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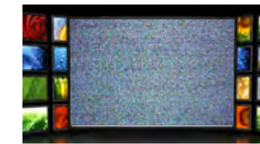

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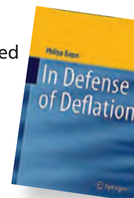

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Looking at the profit motive in education, local currencies...and more

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WELCOME

Migration, the **future of Europe** and the shape and scope of the **sharing economy** are all **extremely hot topics** right now.

So it's entirely fitting they figure prominently in this first **EA** of 2016.

But it doesn't end there. This spring edition from the **Institute of Economic Affairs** also turns the spotlight on two perennially controversial issues – the **funding of the NHS** (page 7) and the **future of the BBC** (page 38).

And **one of the world's leading economists**, **Deidre McCloskey**, delivers her insights on the **inequality debate** on page 4.

Along the way, we **ask whether regulators always have public interest at heart** – and **ask what prison gangs can teach us about economics!**

All, I hope, timely and fascinating stuff.

And, don't forget, you can **read much more** on our website *www.iea.org.uk* or watch over 400 films at *www.iea.org.uk/tv*. And you can follow us on **Facebook** or **Twitter**.

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Happy reading – and happy downloading!

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UNEQUAL but PROSPEROUS

... a better place for the poor to be

DEIRDRE MCCLOSKEY is one of the world's leading historians. Here she takes her place in the IEA interview chair and talks with **PHILIP BOOTH** about poverty, enrichment, inequality and Thomas Piketty

Capital in the Twenty-first Century by Thomas Piketty is the book on every progressive's coffee table at the moment. The book has been dissected by a large number of economists. Does Piketty's argument about the growth of inequality stand up to careful scrutiny?

Not really. Piketty is a serious economist. He's not a liar or a fool. But even serious economists can be wrong in their science: Piketty is.

For example, the only countries in which Piketty finds an actual rise of inequality are the UK, the USA and Canada.

The three cases can be explained by government policies foolishly favouring the rich, such as making it crazily-difficult to build in London, which drives up the price of existing houses – generally owned by the rich. "Capitalism" didn't do it. A form of half-socialism did.

For the other countries, which did not experience a

EVEN SERIOUS ECONOMISTS CAN BE WRONG IN THEIR SCIENCE: PIKETTY IS

rise in inequality, Piketty is warning against the future. But, again, his argument isn't very good. He says that capitalism always causes the rich to get richer and the poor to fall behind. So why not everywhere, every time since 1800? It didn't happen.

One of your criticisms of Piketty's work is that he does not take account of the role that human capital now plays in the economy. How will this affect future trends in inequality?

Most income nowadays in a place like Britain comes not from the physical capital that Piketty measures, and the ownership of which he worries about. It comes instead from human capital – your skills and health and education.

Why and how? Because capitalism has made you the worker 20 to 100 times better off than your ancestors in 1800. You can stay in school much longer or can get highly-skilled training if you are 20 times richer than your great-great-great-great-great grandmum, who went to work herding cows in the Nether Field at age eight.

In 1800 the average person got her bread from labouring with her hands and back. Now you will get it from your better-educated brain.

Once upon a time, the bosses had all the capital, which was mostly land and factories and machines. Now most of the capital is human, owned by the worker – between your ears. (And the physical capital, by the way, is also owned by workers, often, in pension funds and in personal houses.)

Human capital has already made the workers vastly better off, and will do so more and more. Equality of real comfort will go on rising, as it has in the past two centuries – indoor plumbing, colour tellies, better education, overseas holidays, longer life expectancy.

You have made your name as an economic historian. If we look back over the last 200 years what has been more important for promoting increased living standards for the poor: redistribution or economic growth?

Economic growth by far, in what I call the Great Enrichment. How great? As measured recently in real terms per person since 1800 by economic historians, it has been an amazing 20 to 100 times.

In other words (doing the pre-GCSE maths) the Great Enrichment for the average person, including the very poor, was anything from a 1,900 to a 9,900 percent increase over the miserable base in 1800.

And can we quantify the benefits of economic growth compared with redistribution on the living standards of the poor?

Yes, and the results are startling. Redistribution can only take one part of the pie and give it to another person.

Think of a pizza divided among Mr. Boss and 50 Workers. If Mr. Boss starts with, say, 50 per cent of the pizza, then taking it from him and giving all his share to the workers will increase their pizzas by 100 per cent from 1 per cent of the pizza to 2 per cent.

Good – though unfortunately one time only, since you can't expect Mr. Boss to show up for the making of the next pizza if he lost all his earnings from the first one. Still, 100 per cent might be a fine thing for the workers. Hurrah.

But compared with the 1,900 per cent improvement that came during the past two centuries from allowing market-tested improvement to flourish, you can see that the gain from even the most extreme redistribution is very, very small.

The real hurrah is the Great Enrichment. Piketty and others who share his anger at rich people do not acknowledge that capitalism has made everybody by historical standards extremely rich.

Piketty focuses on the often stupid consumption of yachts and diamonds by rich people, and neglects to observe that, compared with the world before capitalism, the standard of real comfort is much more equal than it once was.

Why, through most of human history, have most people been poor?

Mainly because market-tested betterment was slow, letting growth in population

THE DANGER IS THAT EACH NEW GENERATION WILL NOT REALISE HOW GREAT THE BOURGEOIS DEAL HAS BEEN

("diminishing returns" as economists put it) overwhelm any betterment from, say, iron from China (10th century) or windmills from the Arab world (also 10th century). When the great English economist Malthus was first explaining, back in 1798, why population growth kept us poor, it was still keeping us poor.

By now, though, another person on the planet makes the rest of us better off, because he is supplied with human capital in his brain: he invents for us new devices and gives us opportunities to trade with him.

And what facilitated the improvement in living standards in the last 200 years?

The market-tested betterment, the Great Enrichment, was itself caused by another kind of equality: a new equality of legal rights and of social dignity that made every Tom, Dick, and Harriet into an innovator.

Certain strange accidents in European history during the earlier centuries, such as the Protestant Reformation or the English Civil War, had made people bold, and slowly made the crazy new idea that we all should be equal in law and in honour seem plausible.

The Leveller Richard Rumbold, facing his execution in 1685, declared, "I am sure there was no man born marked of God above another; for none comes into the world with a saddle on his back, neither any booted and spurred to ride him."

Few in the crowd gathered to mock him would have agreed; a century later, many would have done so; by now virtually everyone does.

Along with that came another Leveller idea (they were free traders): the "Bourgeois Deal".

In the first act, let a bourgeois try out in the market place a supposed innovation. In the second act there will be competitors imitating her success, driving down prices of the innovations. By the time of the third act the deal is that all will be rich.

And all did become rich, by historical standards – by the 1,900 percent already mentioned when conventionally measured and by upwards of 9,900 percent if we also measure the much improving quality of products over the last two centuries.

Can works such as those by Piketty seriously damage the position of the least-well-off by changing attitudes to make them more hostile to business, commerce and wealth creation?

Yes, which is why I write my own books!

The danger is that each new generation will not realise how great the Bourgeois Deal has been, and will forget how bad the earlier deals have been – the Bolshevik Deal, for example, in which the government takes over the railways and the electricity companies and the newsagents and the newspapers and your employment, and everything else; or the Bridle Deal, in which excessive regulation works against "unbridled" market-tested betterment.

I ask, when has it been a good idea to "bridle" a person, like a horse? Piketty's idea is to bridle most people so that some people will not get rich.

This is a mistake. Allow market-tested betterment: that is the best way to help the poor, in Britain and India and Africa, to become prosperous. And it results in a meaningful form of equality.

FOR MORE...

Watch Deirdre McCloskey's interviews on inequality and innovation on ieaTV.

Go to: ***www.iea.org.uk/multimedia/video/deirdre-mccloskey-on-the-great-enrichmen***

And ***www.iea.org.uk/multimedia/video/deirdre-mccloskey-on-innovation***

Is the NHS UNDERFUNDED?

Many argue that the NHS is "structurally sound… just underfunded". But is that really the case? **KRISTIAN NIEMIETZ** investigates

The NHS is 'at breaking point', 'starved of resources', 'on the verge of collapse', overstretched, underfunded, and everybody knows it.

According to *The Telegraph*, "[The] NHS faces biggest financial crisis 'in a generation'"[1]. "Yet as the NHS deals with the worst "cash crisis in a generation" we can disclose things are only going to get worse", adds *The Mirror* [2].

Such articles often imply that there is nothing structurally wrong with the NHS – all it lacks is money. It is widely believed that, if the NHS were 'properly funded', it would be second to none.

Proponents of this line of argument have a point. Funding constraints are real. The NHS has been protected from budget cuts, and there have even been modest real-term increases in spending (by 3.2 per cent between 2009/10 and 2014/15, Appleby et al 2015).

But the increase in demand has been even greater. It is therefore likely that the more recent problems experienced by the health service – such as deficits and missed targets – are to a large extent a financial matter.

But there are a number of problems with the tendency to ascribe every problem to 'underfunding', and with the

[1] "NHS faces biggest financial crisis 'in a generation" ', *Telegraph*, 09 October 2015.
[2] NHS facing worst ever winter as Tory hospital cuts could see 35,000 doctors and nurses lose their jobs', *The Mirror*, 10 October 2015.

eagerness to hold the NHS blameless.

Lack of revenue-raising powers

Firstly, we cannot treat funding levels as an external constraint which has nothing to do with the health system as such. In a fully tax-funded system, healthcare spending decisions will always be political decisions.

The NHS's budget will always be whatever the government of the day decides it should be. Sometimes we will agree with that government's spending priorities, and sometimes we will not. This is a feature, not a bug.

You cannot sensibly advocate a system which vests politicians with so much power, and then be constantly outraged when those politicians do not use that power in the way you want them to use it. Yet that is precisely what many of the most ardent supporters of the NHS do.

In insurance-based systems, such as the social health insurance (SHI) systems of Switzerland and the Netherlands, politicians cannot directly control the level of healthcare spending. Insurers are free to set their own premium rates, and if those rates are insufficient to cover their expenses, they can raise them. They do not have to ask politicians for permission first, or wait until a government sympathetic to their position is voted in.

In theory, one could imagine the NHS operating in a similar way: It could be given its own revenue-raising powers, e.g. an 'NHS contribution', comparable with National Insurance contributions, accruing

- The NHS budget crisis has been all over the news, and for good reason: financial pressures on the service are real.
- But there is a problem with the frequent implication that the health system bears no blame for its financial woes, and that all would be well if only politicians showered it with money.
- In a single-payer system, healthcare spending levels will always be politicised decisions, which can lead to overfunding as well as underfunding. Ironically, those who defend that decision-making mechanism most vigorously are also the ones who are least happy with the outcomes it produces.
- In insurance-based systems, politicians cannot directly control healthcare spending. If there is a demand for additional spending, providers and insurers will oblige.
- Insurance-based systems can also afford higher spending levels, because insurance premiums are an economically less damaging way of raising revenue.
- There is, however, no reason to assume that an increase in spending would solve the health service's woes. The NHS also performs poorly in efficiency rankings, suggesting that it has greater untapped efficiency reserves than most comparable systems.
- The implication is that even if UK health spending rose to, for example, Swiss levels, we would still not achieve Swiss health outcomes, because we do not achieve anything like Swiss efficiency in the UK health system.

directly to the NHS.

