this proposal.

There is also a strong case for more independent economic and social research in Scotland, on the lines of the London-based Institute for Fiscal Studies (IFS) and National Institute for Economic & Social Research (NIESR). The Universities could contribute under the "relevance" banner.

Such research could concentrate on Scottish issues, remembering, of course, that Scotland is part of the world economy - and the world community.

The public sector needs to study how people respond to incentives, in particular whether through system 1 instincts or through system 2 analysis, and how better system 2 analysis can influence and enhance system 1 reactions .

In some areas, we can rely on well developed institutions, such as taxation advisers; in others we are dependent on the information collected by governments, but not always well analysed by them. And we always must be on the lookout for better data carefully focussed on the particular issue.

Issues, evidence and research results need to be discussed, and tested – in proper Platonic or Ciceronian or 18th Century form. The David Hume Institute provides such a facility, where inquiry, scepticism and evidence can mingle in a conversation worthy of enlightenment Scotland.

Hume himself leads the way - “I find myself ... determined to live, and talk, and act like other people in the common affairs of life, yet in all the incidents of life we ought to preserve our scepticism.”

There may be important lessons to be learned from Westminster. Both the House of Commons, and perhaps more the Lords, have shown that system 2 analyses are always worthwhile.²⁴ They may not always carry the day, but can be effective in stopping, slowing or reversing ill-considered proposals.²⁵

²⁴ The Economic Affairs Committee of the House of Lords is currently conducting an inquiry into the Economic Implications for the United Kingdom of Scottish Independence.

²⁵ I remember asking an official in the Executive Office of the President in Washington DC, what was the main aim of zero-based budgeting. His answer – to get analysis into long unquestioned areas of Federal expenditure – was very instructive

And people in Scotland have shown interest in the performance of other smaller economies. May I quote from a report by the Munich economics institute²⁶ on the successful operation of the Swedish economy - an economy that has managed the recent crisis better than most?

Three lessons stand out :-

"A deep fiscal crisis may help to forge a broad consensus on the merits of budget discipline,"

"Well-defined fiscal objectives, fiscal transparency and a qualified economic-policy debate may be more important to fiscal discipline than binding rules," &

"The framing of budget decisions, particularly a well-defined process for evaluating the scope for active tax & expenditure decisions, may be of great importance."

How far is Scotland along these paths? Plenty of food for discussion there.

So, are Instinct & Analysis choices for Scotland? By instinct, I mean Kaheman's system 1, the system that he says is the hero of his book. By analysis, I mean his system 2, systematic thought and interrogation of data.

Clearly both are needed - like Maisky's bagpipes **and** Hume's scepticism. I would like to push the debate towards more system 2 activity in Scotland - and a development of the institutions that can facilitate this.

I believe that inquiry into matters economic has become too narrow in scope and in focus. It needs to widen out again in a new enlightenment. The world of Econs needs to expand, intellectually and operationally to deal with the world of Humans.

In this city of Hume we should begin by being very careful in the use of the dangerous word "rational".

We must recognise and improve our understanding of the crucial importance of incentives. They are social, psychological and

²⁶ *The EEAG Report on the European Economy*. Eleventh Annual Report 2012. CESifo, Munich 2012
See also Nima Sanandaja *The surprising ingredients of Swedish success - free markets and social cohesion*.
Institute of Economic Affairs discussion paper #41 August 2012

institutional as well as economic and financial; and their effects are both interactive and cumulative.

Institutions matter. I have argued for the creation of a fuller Treasury function inside the Scottish Government: for linking its work to that of Audit Scotland: for challenging its work in the Scottish parliament and by a well-financed independent research body along the lines of the London-based IFS

These issues should be discussed in proper enlightenment conversations, in symposium form, to test the underlying analysis. Scotland is fortunate in the intellectual inheritance of Smith & Hume. It is fortunate in having an educated, articulate and interested bourgeoisie.

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