



**Danish Fairy Tales?
Arthur Andersen and the Copenhagen Consensus**

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transcript of a talk by
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Good evening ladies and gentlemen.

It is a pleasure to see such a wonderful turnout for this inaugural lecture. Before starting I want to express my admiration for the previous holder of this chair, Professor Avinash Persaud. Naturally, while composing tonight's lecture, I looked back at his legacy of the past three years – Professor Persaud has left a pair of very large shoes to fill.

While an enthusiastic turnout is much appreciated, some of my friends have clearly let their eagerness to get that 'one lecture they promised to attend' out of the way over-ride my warning about the first lecture. I intend during this lecture to set the scene for the next 17 lectures, so this may well be the driest lecture of all, at least until the reception afterwards – or perhaps friends have heard the legend of the Gresham's drinks cupboard.

Well, as we say in Commerce – "To Business".



Outline

- The Great 'Commerce' Experiment
- The "End of History"
- Danish connections
- Fret-Enomics
- Might versus Right
- A theory of Commerce?

The Great Commerce Experiment

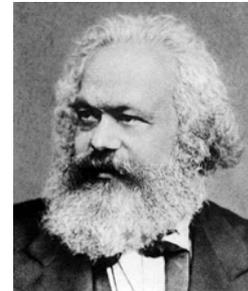
During the 19th century, great people conducted great experiments and developed great theories. Michael Faraday demonstrated electro-magnetism. Louis Pasteur developed vaccines. Marie and Pierre Curie worked on radioactivity. Charles Darwin developed the Theory of Evolution. Albert Michelson and Edward Morley set out to measure the speed of light, in the process demolishing the 19th century's equivalent of 'dark matter' - the ether - and paving the way for Einstein in the 20th century.

During the 20th century, great experiments continued. 20th century experiments were often larger group efforts, sequencing the human genome, developing the computer, the atomic bomb and the hydrogen bomb. Our first Danish connection is the scientist Niels Bohr. He warned us that "prediction is very difficult, especially about the future" and ensured the difficulty by developing quantum mechanics, but we dare to predict further scientific advances in the 21st century by larger teams on quantum computing, unravelling the human proteome or understanding the human brain. What have been the great advances in Commerce?



The Great 'Commerce' Experiment

- Adam Smith
- Karl Marx
- The Great Transformation
- Visible Hand versus the Invisible Hand



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The field of Commerce took a great theoretical leap forward in the 18th century with Adam Smith. Smith developed the foundations of economics, focusing on the creation of wealth and developing the idea that social science could pursue the methodology of the physical sciences, such as physics or chemistry, by breaking down human behaviour into smaller units and modelling the interactions. Smith provides the philosophical underpinning for modern, libertarian, capitalism and the idea that self-interest benefits all, “greed is good”. In fairness to Smith, he felt uncomfortable with pure capitalism and highlighted the moral ambiguity of good arising from “selfish passions” in *The Theory of Moral Sentiments*.

In the 19th century, Marx reacted to the end of mercantilism and the rise of classical capitalism by pointing out that production could not be separated from distribution. Marx developed his theories by focusing on the distribution of wealth as a key determinant of the social consequences of economics. While the Great Powers were busy playing ‘The Great Game’ of empire, I contend that we unwittingly conducted a great ‘Commerce’ experiment in the 19th century when we underwent what Karl Polanyi termed “The Great Transformation”. Polanyi explored the social implications of the 19th century transformation from a mercantile civilization, where social institutions regulate markets, to the market economy, a self-regulating system of markets where markets partially control human society. Polanyi believed that four institutions underpinned 19th century civilization – the balance of power system, the international gold standards, the self-regulating market and the liberal state. It was not a deterministic conclusion that this would work so well with global trade freer than at any time before or since, that whole economies grew rapidly, that millions of people were lifted out of poverty or that innovation would improve lives. Niall Ferguson points out that a combination of Christianity, Civilisation and Commerce was seen as the culminating form of social evolution. The outcome for Commerce, a culture of



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capitalism and free trade done the western way, was definitely not a foregone conclusion, because early in the 20th century all this changed as Marx's concerns became the concerns of all.