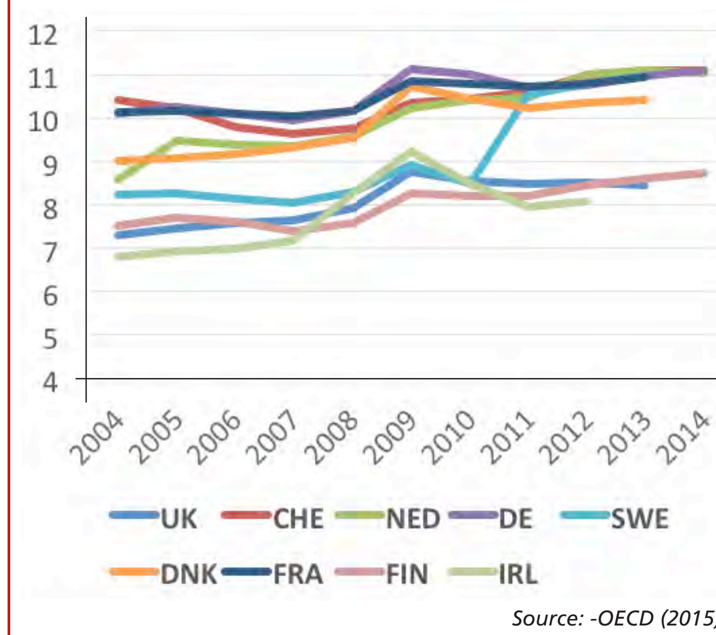
But the monopoly status of the NHS makes this unfeasible in practice. Insurers in SHI systems can be given the autonomy to set their own premiums, because competition with other insurers prevents them from abusing it. If an insurer charges unreasonably high premiums, they will lose customers.

The NHS, as a single-payer system, would face no such constraints, which is why it cannot be given quasi-tax-raising powers. It is therefore reliant on the government of the day for its funding.

Efficiency reserves

But whatever the funding mechanism, there is also good evidence that the NHS has more ability than other systems to benefit from greater efficiency. It has greater 'efficiency reserves' than most comparable systems. Healthcare spending in the UK is lower than

Figure1. Total healthcare spending (public + private) as a % of GDP, 2004-2014



Source: -OECD (2015)

in most neighbouring countries (see figure), and NHS supporters often jump from this observation to the conclusion that the NHS must be more efficient than other systems. This is, to say the least, a bit of a stretch.

The OECD has compiled an holistic estimate of health system efficiency (Joumard et al, 2010). It models health systems as 'production functions' which transform inputs into outputs, subject to external constraints such as lifestyle factors (consumption of tobacco and alcohol, fruit and vegetables etc.).

They find that, given each country's health spending and lifestyle factors, the UK has greater potential to improve outcomes than most other Western European countries.

It is worth noting in passing that some of the countries which receive similarly poor efficiency scores also have structurally similar health systems.

So, even though some European countries spend more on healthcare than the UK, it is nevertheless the UK which has greater efficiency

GIVEN EACH COUNTRY'S HEALTH SPENDING AND LIFESTYLE FACTORS, THE UK HAS GREATER POTENTIAL TO IMPROVE OUTCOMES THAN MOST OTHER WESTERN EUROPEAN COUNTRIES

reserves in the system. Others spend more, but they also appear to spend it better.

The deadweight loss of tax funding

A simple cross-country comparison of health spending misses the fact that different funding methods differ in the costs they impose on the wider economy. In terms of its economic impact, a pound of healthcare spending is not always equal to a pound of healthcare spending: it does matter how that pound is raised.

Suppose one country financed its health system through a beer tax, and another, otherwise identical country, financed it through a wine tax. Other things equal, you would expect lower levels of beer consumption in the first country, and lower levels of wine consumption in the second country.

Now suppose, instead, that one country financed its healthcare system through a tax on labour, while another country financed it through a lump-sum tax not connected to any particular activity. Other things equal, you would expect lower levels of labour supply in the first country.

The comparison between a tax-funded and a premium-funded system is not that far away from this hypothetical example. Imagine that both in the UK and in Switzerland, health expenditure rises by one percentage point of GDP, leading to a tax increase in the UK, and an equivalent premium increase in Switzerland.

In Switzerland, health insurance premiums are flat fees. From the perspective of a Swiss family, they are a fixed cost which they cannot avoid or significantly alter, much like the cost of staple food or heating fuel. So the family

would just have to accept the increase, and find savings elsewhere. But there would be no further economic cost, because there would be no change in people's behaviour.

In the UK, the increase in healthcare costs would most likely lead to an increase in income tax, since this is the most important source of revenue at the national level.

But this not the whole story. The tax increase would make working, saving and investing less lucrative, which means that, at the margin, people would reduce their engagement in these activities.

Tax funding comes at a greater economic 'deadweight loss' than premium funding, because it changes people's behaviour to a greater extent. Other

OTHER SYSTEMS CAN AFFORD HIGHER SPENDING LEVELS BECAUSE THEY ARE FUNDED IN ECONOMICALLY LESS DAMAGING WAYS

systems can afford higher spending levels, because they are funded in economically less damaging ways .

Conclusion

There can be no doubt that the NHS is feeling the pinch. And yet the generally accepted view that the NHS would be a world-class system if only politicians increased funding should be called into question.

Firstly, even if it were true that the service's woes are entirely due to financial constraints, it would still be wrong to treat these as an exogenous constraint that is imposed upon the system by an outside force.

Rather, it is part and parcel of a single-payer system that budgets are set by politicians, and as with any political decision, some of us will agree with it and some of us will not.

In insurance-based systems, spending levels result from the interaction of demand and supply, not unlike in a 'normal' market. That level of spending may well be higher than the level politicians would have chosen. Insurance-based systems can also afford higher spending levels, because premiums come at a lower economic cost than taxes.

Having said that, even though healthcare spending in the UK is lower than in most neighbouring countries, OECD estimates suggest that the NHS has greater untapped efficiency reserves than most other systems. There is no discernible connection between spending levels and efficiency.

The UK, Ireland and Finland are among the lower spenders, but they also receive some of the worst efficiency scores. Switzerland and Japan are among the highest spenders, but they also receive some of the highest efficiency scores.

It is possible to spend large sums of money well, and it is possible to spend lower sums wastefully.

But, whatever the current spending level, it seems a sensible rule of thumb that the countries which are furthest away from the efficiency frontier should seek to move closer to that frontier first before considering further increases in spending●

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[3] This is a simplification. The Swiss system is financed through flat-rate premiums, but not all SHI systems are: The German system is financed through income-related contributions, and the Dutch system is financed through a combination of both. Income-related contributions act like a flat tax: the deadweight loss is lower than under a progressive tax, but higher than under a poll tax.

Do regulations serve the public interest? CHRISTOPHER J. COYNE and RACHEL L. COYNE contend that many proposed regulations – which supposedly advance the public interest – actually undermine the well-being of private citizens…

As Uber, an app which connects riders with private drivers, has spread throughout Europe, it has been met with a backlash from taxi drivers and regulators.

For example, a recent headline in *The Telegraph* read, "Uber faces massive crackdown in London" and went on to note that, "[a] Transport for London consultation proposes new regulations that would ban some of the minicab-hailing app's key features."[1]

Among the proposed regulations are a five-minute mandatory waiting time between a rider ordering a car via their phone and the car arriving to pick them up.

Other proposals would include preventing apps from showing the user the cars that are available for hire and the banning of ride sharing, a service that Uber has introduced in some US markets.

The call for new regulations

on Uber offers the opportunity to consider two very different views of regulation.

The public interest view…

The public interest view of regulation holds that government regulators will implement rules which improve the welfare of private consumers. From this perspective, regulations are meant to protect consumers from harm resulting from irresponsible, greedy, or fraudulent producers.

The public interest view is nicely captured by Garrett Emmerson, the chief operating officer for surface transport of Transport for London (TfL).

He noted that "[in] recent years the private hire industry has grown exponentially and technology has also developed rapidly", hence the need for a consultation regarding new potential regulations.

He went on to say that "[the] consultation sets out a number of ways that standards across the industry could be raised, ensuring Londoners can continue to benefit from the service provided by licensed private hire vehicles."[2]

In other words, the purpose of the proposed regulations is to ensure that the benefits of private citizens are maximised.

Something, however, does not seem quite right. If the goal of regulations is to protect consumers, why would there be a mandatory waiting time of five minutes between ordering a car and its arrival?

The current average wait time for an Uber rider is three minutes, which is clearly preferable to the private citizen whose time is valuable.[3]

Similarly, why would private citizens desire a regulation that prevented them from seeing what cars were available for hire or from sharing the cost of their trip with other riders?

In the absence of regulations, being able to see what cars are available for hire would provide private citizens with more information. Allowing for ridesharing would reduce the cost of transportation through voluntary exchange (and reduce congestion for other Londoners).

The fact that these proposed regulations do not offer any clear benefits to Londoners suggests that the public interest view is incomplete.

IF THE GOAL OF REGULATIONS IS TO PROTECT CONSUMERS, WHY WOULD THERE BE A MANDATORY WAITING TIME OF FIVE MINUTES BETWEEN ORDERING A CAR AND ITS ARRIVAL?

The political economy view…

An alternative view of regulations was provided by economist George Stigler in a 1971 article. He emphasised that regulation is not designed and implemented in a vacuum. Instead, regulations emerge in a political environment populated by self-interested (public and private) actors.

Regulators possess power to coerce private citizens to do as they say, and this power has significant value to those who can influence and control it.

The result, Stigler noted, is that the same private interests who are the target of regulations will often have the strongest interest in attempting to manipulate laws for their own benefits.

When narrow private interests are able to influence and control the content of regulations, they will produce benefits for special interests instead of the general public.

Of course these special interests are never explicit about their intentions and couch their activities in the desire to protect consumers as per the public interest view.

The logic of the political economy view, which is the exact opposite of the public interest view, explains the proposed regulations on Uber. They are not intended to protect private consumers but, rather, are meant to protect black cab drivers who are threatened by the competition introduced by Uber and who have tried to bring London to a standstill with their protests.

Uber tends to be much cheaper (*see figure1*) but also provides a variety of service levels. Entrenched interests are attempting to influence the regulatory body tasked with protecting consumers to protect them from the forces of market competition. But, in doing so, they are making consumers worse off.

They are reducing the information and options available to consumers while

[1]www.telegraph.co.uk/technology/news/11899018/Uber-faces-massive-crackdown-in-London.html
[2]www.theguardian.com/technology/2015/sep/29/transport-for-london-tfl-could-crack-down-uber-taxi-consultation
[3]www.telegraph.co.uk/technology/news/11899018/Uber-faces-massive-crackdown-in-London.html

Figure1

Destination	Cost of trip from central London – black cab	Cost of trip from central London – Uber
Heathrow airport	£65	£37
Gatwick airport	£99	£62
Stansted airport	£110	£52-£69

artificially raising the price – both in monetary terms and in terms of time – of transportation for Londoners.

The regulation reality

Many people equate regulation with benefits for private citizens who are otherwise at the mercy of producers.

Meanwhile, those who question or oppose regulation are often labelled as dogmatic ideologues with an unwavering faith in markets. In reality, the opposite is true.

Those who unquestioningly accept more regulation as necessarily good are taking on faith that regulations are designed with the public interest in mind. This neglects the realities of politics and the nature of government.

The introduction of government regulators creates a new source of power for those who can influence and control the regulatory process and its final output. This power attracts an array of interest groups who seek to shape regulation for their own good at the expense of the general interest. This makes consumers worse off in a number of ways.

The result is generally that competition is reduced and costs increase. An indirect, but crucially important, effect is decreased innovation: regulations raise the costs and risks attached to entrepreneurs developing new and better ways to serve consumers.

We have discussed the politics of regulation in the context of the ongoing situation with Uber. However, the underlying logic is widely applicable.

For example, it helps shed light on why financial regulation is often ineffective in achieving the stated ends. Large, politically-connected banks have the incentive and resources to influence regulators to further their own interests at the expense of the interests of citizens. In the US, cotton subsidies are demanded by a powerful interest group against the general interests of taxpayers.

The central point is that citizens should not automatically assume that proposed and existing regulations are designed to further the public interest.

Instead, they should question the interests and incentives facing the main parties involved in campaigning for and implementing the regulations which affect their daily lives.

However, while large firms and entrenched interests have power, so too do private consumers. Building on Stigler's theory of regulation, Sam Peltzman (1976) noted that regulators not only consider the influence of powerful firms, but also of voters. Where voters are likely to strongly reject a proposed regulation, it will be less likely to pass.

The problem is that the costs of regulation are normally widely disbursed amongst the population who each lose out by a small amount.

In the case of Uber, the benefits are concentrated amongst about 20,000 black cab drivers who have a much stronger incentive to campaign than the losers.

However, within a few days of TfL's announcement, 125,000 people had signed an online petition protesting against the proposals.

When it comes to the economics of regulation, one interesting development is that the costs to the widely dispersed "losers" from new regulation of organising a response have fallen.

Perhaps the interest groups supporting new regulation will not always have the upper-hand in the future●

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TOMORROW 3.0
THE SHARING ECONOMY
...AND YOU

The 'sharing economy' will be environmentally friendly, efficient and allow us to spend a lot less on owning things. But, in the short term, there may well be casualties, says MICHAEL MUNGER

There have been two enormous "revolutions" in human history.

The first was the Neolithic, or the wide scale switch from a nomadic hunter-gatherer lifestyle to fixed agriculture.

The second was the industrial, or the wide scale concentration of production in processes that took advantage of division of labour and capital-intensive work.

The most salient features of both revolutions was unprecedented expansion: after the Neolithic revolution, cities developed and population increased in ways that transformed the landscape.

After the industrial revolution, production processes developed in ways that, within just a few generations, afforded a set of consumer items for the poor that were unattainable even for the wealthy just a century earlier.

In both revolutions, individual liberty, nutrition, and hygiene all suffered, for many people.

But the longer term consequences were that many more people lived on earth, they lived longer, and they had better lives. The increase in population and life expectation after industrialisatIon in Britain, for example, was extraordinary (*see figure1*).

WHY DO WE OWN, RATHER THAN RENT, SO MUCH STUFF? THE ANSWER IS TRANSACTIONS COSTS

The key reason is summarised by Adam Smith. It happened because of the division of labour and the benefits from expanding the horizon of economic co-operation from families, to villages, to nations, and then to the entire globe.

This is so obvious that it escapes our attention most of the time. In a tribe of 100, there may be someone who is skilled at beating bones on a rock. In a clan of 1,000, there may be someone who can play a flute while others pluck a string on a piece of wood. In a city of 100,000 there are chamber orchestras. And in a city of 1 million there is a symphony orchestra with specialised instruments and professional musicians.

The next revolution will be like that, too. In fact, it's like that already.

The sharing revolution

Because of division of labour, I can specialise in a narrow (though productive) activity, because I can rely on other people to specialise in other narrow (though productive) activities, making everything I need, from food to a nice woollen coat.

But until now this system has relied on ownership. We ended up with far more stuff than

Figure1. England and Wales population growth

Date	Life expectation at birth for males (years)	Population
1850	41	18 million
1880	47	26 million
1910	56	36 million
1940	72	41 million

any of us actually needed, or could use. We store the stuff in closets, garages, and self-store containers.

Why? Why do we own, rather than rent, so much stuff? The answer is transactions costs. When I need an electric saw, I don't rent one. I go to my garage and find my electric circular saw. I only use that saw two or three times a year. But I still own one.

On the other hand, when I fly to Oklahoma to work on a video programme or give lectures, I don't buy a car; I hire one. Why do I own a saw, but hire cars?

The reason is that it has paid some entrepreneur to sell reductions in transactions costs, in the form of software. People can enter all their information, including preferences and payment information, into a database.

When I get off the plane, I get a text: "Your car is in space A39". So I can go straight from aeroplane to car. I just turn the key--which is already in the car--and drive to the gate, where they print my contract and check my ID.

Students in Canada no longer need to own cars even if they want 24-hour-a-day access to four wheels. They simply join Student Car Share for about £30.

This kind of approach, combined with the kind of delivery service provided by Uber or Lyft, will soon revolutionise almost every aspect of our lives.

As transactions costs fall much of the "stuff" we now own will be rented or shared. Some of us will become "sellers" and some "renters", but overall each of us will need to possess far, far less stuff at any given time.

From owning to renting, from companies to people

The reason I own a power saw, instead of renting one, is that the transactions costs of renting are prohibitive.

Suppose I could open an app, choose "power saw," and press "rent". A driver somewhere picks up a saw from a hardware store, and conveys it to my security-coded delivery pod by the street. My phone beeps: "saw delivered". I go out, get the saw, use it, and return it to the pod. The pod tells another driver (no particular driver, just whoever is closest; I don't know who it is, and I don't need to know) that there is a package to be picked up.

With sufficient density, the cost of the rental would be no more than $3 or $4. And there is no standing in queues for forms to fill out. Best of all, I would get a commercial quality saw for the period that I needed to use it. The relative benefit of "rent versus buy" is determined by transactions costs – a subject about which Ronald Coase taught us so much.

Most people are now familiar with Uber. This illustrates two points. The fall in transactions costs has made renting car time much, much cheaper – anybody can rent to anybody.

But there are also huge advantages from the division of labour involved. For many people, it may be cheaper to use Uber to take them to work than it is to own a car – and then they can work whilst somebody else drives.

THE BIGGEST CHANGE IN THE SOFTWARE PLATFORM-DRIVEN REVOLUTION IS THAT PEOPLE WILL SKIP COMPANIES – EXCEPT AS MIDDLEMEN

And millions of people who have not got great academic qualifications now have a market opening for earning money whilst driving other people around.

The biggest change in the software platform-driven revolution is that people will skip companies, except as middlemen. We are already used to this for AirBnB and Uber, both of which provide access to privately-owned services (rooms and rides, respectively) for private citizens.

All the software does is provide information, take care of security (through ratings and reputation), and process the transaction (removing most of the risk of robbery or reneging).

But there are hundreds of other examples, relating to stuff you may not have thought of renting.

One company, Spinlister, brings together people who own but are not using for a day or a week, or more bikes, surf equipment and ski equipment. All three of these items are relatively durable, sometimes not used for long periods and expensive.

Some households have more stuff than they can use. Other households need stuff for short periods. With high transactions costs, the choices were either to buy (expensive in terms of cash and storage) or do without.

If an entrepreneur can sell the reduction in transactions costs through a software platform, private individuals will make much more intensive use of the stuff they already have.

Shortly, the result will be that many of us will have a lot less stuff. I won't need to own a laptop, a bike, a car, luggage... and maybe even clothes.

A company called RentTheRunway rents "unlimited clothing and accessories" for $99 per month. It's not really unlimited, of course. Customers can only have one of each item per category at a time. But when you are finished with the dress/shoes/purse you send them back. RentTheRunway takes care of the UPS shipping, and the dry cleaning.

MANY OF US WILL HAVE A LOT LESS STUFF. I WON'T NEED TO OWN A LAPTOP, A BIKE, A CAR, LUGGAGE... AND MAYBE EVEN CLOTHES

The downside

The good news is that we will all need a lot less stuff, to own or to store. The bad news is that....well, that's the bad news.

An economy geared towards making new stuff, in which entrepreneurs have always been focused on making new products or on making more old products more cheaply will be shaken to its foundations.

Instead of 90 million power saws sitting in closets and garages, we will only need 10 million. We will need far fewer cars, fewer bikes, fewer just about everything.

Some people, probably a lot of people, will lose their jobs. And they will not get new jobs, at least jobs in the sense that we understand them. They may work "gigs" or temporary periods as part of teams, much like the construction industry or Broadway plays operate now.

Is this good or bad? As in the previous two revolutions, that hardly matters, because the economic logic is inescapable: it is just going to happen. Still, I think it is fair to say that for most people the effect will be positive.

Cities will not need parking spaces. Houses will not need garages or as many cupboards. Energy use in manufacturing, and the amount of waste produced from packaging and discarding broken or unused products will plummet.

Some people will lose their jobs and perhaps have lower nominal wages. But prices are likely to fall even faster, implying an actual increase in real wages. And many jobs and opportunities will be created.

Many Uber drivers are older people who really value the socialisation and the income it generates. Many who rent out Airbnb rooms will be single people or widows who might be capital rich and income poor. And the remarkable thing about a market economy, of course, is that we can never know what opportunities it will create in the future.

But the winning formula is, less stuff, less strain on the environment, better use of the stuff we have, and many prices close to zero. Tomorrow 3.0 is closer than you think●

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The ECONOMIC CASE for MIGRATION

Migration brings many of the same economic benefits of free trade. It is simply not credible to follow a pro-growth policy whilst, at the same time, remaining hostile to inward migration, argues **JONATHAN PORTES**

The essence of the economic case for migration is very simple: it is the same as the case for markets in general. If people take decisions on the basis of their own economic self-interest, this will maximise overall welfare.

This applies to where people live and work just as much, if not more, than it applies to buying and selling goods and services.

Of course markets fail here, as elsewhere, and "more market" is not always better. But the view that, as a general proposition, markets are good at allocating resources – including human resources – is widely shared among economists.

And this analogy holds in a narrower, more technical sense as well. The classic argument for free trade, as advanced by Adam Smith, is not just analogous to, but formally identical to, the argument for free movement.

It is easy to see this. In economic terms, if markets are perfect, and we ignore taxes etc, allowing somebody to come to your country and trade with you (or work for you, or employ you) is identical to removing trade barriers with their country.

Clearly, people are not as mobile as goods and services, but migration of people is certainly not trivial as the table below shows.

So what then is the impact of reducing barriers to trade or migration? Theory suggests that, for both trade and migration, the impact of reducing barriers will be positive, but there that will be distributional consequences.

That is, national income (GDP) and average incomes (GDP per capita) will increase, but some individuals and households will lose out, at least in the short run.