In the 20th century, we can pick out the numerous great contributors to economic and commercial thinking – Keynes, Samuelson, Hayek, Galbraith, Friedman, Sen, Modigliani, Miller, Merton, Scholes or Kahneman – to mention a few. However, in the field of Commerce, what were our great experiments of the 20th century? Well, strangely, I contend that one 'Commerce experiment' we undertook in the 20th century was far and away the largest experiment ever conducted in the history of mankind. This experiment consumed more resources and had more intellectual input than any physical or medical scientific experiment. Almost every human being who lived during the 20th century had a part in that experiment, though the results have been a bit inconclusive and in many cases conveniently ignored. I call the experiment the 'Visible versus the Invisible Hand'. We divided the world into two halves, with a control group for good measure. We labelled the two experimental halves, 'communist', and 'capitalist', and we called the control group 'the developing world'. Our null hypothesis was that there was little difference between the communist and capitalist systems in equity or efficiency. We stirred in a cornucopia of currencies, plenty of politicians, copious amounts of conflict and a few bits of technology. Then we shut the experimental box, sat back and waited for the results.

The End of History



The "End of History"

- Francis Fukuyama
- Emperor's new clothes



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As the Berlin Wall came down in 1989, we prepared to open the experimental box and peep inside. In 1992, in his influential book, *The End of History and the Last Man*, Francis



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Fukuyama started to publish his version of the results – the Invisible Hand of Adam Smith had prevailed over the Visible Hand of Karl Marx. The combination of liberal democracy and capitalism was probably the most fitting form of government and economics, the culminating form of civilisation. With the demise of centrally planned economies, unable to support the demands of modern societies, Fukuyama mirrored Marx's contention that socialism would be the culminating form of civilisation. Fukuyama seemed to echo Polanyi, who recognised that the market economy had “produced an unheard-of material welfare”, in a world where GDP per person rose seven-fold in the last century alone.

So there we have it. While physicists struggle for a great unifying theory or medical researchers try to find the seat of consciousness in the brain, students of commerce, finance and economics have it mostly tied up. Sure, there are a few refinements to come and little bits of our collection still to mount. We could explore areas where capitalism might work without liberal democracy. We might feel a bit queasy about the solidity of a new paradigm based on never-ending globalisation, but what's the alternative if this is truly the End of History. Basically, we know it all.

Since we do know it all, history has ground to a halt, and we have a bit of time before this lecture is scheduled to end, perhaps we could explain the title of this talk. Hans Christian Andersen was a Danish storyteller who wrote a fairy tale about an Emperor's new clothes. The Emperor was conned by some swindlers and swindled himself into believing that his invisible clothes were the height of fashion. His illusion was shattered when a young boy said, “but he has nothing on at all!”

In many ways, this lecture is about ignorance and Emperors' new clothes. In the field of Commerce, which entangles at least economics, sociology, law, psychology and a smattering of political science, I'm not sure that we know much. In fact we have plenty to be ignorant about, but this ignorance is hardly bliss – it's stress-inducing. Perhaps, in Commerce, we “have nothing on at all.” Let's look at two examples of flagrant ignorance, Arthur Andersen and the Copenhagen Consensus.

Danish Connections

Arthur Andersen, no relation to Hans Christian, was one of the world's great accountants. The son of a Norwegian immigrant to the USA – it would have helped the title of this lecture immensely if he'd been Danish – he founded a firm which grew to be one of the Top 5 global auditing firms. The firm of Arthur Andersen applied our most sophisticated thoughts on accounting, how companies should be controlled, how we measure performance, how responsible managers should be to owners and to society. We know one infamous result, Enron. One bad audit led a global firm to implode in a matter of months. But along the way, it turns out that Enron was not an isolated case for Andersen – there was also Waste Management, WorldCom, Global Crossing and Qwest. It wasn't all Andersen as Tyco, HealthSouth, Adelphia and others show. I don't want to recap the few hundred billions that were lost by investors or trade partners, nor the role of banks, nor the blindness of credit rating agencies, nor the way in which a supposedly sophisticated analytical investment community missed all of this over periods of years. I just want to say that liberal democracy and capitalism seem to have had “nothing on at all”.



Danish Connections

- Arthur Andersen
 - Enron
 - Waste Management
 - WorldCom
 - Global Crossing
 - Qwest...
- Tyco, HealthSouth, Adelphia...
- Emperor's new clothes?