In particular, trade will hurt those working in sectors where the UK does not have a comparative advantage, while immigration will hurt those who are in direct competition with immigrant workers.

Hence, the standard economists' policy prescription for immigration is much the same as for trade: liberalise, but compensate the losers.

However – inconveniently for economists, who tend to favour relatively liberal migration policies – there is a problem with this approach.

In standard "static" economic models, to the extent that immigrants are complements to native workers, the impact of immigration on GDP per capita and overall economic welfare is positive but small.

On the other hand, to the extent that immigrants are substitutes for native workers, the impact on national income per capita is essentially zero.

So it is often argued that the economic impacts of migration – positive or negative – are likely to be small, with the main impact being to increase both population and total GDP, but with little medium-to-long-term impact on GDP per capita or unemployment and employment rates.

If this were the case then, while the economic case for immigration would still be valid, it would not dominate, nor would it be an important policy priority.

But this is a very static view of the world. It does not reflect how economies actually work, or where growth really comes from.

To see this, we merely need to return to the analogy with

Figure1

Region	Total number (stock) of migrants 1990 (millions)	Total number (stock) of migrants 2013 (millions)
World	154.2	231.5
Africa	15.6	18.6
Asia	49.9	70.8
Europe	49.0	72.4
Latin America and Caribbean	7.1	8.5
North America	27.8	53.1
Oceania	4.7	7.9

Source: United Nations (2013), Trends in International Migrant Stock: The 2013 Revision

trade. Again, estimates of the gains from trade liberalisation derived from static models are small. So, for example, estimates of the benefits to the UK of completing the Doha round of multilateral trade liberalisation are typically no more than 0.1 per cent of GDP.

But of course most economists believe that the economic benefits of trade are quite considerable, and that these static estimates are not the whole story or even the main point: the benefits are dynamic and arise from competition and specialisation rather than simple static comparative advantage.

THE STANDARD ECONOMISTS' POLICY PRESCRIPTION FOR IMMIGRATION IS MUCH THE SAME AS FOR TRADE: LIBERALISE…BUT COMPENSATE THE LOSERS

We do not gain from free trade in, say, cars with the EU because either we or the French or Germans have a fixed and static comparative advantage in different types of car, so we can produce one type of car better and they can produce another better.

Rather, because trade increases competition between different producers we get diversification of the supply chain and an incentive for technological innovation together with the copying of that innovation. And there are all sorts of other difficult to measure but important effects that increase productivity in the medium-to-long term.

The same is, in principle, likely to be true of immigration. Immigration is likely to have long-term impacts on productivity and growth in a number of ways:

- Immigrants could bring different skills and aptitudes, and transmit those to non-immigrant colleagues (and vice versa)
- Immigration could be complementary to trade in goods and services (because of immigrant networks or for other reasons)
- Immigrants could increase competition in particular labour markets, increasing the incentive for natives to acquire certain skills
- Immigrant entrepreneurs could increase competition and bring new ideas into product markets (one very obvious example being the catering sector)
- Workplace diversity (across a number of dimensions) could increase (or decrease) productivity and innovation

It should be noted that the large number of immigrant entrepreneurs and self-employed people is not necessarily an entirely positive phenomenon.

This could be a result of the fact that they are self-selecting so that enterprising people are more likely to migrate. But exclusion or discrimination might also force some migrants into low-productivity self-employment.

Immigration – the evidence

So, what does the evidence say? Well, in contrast to the well-established economic literature on the impact of migration on labour markets, we have much less quantitative analysis on these topics. What there is does, however, support the arguments above:

- There is a considerable body of evidence in the US that suggests that immigration is associated with increased innovation (for example, that immigrants are more likely to register patents, and that this, in turn, leads to an increase in patent activity on the part of natives). Immigration is also associated with international trade and knowledge transfer, particularly in high-tech industries.
- Here in the UK, my NIESR colleague Max Nathan has written a number of papers on similar topics, particularly focusing on the impact of diversity on innovation, patent behaviour, and other measures of firm performance. This, and work in other European countries, suggests that similar effects are at work.
- It is often hypothesised that immigration reduces the incentive for employees to train native workers. However, in the US, Jennifer Hunt shows that immigration increases the educational attainment of natives. She hypothesises this is because of increased competition in the labour market. Meanwhile, NIESR research for the Migration Advisory Committee found that "rather than migrants substituting for home-grown talent, there is evidence of complementarities between skilled migrants and skilled resident workers".
- While, looking at the macro-economic impacts on growth, and explicitly putting the impact of immigration in the same analytical framework as that of trade, a recent paper by Ortega and Peri found that, looking across countries, the positive impact of immigration on growth has been very large. Indeed, they find that it is considerably larger than the gains from trade. Crucially, the channel through which immigration increases growth is through its impact on total factor productivity, which would not be expected in the standard model.

This research agenda is still in its infancy. We still do not know precisely the channels through which immigration impacts on growth. Nor will we ever be able to put precise numbers on it, any more than we can identify the contribution of Britain's history as a trading nation to our current prosperity. But we do know enough to set a clear direction for policy.

Implications for policy

So what does this mean for UK policy on immigration? The government's general approach in this area is completely at odds with the market-oriented approach generally espoused by UK governments in other economic policy areas for the last three decades.

EVIDENCE IN THE US SUGGESTS IMMIGRATION IS ASSOCIATED WITH INCREASED INNOVATION

It assumes that bureaucrats in Whitehall can, with the help of "expert economic advice", determine what skilled workers the country needs, in what sectors, now and in the future.

It purports to suggest that they know who companies should be able to employ to fill skilled jobs.

For obvious personal reasons (I worked as a civil service economist for 20 years) I have nothing against either Whitehall bureaucrats or economists.

But we do not let them decide how many cars the UK should produce and what colours they should be. Any attempt to do so would rightly be ridiculed as a throwback to the worst excesses of central planning. Why would we try to do the same for people?

Reducing immigration by keeping out skilled workers, stopping students from staying in the UK and generally promoting, in the government's own words, a "hostile environment" for foreigners is economic masochism.

It is simply not credible for the Prime Minister to claim that the UK is "open for business" and for the Chancellor of the Exchequer to say that he is prepared to take the "difficult decisions" to boost growth, while at the same time making the primary objective of immigration policy the reduction of net migration

Jonathan Portes
Former Director
National Institute of Economic and Social Research

Do prisons provide a microcosm of society?
And if so, what economic lessons can we learn?

In this two-part feature, **VICKY PRYCE** and **DAVID SKARBEK** examine the social and economic aspects of crime and punishment

What **ECONOMICS** can **TEACH US** about **PRISONS**

Economics teaches us that prisons do not work. Crime costs the UK economy hundreds of millions of pounds every year and prisons have a minimal impact on crime.

Prisons do not act as a deterrent to crime: people who commit crimes either act from impulse or do not think they will get caught.

Indeed, the vast majority do not get caught. In 2014, police were unable to find a suspect in half the crimes reported to them.

Value for money is particularly poor. UK government departments are routinely brought in front of Parliament's Public Accounts Committee to explain themselves if money is wasted. The Ministry of Justice, with an annual budget of some £7bn, should receive greater scrutiny.

The average cost of keeping someone in prison is £30,000 to £40,000 a year – more than most expensive private boarding schools.

Yet re-offending rates are nearly 60 per cent for those in jail for less than 12 months, and the cost to the economy from re-offending alone is estimated at some £9.5bn to £13bn a year.

Economics gives us the tools to evaluate policies to test correlations and prove causality. But we ignore the fact that most known forms of crime have been falling consistently. This is true both for crimes reported to the police and those that are outlined in the annual crime surveys.

Why is this? It is not because we have doubled the prison population in the last 20 years.

The decline is due to other factors. Getting richer helps: there is more to lose if caught. So is getting older as a nation: peak crime age is around 24. Better security technology also contributes: automated cash tills make it more difficult to commit retail crime and increased use of sophisticated locks and alarms acts as a deterrent. And so on...

In truth, people in prison are there in greater numbers because there are more offences now classified as meriting a custodial sentence and tighter sentencing policy has resulted in longer sentences.

THE AVERAGE COST OF KEEPING SOMEONE IN PRISON IS £30,000 TO £40,000 A YEAR – MORE THAN MOST EXPENSIVE PRIVATE BOARDING SCHOOLS

And yet there is no evidence that raising a sentence from say two to four months or from three to five years makes any difference to the likelihood that someone will commit the relevant crime.

What the evidence does suggest is that the only thing that might affect the willingness to commit a crime is the absolute certainty of being caught. This implies much more money spent on detection. This will not be easy as resources are being cut back aggressively.

Alternative solutions, such as community sentencing are less costly and have a much lower re-offending rate.

Even more important is understanding what does reduce crime. Offenders tend, on average, to be under-educated and much more likely to be unemployed than the rest of the population.

Women prisoners are known to have already been vulnerable before committing crimes with 50 per cent of them victims of domestic abuse and one in three victims of sexual abuse. Many are drug and alcohol dependent.

Furthermore, whereas only 1 per cent of children are in care in the UK, about a quarter of adult prisoners have been in care at some point in their lives.

And then, on leaving prison, life chances decrease. It is harder to get a house, to obtain credit or insurance, and to get a job. Only 25 per cent of prisoners enter employment on release – and their children who had been separated from them are more likely to offend too at some stage.

Keeping people in the community, tackling mental health issues and better education and employment are key to reducing crime. That is what the economic evidence suggests and where the emphasis of policy should be•

Vicky Pryce is the author of '*Prisonomics*' (Biteback Publishing) and a patron of Working Chance, a charity that finds quality jobs for women ex-offenders
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What PRISONS can TEACH US about ECONOMICS

With the exception of Vicky Pryce, few economists will ever step foot in prison. Most will never study crime and punishment in any form.

Instead, the vast amount of research on the topic is conducted by sociologists and criminologists. That is a shame, however, because the economist's toolkit is perfectly suited to understanding nearly every aspect of the goings on within a prison.

And life in prison teaches important economic lessons, too. In particular, life behind bars has much to show economists about how people respond to incentives and the general problem of how to sustain social cooperation.

The very nature of prison is rules. Inmates are prohibited in their movements, in what they can own, and with whom they can interact.

There is a long tradition in political economy studying how rules work, what differs between formal and informal rules, where rules come from, and what makes for a good rule.

Indeed, Adam Smith studied such things. A major challenge in this tradition is in determining how to devise rules that lead to good outcomes, even when the people governed by those rules are less than angelic.

Inmates want to feel safe from other inmates; they want their property protected; and they want assurances that dealings with other inmates will be carried out. Sometimes prison guards provide governance, but very often this is not the case.

One problem facing inmates is that they tend to have less self control, less education, come from poorer backgrounds and broken families, and are less trustworthy than the typical person in society.

Despite these limitations, my work on prison life in California shows that they are actually able to sustain a high level of cooperation. Consider two different situations.

Firstly, when prison populations are small, inmates know each other well. Fear of being deemed an outcast amongst a tightly-knit group of convicts encourages people to be nicer to each other.

When inmates want drugs or alcohol, they can only turn to inmate entrepreneurs. Somebody who takes advantage of another inmate in such an exchange will be ostracised or assaulted. Fear of becoming an outlaw among outlaws incentivises good conduct. As a result, the underground economy flourishes.

However, when prison populations get too big, it becomes difficult to keep track of other inmates' social standing. Decentralised rules fail. It is too hard to know who amongst the thieves and killers will be trustworthy and who should be shunned.

As such, ostracism is not a feasible punishment device, and the fear of being an outcast no longer provides a sufficiently strong check on bad behaviour.

In such situations in California a major source of order has emerged from among a group of people that we typically assume are a primary cause of disorder – prison gangs.

FOR MORE...

See David Skarbek speak on the economics of prison gangs at our THINK conference.

Go to: ***www.iea.org.uk/tv/search?search=skarbek***

Prison gangs wield violence to govern the social and economic affairs of inmate life. They develop written constitutions. They have informal courts to adjudicate disputes between inmates. Their extensive record-keeping allows them to keep track of disruptive inmates far more carefully than in a decentralised system.

When the prison yard is peaceful, gangs make substantial profits selling drugs, so they have an incentive to control chaotic acts of violence. Stability and peace are the key to profits.

There are two lessons here. Even amongst the least trustworthy people in society, prison life shows us that order can emerge in a spontaneous way, and that this process can sometimes achieve very high levels of social and economic cooperation.

Secondly, the larger the grouping, the more important are more formal rules. This is something that we also see, for example, in financial markets. It is amazing how far these observations generalise to other areas of economics•

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BREAKING UP IS HARD TO DO

BRITAIN and EUROPE'S dysfunctional relationship

Economists should welcome institutions that promote free trade and can help provide cross-border public goods. But, is the EU such an institution? If not, asks LEN SHACKLETON, what does it need to do to become such an institution?

'Should the United Kingdom remain a member of the European Union or leave the European Union?' is the rather clumsy question – its wording has been fought over – with which the electorate will soon be faced. Many EA readers may have a vote in this referendum; they will certainly be affected by its consequences.

The debate around this question does not take place at the EU's finest hour. The euro zone crisis, and disagreements over how to handle the mass migration resulting from the crisis in the Middle East and elsewhere, have shown acrimonious disunity rather than a spirit of 'ever-closer union'.

Within the UK, there are considerable and constantly shifting political divisions about our relationship with Europe, and polls suggest that public opinion is volatile. The possibility of a 'Brexit' is very real. Much may depend on concessions which the Prime Minister has been able to negotiate with the European Commission and fellow member governments. But what should he have been seeking?

The Institute of Economic Affairs has recently published a study exploring the issues in more detail than is usually found in the media. The authors undertook an unusual task. They have suggested what the EU should look like if it were designed to promote economic liberalism in line with the four freedoms of movement of people, goods, services and capital. Some of the authors argue that no changes can improve the EU sufficiently to make it worthwhile to continue in membership, but most offer intriguing suggestions for reform.

Institutions

Firstly, consider the institutional framework. Martin Ricketts, using economic analysis of bargaining, agency and decision-making costs, argues that powers and responsibilities are not always assigned to the appropriate levels of government in the EU. One of government's basic roles is providing public goods, and the existence of spillovers between national jurisdictions may suggest that, in some fields, the appropriate level of decision-making is supra-national. However this does not necessarily mean that international public goods are best provided by the EU; in defence, for example, NATO is probably more appropriate.

Moreover an emphasis on spillovers should not detract us from noting that in some areas – such as corporate taxation – there are good arguments for retaining national powers, as competition between jurisdictions can produce better policies. Yes, there may be problems arising from having 28 different tax systems, but the costs of centralisation may be greater.

In the book, German economist Roland Vaubel insists that the EU's major institutions are inappropriate for effective governance. The European Court of Justice has a vested interest in centralising powers: its judgments have in his view inappropriately extended European control over areas such as employment regulation and social security. The European Commission breaches the liberal principle of the separation of powers by being both the initiator of legislation and its enforcer. The European Parliament is too large and an ineffective check on the Commission.

Vaubel offers a programme of reform based on institutions such as arbitration tribunals to settle disputes between member states; independent international prosecutors to enforce laws; a second revising chamber; and a separate competition authority.

According to Vaubel and Gwythian Prins, another contributor, EU institutions were designed by the founding fathers of European integration as a means to bring about 'creeping federalism'. They imply a ratchet effect by which the famous *acquis communautaire* – the body of existing EU law and regulation – can only be added to, rather than reduced, as the EU moves towards greater integration.

Massive institutional inertia, lawyer Martin Howe argues, makes reforming the UK's status from within the European Union very difficult – perhaps impossible - to achieve. He believes that the best chance for real change, though it would be a risky strategy, is for the country to vote to leave the EU and then negotiate from first principles for a new arrangement which would be beneficial to both parties - the 'zero-plus' approach to renegotiation.

MASSIVE INSTITUTIONAL INERTIA MAKES REFORMING THE UK'S STATUS WITHIN THE EUROPEAN UNION VERY DIFFICULT – PERHAPS IMPOSSIBLE – TO ACHIEVE

Core EU policies

Central to the European Union's development from the 1957 Treaty of Rome onwards has been an emphasis on the free mobility of labour. This principle has been increasingly challenged, not least in the UK.

However, Philippe Legrain offers a spirited defence of the principle. Most migrants wish to work. Their energies are likely to promote entrepreneurship, innovation and growth. They may also make a substantial net contribution to government revenue. Legrain emphasises, though, that his is not a narrowly economic argument. The freedom to travel and work abroad is a liberal freedom of value in itself.

In Legrain's ideal world, everybody would be free to relocate to wherever they want. Freedom within the EU is a step towards his ideal.

Two other core EU features are the customs union - a common external tariff but no import duties between members – and the Common Agricultural Policy (CAP). These are more problematic from a liberal perspective. Patrick Minford argues that the customs union has been negative in its impact on the UK. Firstly, it is incomplete, as many EU countries have erected non-tariff barriers (such as unnecessary product standards) against imports, and it has never been properly applied to services, which now account for a much larger proportion of our GDP than manufacturing. Secondly, there is significant 'trade diversion' arising from the fact that we import goods from within the EU rather than cheaper goods from the rest of the world. This arises because the EU is protectionist in relation to the rest of the world. The CAP also diverts trade in agricultural products, meaning that member countries pay more than they need to for food, and it has a substantial budgetary cost (accounting for 40 per cent of EU expenditure).

Minford estimates the total cost of these policies to be about 4 per cent of UK GDP. In addition, Sean Rickard, writing in more detail about the CAP, sees it as holding back productivity growth through its emphasis on supporting small farms, its susceptibility to farmers' lobbies and its opposition to GM crops. He argues that agricultural policy should be devolved as far as possible to nations or regions.

The management of sea fisheries was originally something of an add-on to the CAP, agriculture being defined in the Treaty of Rome to include the products of fisheries. Since the 1970s the EU has treated European fish stocks as a 'common resource', allocating fishing rights and quotas to member nations, and using structural funds to reshape the fishing industry by reducing capacity. As Rachel Tingle explains, the Common Fisheries Policy has been unsuccessful in preserving fish stocks and its control and inspection regimes have been costly and ineffective. Fisheries need to be managed at the appropriate ecological unit for the fish concerned, while the quota system would benefit from allowing tradable quotas.

Economic regulation

The European Union obtained a significant role in employment regulation following the Maastricht Treaty of 1992 (although the UK opted out until 1997). Interventions such as the Working Time Directive and the Temporary Agency Workers Directive have imposed significant costs on UK employers. These have been passed on through lower wages and lower levels of employment, as I argue in the book.

Employment regulation should be largely devolved to member nations although there are some areas - such as working time in cross-border transport - where EU co-ordination makes sense. However in this as in other areas, there is a strong domestic appetite for regulation. Eurosceptics should not assume that returning powers over employment to UK governments would lead to substantial deregulation – it may well not do so.

Quotation in bold: there is a strong domestic appetite for regulation. Eurosceptics should not assume that returning powers over employment to UK governments would lead to substantial deregulation – it may well not do so.

The EU plays an increasing role in transport policy, particularly in relation to emissions standards, plans for switching freight from road to rail, and partial funding of (often wasteful) infrastructure. Kristian Niemietz and Richard Wellings, while recognising that aviation policy and cross-border rail transport (for example), need some international co-operation, argue that equivalent results could be achieved by bilateral agreements. They advocate a comprehensive deregulation of transport. If the EU retains a competence in this area, much decision-making should be shifted down to nations and regions.

Climate change policy is another major area of EU responsibility which the Treaty of Rome never envisaged. However, given its cross-border nature, there is at least an economic justification for EU action in this area. EU policy currently comprises emissions reduction targets, the Emissions Trading System, renewable energy subsidies and green taxes. There is also a range of requirements for greater energy efficiency (for example, in regulations setting requirements for average fuel efficiency in motor vehicles).

EUROSCEPTICS SHOULD NOT ASSUME THAT RETURNING POWERS OVER EMPLOYMENT TO UK GOVERNMENTS WOULD LEAD TO SUBSTANTIAL DEREGULATION

Matthew Sinclair argues that the European Union has been hugely ambitious in target-setting, but ineffective in devising detailed policies. The Emissions Trading System has been subject to fraud and the carbon price has been subject to excessive fluctuations, caused partly by over-allocation of emissions allowances. Renewable energy subsidies have been poorly directed, with the most expensive energy sources receiving the most subsidy, and are proving so costly that governments are having to cut back on them.

Sinclair thinks that EU climate policy attempts the impossible: it assumes that an effective global policy can be instituted, and tries to organise Europe's 'share' of such a policy. In reality no effective global policy is ever going to be implemented. The EU should recognise this and focus instead on directly supporting research into new technologies which could reduce greenhouse gas emissions intensity (an intervention which could be done unilaterally, but affect emissions globally) and promoting adaptability and resilience in the face of global warming. The UK might quite possibly form better policy on its own. This is an especially interesting area of policy, because, arguably, there is a theoretical economic justification for EU action but the practicalities of an organisation with 28 members and highly complex institutions with different interest groups fighting for particular policies have meant that the result has been widespread "government failure".

Finally Christopher Snowdon focuses on the growing field of 'lifestyle regulation' – in particular, attempts by government prohibitions, taxes and subsidies to cut tobacco and alcohol consumption and change diets to reduce the prospect of obesity.

This overtly anti-market agenda threatens to limit personal freedoms. In the context of the EU, however, the interesting issue is that measures such as tax rises, advertising bans and minimum pricing can conflict with free trade and the single internal market. The European

Commission (which funds many 'lifestyle' pressure groups) may indeed sometimes have been frustrated by the European Court of Justice. For the ECJ has usually held that the single market trumps lifestyle regulation, if such regulation threatens competition across the EU. An example is the recent ECJ opinion against the Scottish attempt to introduce a minimum per-unit alcohol price.

Snowdon finds that the British (and Scottish) governments are frequently more draconian than the European Union has so far proved to be. UK consumers have thus been protected against their own governments' legislative appetite by EU requirements for free trade. Although 'sin taxes' such as those on tobacco and alcohol are arguably far too high in the UK, they would probably be higher still if the possibility of consumers legally importing significant amounts of these goods for personal use from the rest of the EU did not exist. Paradoxically British governments outside the European Union - whether Conservative, Labour or Coalition – would be likely to be more interventionist, restrictive and bureaucratic lifestyle regulators than the European Union.