One Danish connection is the Copenhagen Consensus. In 2003, Denmark's National Environmental Assessment Institute came up with an initiative to evaluate the costs and benefits of alternative public policy actions in a wide range of key policy areas. The basic idea was to produce cost/benefit analysis for 10 challenges and have these analyses rated by eight leading economists (in the event, three of the eight were Nobel laureates). The idea was championed by Bjørn Lomborg, director of the Institute, and the controversial author of *The Skeptical Environmentalist*. *The Economist* newspaper supported the idea and reported on a number of the challenges as well as the overall consensus in mid-2004.

Starting with a long list of 33 challenges facing humanity, the Consensus team focused on 10 they believed to be most promising; they didn't shirk tackling the genuine 'Biggies'. The results were that these leading economists felt that public policy monies were best spent on curing the communicable diseases of AIDS and malaria, liberalising trade and tackling malnutrition and hunger by providing micronutrients.



Copenhagen Consensus – 10 out of 33

- Climate change
- Communicable diseases
- Conflicts and arms proliferation
- Access to education
- Financial instability
- Governance and corruption
- Malnutrition and hunger
- Migration
- Sanitation and access to clean water
- Subsidies and trade barriers



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The final results have startled a number of people and generated quite a bit of controversy, particularly the low ranking of climate change initiatives. For instance, initiatives for stopping climate change are ranked not only well below trade liberalisation, but even below reducing the costs of starting a new business. The controversial elements are exacerbated by Bjørn Lomborg's reputation – he is a bit of a *bête noir* for environmentalists. But a number of less passionate critics also feel “something is rotten in the analysis of Denmark” when the need to stop global warming is ranked below lowering barriers to migration for skilled workers. A critical consensus (sic) seems to have arisen among gainsayers:

- ◆ the Copenhagen Consensus is discriminatory – the economists, particularly Lomborg, are characterised as systematically discriminating against environmental challenges, e.g. via the use of an inappropriate discount rate;
- ◆ *ab initio* rejection - you just can't do this kind of analysis;
- ◆ garbage in, garbage out – the data was poor or the starting set of opportunities was poor, particularly for the environment.



Copenhagen Consensus – Go!

Ranking	Challenge	Opportunity
Very Good	1. Communicable diseases	Control of HIV/AIDS
	2. Malnutrition and hunger	Providing micronutrients
	3. Subsidies and trade	Trade liberalisation
	4. Communicable diseases	Control of malaria
Good	5. Malnutrition and hunger	Development of new agricultural technologies
	6. Sanitation and water	Community-managed water supply and sanitation
	7. Sanitation and water	Small-scale water technology for livelihoods
	8. Sanitation and water	Research on water productivity in food production
	9. Governance and corruption	Lowering the cost of starting a new business
Fair	10. Migration	Lowering barriers to migration for skilled workers
	11. Malnutrition and hunger	Improving infant and child nutrition
	12. Communicable diseases	Scaled-up basic health services
	13. Malnutrition and hunger	Reducing the prevalence of low-birth-weight (LBW)
Bad	14. Migration	Guest worker programmes for the unskilled
	15. Climate change	Optimal carbon tax
	16. Climate change	The Kyoto Protocol
	17. Climate change	Value-at-Risk carbon tax

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If this Copenhagen Consensus approach is so good why does it come up with an answer many, e.g. the environmentally concerned, feel is so wrong? We have plenty of scope to conclude that “1. Our Approach Is Wrong And We Got The Wrong Answer”. We can critique cost/benefit analysis on many inputs such as cost calculations, benefit calculations, timeframes or discount rates. Can you divorce benefits from values? Is the currency used for these decisions, ‘quality of human life’, measurable or right? Does this kind of analysis encourage ‘train wrecks’, i.e. could we wind up unwittingly passing a point of no-return on climate change?

We could also conclude that “2. Our Approach Is Right, But We Got The Wrong Answer” if we used poor data or inconsistent data across these enormous issues. Policy decisions depend on having options to implement. Perhaps climate change investment is the most important policy area, but we don’t yet have good options for investment. Perhaps we should invest in creating more innovative options.

We could also conclude that “3. Our Approach Is Right And We Got The Right Answer”, but we feel we’re wrong because we have to change our perceptions of risk. Perhaps “We’ll Never Know If Our Approach Is Right or Wrong – Or The Answer Is Right Or Wrong”. Perhaps our progeny want to live in a world where they huddle around oxygen-generators in a 65-degree Celsius world? Perhaps some futuristic, intelligent CO₂-breathing lizards will thank us.