Conclusion

A common thread running through the book is that the goal of 'ever-closer union' – understandable for the generation which pioneered European integration – is no longer a useful guide to the EU's future development in a rapidly-changing world. It is certainly not a useful guide to the EU's appropriate economic role.

SOME SUGGESTIONS FOR REFORM

- There should be greater competition between national jurisdictions in regulatory matters
- The role of the European Court of Justice in interpreting EU Law should be ended
- The European Parliament should be reduced in size
- The European Commission's dual role as initiator of legislation and enforcer of regulation should cease
- The commitment to 'ever-closer union' should be dropped
- Most aspects of the Common Agricultural Policy and the Common Fisheries Policy should be 'repatriated'
- There should be free trade in services
- Non-tariff barriers to internal trade should be scrapped
- EU transport policy should concentrate on issues where there are genuine externalities across border, though this could be done with cross-border agreements
- EU climate change policy should concentrate on promoting research rather than setting emission standards
- The EU should not try to push its competence into lifestyle regulation, and should stop funding activist organisations to lobby governments
- The EU role in restricting nation state regulation of lifestyle issues and of migration is to be welcomed

This study suggests that there are some areas where co-operation with our European neighbours brings positive benefits. There are also some areas where the EU and its institutions actually help to promote a more free and prosperous economy. However, in many other areas, the EU moves us in a direction of much less economic freedom than we could have outside – including in the crucial area of trade. If the EU is going to be a liberal institution in the long term it also needs institutional reform. This book provides a benchmark for such reform. David Cameron's much more limited reform agenda may have moved the EU a little in the right direction. On the other hand, depending on what happens in relation to migration policy, it is possible that renegotiation will leave us with a European Union that is less liberal than the one we have now.•

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FOR MORE...

The IEA study *Breaking Up Is Hard To Do: Britain and Europe's Dysfunctional Relationship* is available for free download at: ***www.iea.org.uk/publications/research/breaking-is-hard-to-do***

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FAST FOOD... SLOW RESULTS

In the last 20 years, research on the minimum wage has called into question economists' traditional views that such policies adversely affect employment. In this article, leading labour economists suggest this is because this more recent research hasn't taken sufficient account of long-run effects…and they look to the restaurant industry to underline their findings

When people who work full-time still live in poverty, there is often a strong urge for legislators to ameliorate their situation by requiring employers to pay a higher "minimum wage" or "living wage."

Indeed, such legislation dates back over a century in some countries.[1] Recently, there have been several initiatives in countries such as Germany, the UK and the US to expand the scope or increase the level of minimum wages.

The current federal minimum wage in the United States is $7.25 per hour, with some states and cities mandating higher rates. In the UK, the national minimum wage is £6.70 per hour for those aged 21 and older and ranges between £3.30 and £5.30 for those under 21.

However, for a family of four supported by a single full-time worker, those hourly rates are not sufficient to escape poverty.

Governments have various schemes to help such families out of poverty but, in the last year or so, politicians have been making proposals to relieve poverty by higher statutory minimum wages rather than through government income top-ups.

This has been the case in the UK, Germany and also in high cost-of-living cities such as Los Angeles, New York, San Francisco and Seattle (see table1).

Economists and the minimum wage debate

Economists recognise that the alleviation of poverty is a primary goal of policy. However, prior to the 1990s, economists almost uniformly opposed minimum wage legislation.

The rationale was that raising wages led to lower employment, potentially causing significant earnings losses to those who lost work opportunities.

This argument seemed to be supported by the best research, which consistently found a small but statistically and economically significant loss in employment after a minimum wage hike.

However, beginning in the early 1990s, a heated debate ensued about the size and even direction of the employment response. Some prominent researchers found that fewer people lost their jobs when the minimum wage went up than standard economic theory predicted.

ECONOMISTS RECOGNISE THAT THE ALLEVIATION OF POVERTY IS A PRIMARY GOAL OF POLICY. HOWEVER, PRIOR TO THE 1990S, ECONOMISTS ALMOST UNIFORMLY OPPOSED MINIMUM WAGE LEGISLATION

Advocates of a higher minimum wage often use this more recent research to justify their position that the minimum wage can be increased with few negative side effects.

Research on minimum wages can be easier to conduct in the US than in the UK because individual states often raise the minimum wage above the federal minimum.

Table1: Some recent minimum wage proposals and policy announcements

Country/city	Proposal/policy
UK	Increase minimum wage for people aged 25+ from £6.50 per hour at the time of announcement to £9 per hour by 2020
Germany	Introduced first ever minimum wage of £6.80 per hour from 2015
US – New York City	Increase minimum wage to £9.60 for fast food restaurants by 2018

That sets up a "natural experiment" – a simple comparison of employment in states that raised the minimum wage with comparable states that did not, both before and after the hike.

Some studies even compare the employment growth of neighbouring US counties that are separated by a state border, and therefore face nearly identical economic conditions other than the required minimum wage.[2]

This approach to research tended to deliver a smaller, and often statistically indistinguishable from zero, employment response to an increase in the minimum wage.

WHEN THE MINIMUM WAGE INCREASES, LABOUR-INTENSIVE RESTAURANTS – THOSE WHERE PEOPLE DO MORE WORK – ARE MORE LIKELY TO SHUT DOWN

Distinguishing the short run from the long run

One limitation of the great majority of these studies is that they focus on employment in the first few months, or at most a few years, after a minimum wage hike – we label this time frame as the "short run".

The supply of and demand for both products and factors of production such as labour and capital might well be more elastic in the long run than in the short run.

This means that the effect of changes in wages on the number employed might be greater in the long run. Indeed the process by which firms change the way they produce their goods in reaction to higher labour costs might be slow.[3]

In some cases, for example, this process might require firms which operate a large low-skill labour force to shut down in the face of higher costs and these firms may be replaced by firms that operate with fewer workers and more capital.

This is a process that takes time. The long-run loss of jobs in response to the minimum wage hike might be bigger than the short-run effect often estimated in the literature.

Our recent research[4] presents new evidence on how the restaurant industry, the largest US employer of low-wage labour, responds to minimum wage hikes. We document three new findings, as follows:

- Fast food restaurants are more likely to shut-down (exit) and open up (enter) after a minimum wage hike.
- The rise in entry is higher among chains, which use less labour.
- There is no change in employment among existing fast food restaurants that continue to operate – the fall in employment arises as a result of more labour-intensive restaurants being replaced with less labour-intensive restaurants.

Together, these results imply a small decline in employment two years after a minimum wage hike.

To interpret these findings, we develop a model where new restaurants can choose how mechanised their production will be. However, once they open, they cannot change the way they make their products.

Economists call such a technology "putty-clay": the initial choice of how to operate is flexible like "putty", but once the firm is open, the production process hardens into "clay" and cannot change.

For instance, some restaurants might choose to have customers order their meal from a worker, while others might set-up a computerised ordering system. But, once the systems are established, they do not tend to change.

This does reflect the reality of how businesses operate - of course old establishments can change how they use technology but, in this industry, it is new entrants that tend to bring about changes.

This model predicts that when the minimum wage increases, labour-intensive restaurants – those where people do more work – are more likely to shut-down, whereas capital-intensive restaurants – those where machines do more work – are less impacted by the minimum wage and may even open new restaurants to replace labour-intensive competitors that exit.

In this model, the employment loss due to the minimum wage grows over time because labour intensive restaurants are slowly replaced with more capital intensive restaurants. This process is slow, since it is costly to shut down a restaurant and open a new one in its place.

RAISING THE MINIMUM WAGE REDUCES THE NUMBER OF JOBS IN THE LONG-RUN

The results of this research suggest that a typical minimum wage hike causes an older fast food restaurant to shut down one year earlier than it otherwise would have done.

Our model has additional predictions that are consistent with previous research. Most prominently, as minimum wages rise, so do product prices. The reason is that restaurants still have to pay their workers the higher minimum wage, regardless of whether they are new or continuing establishments and they pass this additional cost onto their customers by making meals more expensive.[5]

Previous work has shown that all the higher labour costs of the minimum wage are pushed on to consumers in the form of higher prices.

But, what about the level of job losses? How big are the potential effects? These are difficult to measure precisely, although our estimates suggest that a 10 per cent increase in the minimum wage reduces restaurant employment by less than 1 per cent one year after the hike.

Our model, which matches this very small short-run effect, as well as the facts on restaurant entry and exit rates, predicts a 4 per cent reduction in restaurant employment in the long run.

Conclusion

Raising the minimum wage reduces the number of jobs in the long-run. It is difficult to measure this long-run effect in terms of the numbers of jobs that might be lost.

However, the key mechanism behind the model – that more labour-intensive establishments are replaced by more capital-intensive ones – is supported by evidence.

As such, recent research suggesting that minimum wages barely reduce the number of jobs in the short-run, should be taken with caution.

Several years down the line, a higher real minimum wage can lead to much larger employment losses•

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[1] See Kennan (1998) for a succinct discussion.
[2] See Dube, Lester, and Reich (2010).
[3] Aaronson and Phelan (2015) provide evidence that this process might be task-dependent as well. They find that low-skill/low-wage jobs that are cognitively-routine are particularly susceptible to being replaced soon after a minimum wage hike. That is not the case for jobs that are heavily manually-routine or non-routine.
[4] See Aaronson et al. (2015) and Sorkin (2015).
[5] See Aaronson (2001), Aaronson et al (2008).

A BETTER PICTURE

Television has been a public good, provided in a distinctive way, for a very long time. But technological innovation means TV is now a club good and can be supplied via a subscription system. IEA Education Director STEVE DAVIES says this will have profound implications for the BBC – and lead to greater variety, higher quality and more innovation

The question of how television broadcasting should be funded and supplied is very topical and highly contentious.

To the non-economist, all goods and services are the same in terms of their basic nature, however much they vary in superficial details.

Economists, however, have known for a long time that this is not so and that there are several different kinds of good and service. In analysing this there are two important questions that economists ask.

The first is whether the consumption of the good is rivalrous. If it is, then one person's consumption means others have less available to them. If I eat a chocolate bar, for example, nobody else can consume that bar.

Some goods and services, though, have non-rivalrous consumption so that more than one person can consume them at the same time. So if I walk down a street benefiting from the lights, this does not prevent other people from doing so.

The other major question is whether the good has the quality of non-excludability. With some goods and services the supplier can exclude people if they do not pay.

With other goods and services, however, people benefit from it regardless of whether they pay or not. The reception of radio signals is currently an example of this characteristic.

Public goods and club goods

Much semi-informed discussion assumes that there are only two kinds of good in the real world – those that are rivalrous and excludable (which we call 'private goods') and those that are non-rivalrous and non-excludable ('public goods').

However, in 1965, James Buchanan pointed out that there is actually a wide range of goods that are broadly non-rivalrous but excludable. These kinds of good are known as 'club goods'.

So what are the features of club goods? These are goods where, at least initially, and sometimes indefinitely, consumption is non-rivalrous so that one person consuming the good does not reduce the benefit others gain from it. At the same time, however, there is a means of excluding non-payers.

The classic example of this is a toll road. There is clearly a way of excluding non-payers. However, initially and for a considerable time, additional users do not reduce the benefit other users gain. Eventually, however, use becomes congested and an additional car on the road reduces the benefit to other users.

Policy implications of a public good becoming a club good

Buchanan's insight was that such goods do not need to be provided by governments or regulated monopolies. It is possible to have a charging system whereby potential users pay for access, typically using a subscription system.

After paying the subscription, users can consume as much as they like, though in some cases, there might be a small charge reflecting marginal cost – especially at busy times.

Furthermore, if the good is becoming over-used (for example a congested road) access can be limited by raising subscriptions or by charging different prices at peak times.

Alternatively, a competing road could be built. The owner has an incentive to respond to congestion and the existence of spare capacity in a rational way.

As such, in many cases there can be many different and competing 'clubs' providing the same good – this is the case in the actual instance of social clubs or sports clubs for example.

In other cases there may be a natural monopoly but the good can still be provided through a club mechanism whereby a fee is paid to the provider.

Of course, not all club goods have the quality of a 'congestion frontier' – consumption can remain non-rivalrous indefinitely: it is the quality of excludability that is key to the definition of a club good so that it can be provided through some kind of membership or subscription based institution.

All change in the world of broadcasting

When we combine economic reasoning of this kind with the history of changing technology, we also discover something interesting.

Changes in technology can cause goods to move from being public goods to club goods. There can be significant implications for public policy when the shift happens. The classic example of the moment is television broadcasting.

When television broadcasting first appeared in the 1920s, it was clearly non-rivalrous as indeed it still is – if an additional person watches a programme, it has no impact on other people's enjoyment of it.

Also, anyone who had access to a television receiver could enjoy broadcasts without paying for them. Television programmes and signals were public goods because they were both non-rivalrous and non-excludable.

One solution was to fund television programming through taxation. Another was to tie programming in with advertising.

In the UK, however, a third way was hit upon. Here the government decreed that you could not buy a television receiver without paying a compulsory licence fee and the income from this was used to fund the BBC – as it still is of course.

This worked because of the nature of the technology. You could only receive television broadcasts on a specially made set. The set was only useable for the purpose of watching television and could easily be linked to a particular address.

There was no way of ensuring that broadcasts could only be received by specific set owners who had paid for a particular programme, so there was non-excludability.

As a result, all set owners had to pay the "television levy" even if they did not choose to watch the BBC programmes the levy was designed to fund.

In the last decade the technology of television broadcasting and reception has been transformed.

GOOD OR SERVICE	RIVALROUS?	EXCLUDABLE?	TYPE OF GOOD
TRIDENT MISSILES	No	No	PUBLIC GOOD *(or bad, depending on your point of view)*
ROADS	No *(up to a point)*	Yes	CLUB GOOD
BROADCASTING PRE-1980	No	No	PUBLIC GOOD
BROADCASTING TODAY	No	Yes	Club good

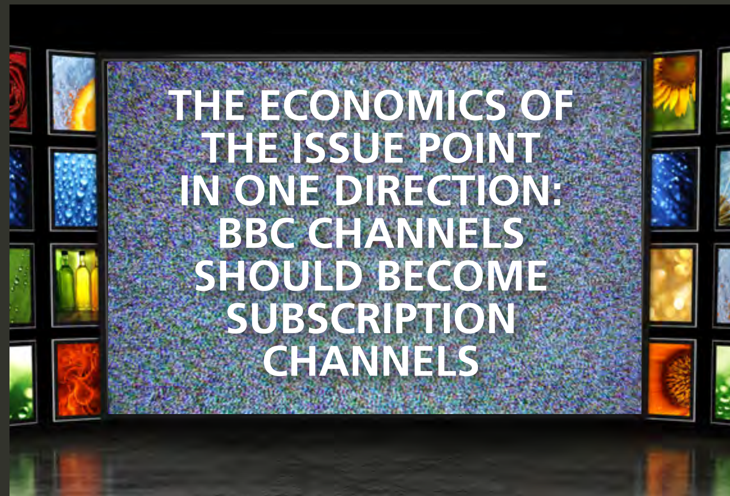
Amongst other changes, it is now possible to exclude people who do not pay for a specific programme from receiving it. This has profound implications for policy.

What this means is that television broadcasting has now become a club good rather than a public good. Programming now has the quality of excludability while still being non-rivalrous. The club mechanism of provision is now economically feasible through pay per view and subscriptions to channel packages.

This has a number of very important benefits. There can be many competing suppliers which means greater pluralism and variety. There is also more scope for competition and innovation.

The evidence of broadcasters such as HBO (funded by subscription) is that the model can lead to consistently higher quality.

Most interestingly, perhaps, the problem of 'lowest common denominator' broadcasting which plagues advertising-funded broadcasting is avoided.



When television is provided as a club good there is an optimum size of audience for any one channel that will provide the highest level of funding compatible with the content and quality that appeals to a given audience. Within subscription broadcasting both niche and popular programming are readily available.

This is all very relevant to the current BBC Charter Review. The economics of the issue point in one direction – BBC channels should become subscription channels•

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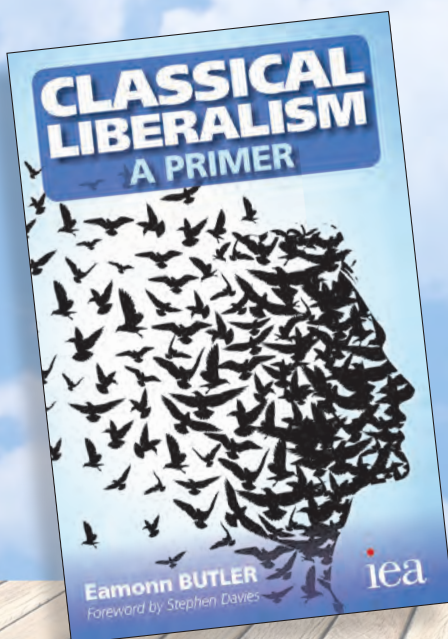

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A 'de SOTO EFFECT' IN INDUSTRY? EVIDENCE FROM THE RUSSIAN FEDERATION

Extending private land ownership has often been prescribed as a way to facilitate the flow of credit and private investment in low- and middle-income countries. But empirical research so far has struggled to test this hypothesis empirically.

- The authors take advantage of a particular set of circumstances in post-communist Russia to explore whether private land ownership increases access to finance and promotes investment.
- Privatisation in Russia in the 1990s applied to equipment and buildings, but the land on which they sat remained state-owned. Later, initiatives at federal and regional levels have promoted land privatisation. These circumstances allow the authors to isolate the effects of land privatisation from other factors unrelated to it.
- The authors survey a homogeneous group of 359 large urban industrial enterprises, dividing them into three groups: those which owned the land on which their capital sits; those which lease it from the government; and those which operate under the old Soviet system of land tenure.
- They find that plot ownership is associated with greater access to external financing and more intense investment activity. Notably, when surveying the managers of the firms studied, the latter pointed to land's value as collateral for loans as a major factor for purchasing the land•

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WHY ARE THERE STILL SO MANY JOBS? THE HISTORY and FUTURE of WORKPLACE AUTOMATION

- Over the past 250 years, the world economy has grown and changed beyond recognition thanks to technological improvements. Each wave of technical innovation – from the steam engine to automobiles to the personal computer – has brought about fears that the potential to substitute for human labour might render labour obsolete.
- So far, this fear has not been borne out. The employment-to-population ratio rose during the 20th century. Moreover, there has been no apparent long-run increase in unemployment. Nevertheless, increased computing power, artificial intelligence and robotics have led some to believe that this time could be different.

The author challenges this gloomy view of the future prospects for human labour:

- He shows that tasks that cannot be substituted by automation are complemented by it. This means that the value of the remaining human tasks is enhanced by automation, since technology makes production cheaper, faster and more reliable.
- The author uses the example of ATMs and bank tellers in the US as an illustration. Far from leading to lower employment of bank staff, ATMs reduced the cost of operating a branch and thus led to a substantial increase in the number of bank branches, and an overall increase in the number of counter staff. Additionally, information technology in retail banking increasingly enabled counter staff to move from low-value-added tasks such as cash-handling to higher-value work such as selling additional bank services to customers.

How about the claim that automation may not affect the number of jobs available, but might affect their quality?

- Autor acknowledges that ever cheaper computing power has tended to substitute for human labour in routine tasks such as bookkeeping and clerical work. But many of the tasks performed by humans require judgement, flexibility and common sense – the kinds of qualities that cannot be easily transferred to computers. The implication is that computing power can only be expected to substitute for some types of work. Jobs requiring large amounts of analytical and communications ability – such as top managerial work – and jobs demanding adaptability, empathy and personal interaction – such as nursing – are unlikely to be automated.
- It emerges that the employment polarisation between high-skill, high-wage and low-skill, low-wage jobs that American and European economies have seen recently is likely to be a temporary phenomenon. While some of the tasks in middle-skill jobs can be expected to be automated in the future, middle-skill jobs themselves will not disappear but will evolve towards more productive tasks, focused on those things that only humans can do•

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Journal of Economic Perspectives Volume 29 number 3 Summer 2015

MONEY MATTERS

LESSONS from RECENT HISTORY

What is the purpose of the National Institute of Economic and Social Research?

According to the home page of its website, it has provided "independent and influential economic research since 1938". That apparently remains its mission, with the website having five tabs, on "Financing Britain", "Macroeconomics", "Productivity performance", "Social mobility" and "UK, Europe and devolution".

On the face of it, the National Institute's interests today are eclectic and wide-ranging, and it has no particular ideological axe to grind. But that has not always been so.

Its heyday was in the 25 or so years from 1953 when, at the initiative of Christopher Dow and Bryan Hopkin, it established a macroeconomic forecasting group.

From the outset the National Institute's forecasting work had strong support from the Treasury. At first this support was mostly intellectual, but for many years from 1961 it took the form of financial grants, so that the National Institute was really part of the public sector.

The National Institute had a definite world-view. It was the champion of a Keynesian approach to macroeconomic policy, where "Keynesianism" meant the centrality of fiscal policy in so-called "demand management".

Dow pioneered the application of the Keynesian income-expenditure model to real-world macro-forecasting and policy decisions.

According to the model, which is a standard part of A-level and much undergraduate instruction in economics, output depends on expenditure which depends on income, with the incomes received as a result of the production of output.

The payments in an economy are then conceived as being a so-called "circular flow", which goes on forever unless it is hit by an outside shock of some sort.

An important characteristic of this model is that there is no role for the banking system or the quantity of money in determining macroeconomic outcomes. (Whether the National Institute's interpretation of Keynesianism had much contact with Keynes' own work is a moot question.

THE KEYNESIANS' TENDENCY TO POOH-POOH MONEY AND MONETARY POLICY WAS ASSOCIATED WITH AN ENTIRELY NON-MONETARY THEORY OF INFLATION

Dow was particularly dismissive of money, claiming that the quantity of money reflected expenditure and incomes, rather than the other way round.