Finally, we could conclude “4. Our Approach Is Wrong But We Got The Right Answer”. A happy accident despite the application of our finest minds. If the approach is wrong, what do we suggest as an alternative?

This Copenhagen Consensus approach is important, because the cost/benefit approach these economists used to tackle our biggest worries is the same approach that economists and politicians believe to be core to effective policy-making. While not on the scale of the ‘Visible Hand versus the Invisible Hand’, the Copenhagen Consensus was one of the first great Commerce experiments of the 21st century. If the approach and results are right, then our priorities should change rapidly. We should stop whinging about Kyoto and declare total war on malaria.

So where are the Emperor’s clothes? Our greatest economic minds and policy makers seem unable to persuade us to re-order our priorities based on rational analysis. Shouldn’t we be concerned – are we making the wrong choices? Shouldn’t the economists and policy makers be concerned – are they irrelevant? Perhaps they, and we, have “nothing on at all”.

Fret-Enomics



Fret-Enomics

- Homo economicus
- Efficient Markets Hypothesis



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So if History is at an End, it’s not a pleasing one with a rickety governance structure and almost wilful ignorance of the disciplines that got us here. If economists and policy makers were forced to apply Hippocrates’ dictum, “first, do no harm!”, what might they be allowed to do at all? Yet while the Great Experiment may have concluded slightly inconclusively in the 20th century, in the 21st century we continue to experiment in Commerce. The Euro (€) experiment is not over. Pension experiments abound in countries throughout the world. We continue to try to re-establish proper free trade using the World Trade Organisation. Regulatory tests proliferate from banking regulation to hazardous chemicals. So where should we fret about economics experiments?



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Classical and neo-classical economics are primarily about the efficient allocation of resources. But they are not the only economics, as any Marxian would rapidly assert as he or she explains the importance of the distribution of wealth. Classical economics is easily criticised. Chuck Reid is supposed to have remarked, “In theory, there is no difference between theory and practice; In practice, there is.” Classical economics relies heavily on the theoretical ideal of homo economicus, the ‘rational man’. The rational man is certainly someone you don’t want to go out with for a friendly chat – he is fixated on a goal, highly logical, exceedingly well-informed and unswayed by emotion; Star Trek’s Mr Spock without the small talk. Rational man would always maximise his general ‘happiness’, or ‘utility’ to Jeremy Bentham and John Stuart Mill. Economists seem to have had no lack of imagination when making assumptions about their fellow man, but not a lot of empathy. Human behaviour leaves a lot to be desired – or we seem to desire a lot before we start to behave the way economists expect. This is a bit unfair. Economists have long realised the limitations of assuming that actors are all rational people. As *The Economist* newspaper explains, “The dominance of rationality went hand-in-glove with the growing use in economics of mathematics, which also happened to be much easier to apply if humans were assumed to be rational.”

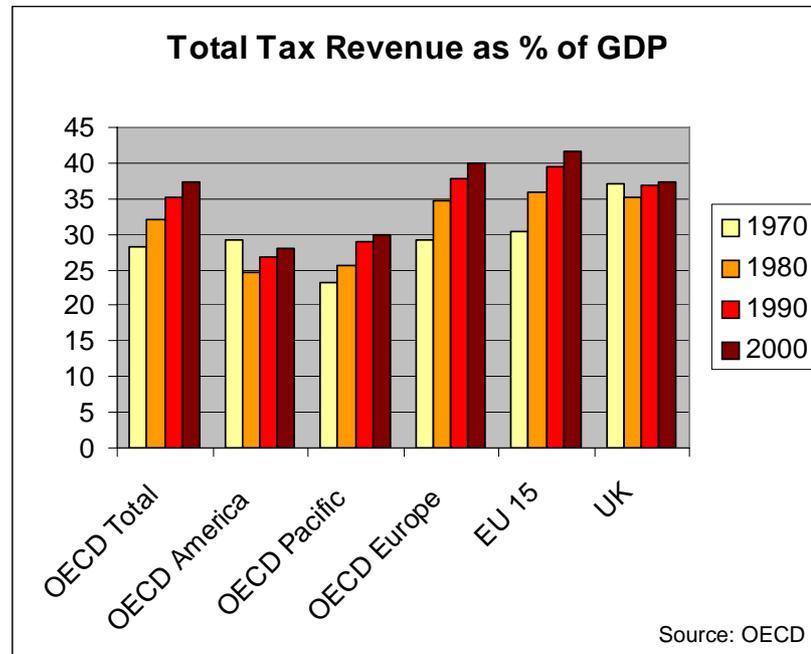
So no one seriously assumes that people are wholly rational, i.e. making near-perfect decisions, nor wholly irrational, i.e. making decisions on whims. A lot of the fun in current economics involves studies of how human beings exhibit consistent non-rational behaviour. This has given rise to behavioural economics. One of the leading theories in behavioural economics is Prospect Theory, for which Daniel Kahneman was awarded the Nobel Prize for Economics in 2002. Prospect Theory looks at how real people make decisions under uncertainty. For example, Colin Camerer, an economist at the California Institute of Technology, points out that New York taxi drivers tend to stop work each day when they hit a daily income target. A rational person would work longer on a busy day because the hourly wage-rate is higher, not stop because he’d met his target. Prospect Theory predicts that the taxi driver has ‘framed’ his success. If he or she fails to hit the daily income target it feels as if he’s losing, so he works longer. If he or she beats the target he’s winning and loses the motivation to continue. But if so much of economics depends on non-existent rational people, perhaps economics as a discipline “has little on at all.”

Like the rational person, there is a similar article of faith in finance, the ‘Efficient Markets Hypothesis’. This theory assumes that the prices of financial assets are rationally based on all available information. As all available information is contained in today’s price, future random events will dictate the outcome of any investment. As a result, we know for a fact that no one can consistently earn a higher return than the market average. According to this theory, towards which I happen to lean, no one should have a successful job picking stocks. However, it is a bit strange that many people who believe the Efficient Markets Hypothesis and study at our great financial universities then go and seek jobs with investment management firms and ask for our money in order to go picking stocks. We have even seen Nobel Prize winners humbled by the Efficient Markets Hypothesis as their investment strategies collapsed catastrophically in Long Term Capital Management. Is it surprising when looking at the extent of financial disasters for consumers – just take the recent split capital trusts, endowment mortgages, pensions mis-selling, insurance company collapses or bank failures, punctuated now and again by a stockmarket collapse – that there is little trust between the engines of finance and the end customer? Perhaps finance as a discipline “has little on at all.”

Might versus Right



Might versus Right



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A good example where all theory is thrown out is taxation. As our enormous ‘Visible Hand versus Invisible Hand’ experiment demonstrated, capitalism rules. Strangely though, since publication of the results of the experiment, government tax takes are increasing, and not just in absolute terms, but as a proportion of bigger economies. According to theory, tax competition among countries should mean that taxation as a percentage of GDP decreases over time. Unfortunately for theory, it has been steadily increasing. And increasing in the face of the great experiment. While the UK figures make it seem as if we’re muddling through, don’t forget that they are flattered by the off-balance sheet presentation of the Private Finance Initiative and Public Private Partnerships. Further, the liabilities of unfunded public sector pensions now exceed public debt.

As evidenced by their taxing and spending, governments seem mainly concerned with redistribution, reducing one group’s welfare so as to improve another’s, with some transaction costs in between, and all in pursuit of votes. Andrei Shleifer of Harvard University and Robert Vishny of the University of Chicago explore the ‘grabbing hand’ of government by pointing out that while it frequently masquerades as a ‘helping hand’ to the ‘invisible hand’, correcting market failure, government is a self-perpetuating entity with an appetite for growth. Governments are chiefly concerned with winning power, exercising power and hanging on to power. Even today, politicians such as Venezuela’s Hugo Chavez get away with saying it’s “either capitalism, which is the road to hell, or socialism, for those who want to build the kingdom of God here on earth”.



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We find that our great experiment's results are not clear cut, possibly because we haven't defined capitalism properly. Variety within capitalist systems is great. We have countries with over 50% of GDP taken by tax, others with as little as 15%. Some capitalist societies nationalised health or transport or telecoms or energy or broadcasting, others not. While communists may believe solely in the visible hand, social democrats make sure the visible hand stays in sight at all times as they try to remedy what they see as the inevitable market failures inherent in the system. In contrast, an overly-pure Chicago School disciple believes that, as the market always provides what is best, then this is the best of all possible worlds, except where even freer markets would make it a better world. If Fukuyama's thesis is correct, that liberal democracy and capitalism are the end of the road, the new challenge is to decide within liberal democracy and capitalism what is best done by the 'state' and what is best done by the 'market'. We move from a few macro-decisions to many micro-decisions, and this provides us with lots of other little puzzles to ponder that show we may "have little on at all", for instance:

- ◆ At a firm level, why do the great multi-national corporations look more like centrally planned bureaucracies than challenging capitalist hothouses? Instead of being mini-capitalist societies, these organisations are budget-obsessed with communist-sounding three and five year plans. These behemoths are run like communist-era entities, but then spend enormous amounts of money on training courses in innovation, radical change and leadership;
- ◆ At a state level, why is a state with a chronic water problem at the heart of the USA agricultural industry, producing almost all of America's grapes and three-quarters of America's strawberries and lettuce? If the distortions of subsidised water are not altering behaviour badly enough, California also managed to manage its energy market into a joke, a joke full of brown-outs and black-outs;
- ◆ At a country level, why do we have corporation taxes? Corporations are owned by us – directly or through our investments such as pensions. 'Corporation tax' is a fiction – we pay the taxes as shareholders and the resultant confusion hampers the debate on the correct level of overall tax. Why are flat taxes so hard for old capitalist countries and so easy for the new?
- ◆ At an international level, why does Europe persist in subsidising sugar beets well up in the Northern Hemisphere? The Anti-Nobel prize for Economics could easily go to almost any section of the European Union's Common Agricultural Policy. How can a Trade Commissioner representing 25 nations on textiles take so long to understand quotas? As Peter Mandelson said, "When you intervene in a market in this way the law of unforeseen consequences will inevitably kick in." Trying to manage trade through quotas, he said, is "intrinsically difficult". Why couldn't he just say, "wrong"?
- ◆ Why do we still have poverty in a world where overall production is sufficient? If distribution is the problem, why can't markets fix this? At the same time, why do numerous small countries around the world believe that they can 'manage' their economies, when countries with plentiful resources and skills can't?
- ◆ At a global level, economists are seriously debating whether the world is experiencing excess saving or excess liquidity. They are returning to Sir John Hicks Investment/Saving : Liquidity/Money framework of 1937. But if they can't answer the saving or liquidity question, how can we start to use the policy tools on currencies or investment that need these parameters? Brent Crude has moved from less than \$15 a barrel in 1998 to over \$60 in 2005 – yet why are production and consumption levels very similar? How can financial technicians complain about the abnormal distributions of finance, yet be surprised that 1 in 300 year events happen every 3 years?

- ◆ Why do we believe that the defence of intellectual property with patents, trademarks and copyright has led to fantastic exploitation of knowledge rather than gridlock? Most appropriation of intellectual capital occurred after innovation rather than before. How can we countenance the ownership of previously free goods such as plant genomes or business processes? Is this bio-piracy or process-piracy?
- ◆ How can consumers, who persistently want low-priced goods in order to improve their standard of living, hate globalisation? Clare Boothe Luce may have coined the term 'globaloney' in 1943 to trash Vice President Henry Wallace's 'global thinking', but Michael Veseth is right to resurrect globaloney to point out that globalisation involves "a complex and subtle web of economic, political, and social change" subject to much misconception. We seem to have debunked the myth that world trade and investment benefits the wealthy at the expense of the poor to the point that leading charities and development agencies now support free trade, yet trades unions and the general public seem to have missed the exposure of anti-globalisation as claptrap. We may be winning some minds to support globalisation, but few hearts;
- ◆ Yet while great swathes of the population hate globalisation, large numbers of people, including many in the anti-globalisation camp, appear to support privatizing air rights and trading them on a global basis, the Kyoto Protocol.

A Theory of Commerce?



A Theory of Commerce

- ◆ Economics with finance
- ◆ Decision theory
- ◆ Stochastic systems theory
- ◆ Competitive selection



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So what is Commerce as a field of study? At heart, Commerce is about exchange between people. Commerce is about social interactions where people exchange ideas, opinions or merchandise. Commerce is intrinsically linked with economics and finance. Yet Commerce is also intrinsically linked with politics and sociology. I don't want to be caught



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trying so hard to avoid the danger of seeming to be captured by economics or finance that I struggle too hard with artificial distinctions among disciplines. Commerce looks at economics and finance, but it equally looks at government and society. What is best done in the state, best done in markets or perhaps best done in neither, perhaps the voluntary sector? In many ways Commerce is concerned with public-choice theory and private-choice theory, and where the two interact. Commerce attempts to span a sea of atomistic decisions and a land-mass of concentrated decision-making.

Sir Thomas Gresham founded Gresham College in order to promote the New Learning of Natural Philosophy. What is the New Learning in Commerce today? The physicist David Deutsch remembers the wonder of being told as a small child “that in ancient times it was still possible for a very learned person to know *everything that was known*.” He points out that a good interpretation of *everything* was that the very learned person should have the right concepts, explanations and theories to understand and explain the fabric of reality. Deutsch contends that the four key theories for understanding the universe are quantum physics, epistemology, the theory of computation and the theory of evolution. Deutsch prompts an excellent, similar question for us, what should a learned person know in order to know *everything that is known* about Commerce?

I would contend that there are some strong parallels in Commerce with Deutsch’s answer for the physical world. I would set out four basic areas of knowledge that we must integrate in order to have a framework for understanding and explaining Commerce:

- ◆ economics with finance: rather appropriately, these two disciplines form Commerce’s parallel to quantum physics. With economics and finance we can work on the fundamental calculations of exchange between people. I will draw upon economics and finance in future lectures, including topics such as how corporate social responsibility or good governance can be calculated to add to shareholder value and the puzzle of corporation tax;
- ◆ decision theory: understanding the complexity of human choice starts with epistemology, but adds physiology, psychology and sociology. We need to understand how humans develop knowledge and biases and how these perceptions affect their behaviour individually and in groups. I intend during future lectures to explore decision-making under uncertainty, the perils of too much choice and how measurement skews choice;
- ◆ stochastic systems theory: Commerce’s closest equivalent to computation theory melds a systems theory view of the world with an ability to handle non-deterministic outcomes. Systems theory encourages us to decompose complex systems into sub-systems, recognising interlinked feed-forward and feed-back loops. A stochastic view of the world develops our appreciation for the roles of chance and imperfect information both in planning forward and evaluating backward. Stochastic systems theory will feature in future lectures concerning chaos, the governance of markets and the links between markets and governments;
- ◆ competitive selection: in many respects Commerce too requires its own application of the theory of evolution acting at the level of families, firms, societies and governments. Joseph Schumpeter initiated evolutionary economics with his concept of ‘creative destruction’. At the extreme, we could view war as “the continuation of Commerce by other means”. A good question for a theory of Commerce might be – “how can one of the greatest market economies jump-start a medium-sized economy in the Middle East for a country about twice the size of Idaho and with one-tenth of the USA’s population?” There are numerous comparisons to be made between Commerce and



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evolution including the idea of a fitness algorithm for survival or the constitution of an ‘institutional’ gene. Studying evolution starts with a study of history. I will incorporate competitive selection in explaining NGO development, trade policy formulation and the evolution of standards.

So there we are, four key theories we need to develop in order to have a framework for understanding and explaining Commerce – economics with finance, decision theory, stochastic systems theory and competitive selection. What would we do with an overall theory of Commerce? Edward O Wilson, Harvard’s famous entomologist, has resurrected the term ‘consilience’ to describe the means of unifying knowledge. He believes as I do, as many other Gresham professors do, that “the greatest enterprise of the mind always has been and always will be the attempt to link the sciences and the humanities”. Consilience was coined by William Whewell in the mid-1800’s: “That rules springing from remote and unconnected quarters should thus leap to the same point, can only arise from that being the point where truth resides. Accordingly the cases in which inductions from classes of facts altogether different have thus jumped together, belong only to the best established theories which the history of science contains ... the Consilience of Inductions.”

I believe that Commerce is a justifiable ‘jumping together’ of knowledge linking facts and theories across disciplines. Commerce is a bit like palmistry – we study the visible hand, the invisible hand, the helping hand and the grabbing hand. We do so with a keen eye on the translucent hand. The translucent hand is the hand that gently tips certain choices, say whether to go to war, to government and democracy, while tipping other choices, say on buying a meal, to markets.

Commerce should be invoked when we encounter paradoxes of externalities. Market externalities are spillover effects on the welfare of people outside a market caused by transactions among sellers and buyers within that market. Government externalities are spillover effects on the welfare of sellers and buyers inside a market caused by political decisions. It is easy to observe that governments and markets only exist together – while there are no examples of 100% government societies working, equally there are no examples of a government-free society working. If markets are government externalities and governments are market externalities, then governments and markets are mutual internalities. Markets only exist for society’s sake and therefore must exist within frameworks of law, regulation and taxation. Governments only exist for society’s sake and therefore must exist within frameworks of economics, finance and value creation. Before either the visible hand or the invisible hand can be effective, the translucent hand has to decide which bits are decided where. When the translucent hand makes a good decision, overall wealth is created. When the translucent hand makes a bad decision, we waste time, energy, resources, and even lives.

The overwhelming theme of the next three years of lectures is Choice. I fervently believe that if people had and made better choices every day, then the world would be a better place. Enhancing choice is crucial to successful societies. Sometimes the choices are best made in the market, sometimes in the political arena, sometimes in neither. I would like to make sure that Commerce is about ‘informed’ exchange by giving people more appropriate choices, by putting more science into choices, by putting better choices into societal systems, and by injecting a bit more humour everywhere.



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To conclude, I'm particularly interested in the questions that people feel should be appropriate for the domain of Commerce. We know that the questions "how old is the universe" or "why do planets have elliptical orbits" are proper questions for physics. We know that "how can we treat cancer" is a proper question for medicine. What are the questions for Commerce? –

"How much market, how much state?"

"How do we build successful economies?"

"Is free trade ever bad?"

"Why do we need so many lawyers?"

"Is the customer always right?"

or even Screaming Lord Sutch's excellent conundrum - "Why is there only one Monopolies Commission?"

I hope that tonight's lecture has piqued you enough to pose a few questions or make a few comments.

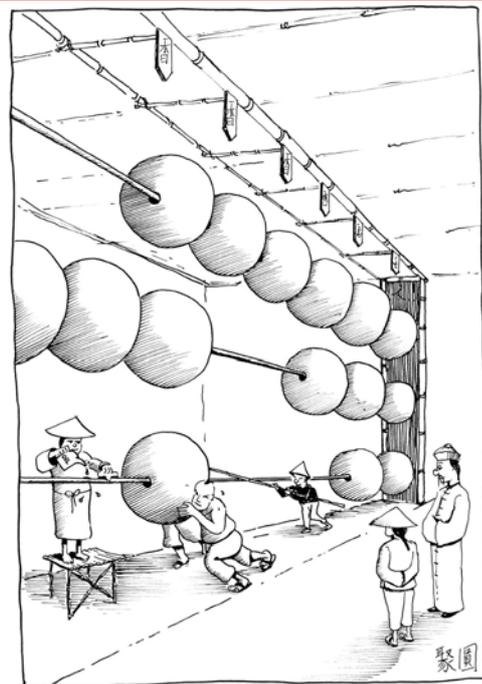


Discussion

What are the frontiers
of our ignorance?

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"Get a big picture grip on the details."
Chao Kli Ning



Thank you for listening.



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Further Discussion

1. Can you make some suggested entries for a Top 10 of failed markets?
2. By what measures have the Top 10 failed markets failed?
3. Where else do economists and financial people seriously misunderstand important aspects of everyday social life?

Further Reading

1. DEUTSCHE, David, The Fabric of Reality, Penguin, 1997.
2. FUKUYAMA, Francis, The End of History and the Last Man, Penguin, 1993.
3. LOMBORG (ed.), Bjørn et al, Global Crises, Global Solutions: Priorities for a World of Scarcity, Cambridge University Press, 2004.
4. POLANYI, Karl, The Great Transformation, Beacon Press, 1957 – originally published 1944.
5. SCHLEIFER, Andrei and VISHNY, Robert, The Grabbing Hand: Government Pathologies and Their Cures, Harvard University Press 2002.
6. SMITH, Adam, The Wealth of Nations, Random House, 2003 – originally published 1776.

Further Surfing

1. www.copenhagenconsensus.com
2. www.oecd.org

Thanks

My thanks to Ian Harris and Andrew Smith for their kind reviews and critiques of this talk. I also capitalised (sic) on a few of their ideas.