The Keynesians' tendency to pooh-pooh money and monetary policy was associated with an entirely non-monetary theory of inflation.

Price increases were said to stem from cost pressures which were attributed to trades unions' wage demands. The unions had therefore to be restrained by direct government control of wages and prices.

National Institute thinking endorsed "the dash for growth" under Ted Heath's Conservative government from 1970 to 1974.

Highly expansionary policies began in late 1971 and early 1972, with big increases in public expenditure and explosively rapid increases in the quantity of money.

By early 1973 inflation was starting to become a concern, causing the government to impose limits on future price and wage increases, so that the annual rate of inflation was to stay in single digits. At the same time the quantity of broad money was growing at about 25 per cent a year.

Would money growth or the incomes policy determine inflation? Would the boom in demand stimulate sufficient extra supply? Would the dash for growth succeed?

The National Institute's February 1973 Review gave its blessing to official policy. Its author saw Heath's policies as Britain's exercise in expansionary Keynesianism, following the model of the USA in the Kennedy years when fiscal reflation had (allegedly) been the spur to several years of above-trend output growth.

The key features of the National Institute's February 1973 forecast are given in table 1. The forecast for output was annual out to 1976, but quarterly for the next 18 months, that is, to the second quarter of 1974.

The table compares the National Institute's view of output growth up to 1976 with the outturn.

The table shows that the National Institute was fantasising over the possibility that the Keynesian dash for growth in

Table1: The National Institute's forecast of UK output growth in early 1973, compared with the outturn

Year	Forecast in February 1973 *Review*	Outturn, according to latest data in 2015
1972	2.25	3.9
1973	6.25	8.0
1974	5.25	-0.9
1975	5.00	-0.2
1976	3.25	2.1

Source: National Institute *Review* for February 1973 and Office for National Statistics for outturn. (Mnemonic CDID in September 2015 database. Note that the outturn is on 2010 price basis, whereas the 1973 forecast was on a 1963 price basis, and this may affect the comparison).

the UK would succeed.

Instead of several years of smooth above-trend growth, the UK had one year of crazy boom (1973) and then two years of falling output. (To give some perspective on how dreadful the boom-bust experience was, the UK did not suffer a single year with an outright output decline in the 25 years from 1948 to 1973.)

It is also clear that the National Institute was hopeless at predicting inflation. Whereas in February 1973 it had expected consumer prices to rise by 6 per cent in the next six quarters, in practice they went up by over 16 per cent. The peak increase in the retail price index came a bit later, in August 1975, at 26.9 per cent, a figure which was uncannily close to the highest rates of money growth seen in 1973.

The similarity of the peak rates of increase in both the price level and the quantity of money was compelling evidence that money did matter, regardless of the views of Christopher Dow and the Treasury mandarins.

The next period of extremely fast money growth began in late 1985, as the Thatcher government ditched the monetary control that had been basic to its original agenda.

By early 1987 the stock market and house prices were advancing quickly, and once more a boom was under way.

But the National Institute denied that anything of the sort was happening. It failed completely to anticipate the 5.0 per cent and 5.5 per cent growth rates of national output recorded in 1987 and 1988.

After gleefully reporting that the Thatcher government's monetarist framework had been "almost entirely abandoned", the February 1987 issue of the National Institute Review forecast output growth of 1.5 per cent in the last three quarters of 1987 and 2.5 per cent (i.e., at an annualised 1.4 per cent) in the seven quarters to end-1988. The outturns were three times higher to end-1987 and four times higher to end-1988.

Because banking and money are not integrated in National Institute forecasting, its model breaks down – hopelessly – in periods of financial upheaval and monetary instability.

Needless to say, the forecast in its July 2008 Review gave no warning about the Great Recession.

It gave an 18-page analysis of "Prospects for the UK economy", with quarterly changes in output projected to the end of 2010. Not one quarter of falling output was foreseen.

Again, the National Institute's forecasting team had been unable to spot the early signs of a damaging boom-bust episode.

The National Institute has failed to forecast these episodes correctly because of the failures of the Keynesian income-expenditure model and the associated apparatus of macro-forecasting.

These failures have been both intellectual and practical, and at root go back to the ludicrous notion that the quantity of money is irrelevant to the economy's behaviour.

That notion was put about by Dow and many others in the 1940s and 1950s, in a mendacious misrepresentation of Keynes' own beliefs•

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PHILIP BOOTH EXAMINES THE POPE'S VIEWS ON THE ENVIRONMENT

Pope Francis' analysis of the state of the world in his encyclical *Laudato si* is unduly pessimistic.

It is correct to say that pollution leads to premature deaths. But the underlying picture is one of huge increases in life expectancy and health because of economic development that is taking place.

Within the document there are also various ad hoc attacks on the market economy. The Pope argues that water should not be privatised because it is a scarce resource. In fact, the purpose of markets is to allocate scarce resources.

Whilst it is important that all have access to clean water – and improvements in this regard are a crucial element of the economic development of the last 30 years – to argue that it should not be provided by markets is no more sensible than arguing that food should not be provided by markets.

Indeed, in many African and Asian countries, water shortages are seriously exacerbated by relatively wealthy industrial and farming interests benefiting from water subsidies and growing totally inappropriate water-thirsty crops.

Nowhere in the document did the Pope mention fossil fuel energy subsidies – in other words, the policy of paying people to emit greenhouses gases.

As *The Economist* put it: "It would be hard to find a worse [mistake] than energy subsidies. Recent research has shown that they enrich middlemen, depress economic output and help the rich, who use lots of energy, more than they do the poor."

Also, there is no recognition that the models of development that are criticised by the Pope have led to rapidly falling rates of poverty and deaths from natural disasters whilst access to education and healthcare has improved.

Furthermore, nowhere is it acknowledged that the natural resource intensity of production falls dramatically as countries develop. The carbon intensity of production falls; we stop using whales for oil; we stop plundering forests and instead nurture them; and so on.

Economists see environmental problems as problems of property rights not being enforced or defined.

For example, business ABC cuts down a rain forest in Brazil and destroys the livelihoods of indigenous tribes and causes flooding in a neighbouring country.

In developed countries, these problems are generally solved. Sometimes they are solved using regulation and sometimes using traditional common law property rights. Good governance, the rule of law and the effective definition of property rights are essential pre-requisites for addressing many environmental problems.

Given that poorly defined and enforced property rights lie at the heart of so many environmental problems, especially in poor countries, this whole area is a big omission from this encyclical.

It is far more fundamental than many of the political-economic issues discussed by Pope Francis which really were a diversion from the excellent moral-theological analysis•

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Full version at: www.iea.org.uk/blog/property-rights-and-the-environment-a-response-to-pope-francis%E2%80%99-encyclical

KRISTIAN NIEMIETZ ANALYSES THE STRIKING DIFFERENCE BETWEEN LEFT AND RIGHT

"Strikes have the added benefit that they give people a nice opportunity to signal their ideology to others", a friend of mine tweeted yesterday.

At least as far as my timelines on Twitter and Facebook were concerned, that was exactly right.

At the heart of our disagreement over strikes lies the fact that different political camps hold fundamentally different assumptions about the question of what determines the living standards of ordinary people.

Why is a manual labourer in 2015 so much better off than a manual labourer in 1915, and why is a manual labourer in the UK so much better off than a manual labourer in the Philippines? People who broadly believe in free markets would answer the question more or less as follows.

With the right set of institutions in place, an economy's capital stock grows over time, which raises the productivity of labour, and thus its remuneration.

Technological and organisational innovation raises total factor productivity, which works in the same direction.

Improvements in transport, logistics and communication technology lead to 'thicker' markets, as they enable wider, more sophisticated patterns of specialisation and exchange.

We get better at matching the right kind of labour with the right kind of capital. The economy grows, we all grow richer.

For large parts of the left, these are at best sideshows. They believe that progress in the lives of ordinary people is the result of power struggles. It does not just happen 'naturally', it has to be actively fought for, wrestled from the hands of a reluctant elite, and then constantly defended.

When it comes to telling stories, supporters of the market economy would talk about the first railways, the first telegraph, the first transatlantic flight and the first mass-produced car, about digitalisation, about the emergence of discounters and no-frills airlines.

Left-wingers would talk about the history of factory acts and other pieces of 'progressive' legislation, the emergence of trade unions and the creation of the welfare state.

For the left, tube strikes touch the right buttons. They earn far more than soldiers, firefighters, nurses, teachers and policemen, you say?

Well, that's an argument for raising the wages of soldiers, firefighters, nurses, teachers and policemen, not for cutting the wages of tube drivers. Never mind that, in a country where the average full-time salary is £32,250, we cannot all earn over £50,000, no matter how strong the union movement.

But such details are as unimportant as the specifics of what a strike is about. Strikes divide us, because we tell ourselves different stories about how the world works, and role of strikes differs vastly from story to story•

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Full version at: www.iea.org.uk/blog/power-or-productivity-why-we-disagree-over-tube-strikes

LEN SHACKLETON APPRAISES THE APPRENTICESHIPS LEVY

Real apprenticeships provide skills which workers can take to other employers and obtain a wage higher than they would have earned otherwise.

Historically, they were paid for by binding young employees (with legal sanctions for breaking the agreement) to work for a fixed period with very low pay, and often with an upfront payment from the family or sponsor of the youngsters.

In modern conditions, with few restrictions on employee movement, minimum wage legislation (albeit with a lower rate for some apprentices), and when the costs of many types of training are beyond family resources, a shortage of apprentices can arise.

The obvious government intervention, if this is a problem, is to provide income-contingent loans, as we do for undergraduates, and allow young people to look for apprenticeships which suit them.

Governments like ours do not think about apprenticeships as rational career investments by individuals, but rather as the key to higher productivity for what they often describe as "UK plc".

Anecdotal arguments about shortages of highly-skilled workers are quoted, but the argument that 3m apprentices by 2020 will produce big productivity gains has no secure basis.

Recent governments have spent a lot of money subsidising apprenticeships: in England, £1.6bn in 2014-15. They have done it in an odd way, too: a government-funded organisation, the Skills Funding Agency, has contracted with "providers" (such as further education colleges) to sign up a certain number of employers.

Employers have been fairly passive in this set-up, with much paperwork and assessment of apprentices being dealt with by providers. Formal training programmes relate to standards laid down by the Skills Funding Agency and other external bodies.

The incentive for providers has been to generate large numbers of low-level apprenticeships, which are short, cheap and easy to complete as payments are made for successful completion.

In 2013-14, only 2 per cent of apprentice starts were at the higher level, the equivalent of most German apprenticeships. Two-thirds of the 440,000 starts were at the lowest (misleadingly termed "intermediate") level.

Rather than new apprentice jobs being provided, some employers were simply rebadging existing staff, as in the notorious case where over 20,000 existing Morrisons supermarket workers, 88 per cent of whom were over the age of 25, were enrolled as "apprentices".

This isn't only a wasteful policy. There will be other negative consequences. In practice, ``the apprenticeships levy acts as a crude payroll tax.

Such taxes are eventually passed on in reduced wages and/or reduced employment, probably – paradoxically – for the lower-skilled. This is, then, a tax on shelf-stackers.

This article also appeared in CityAM•

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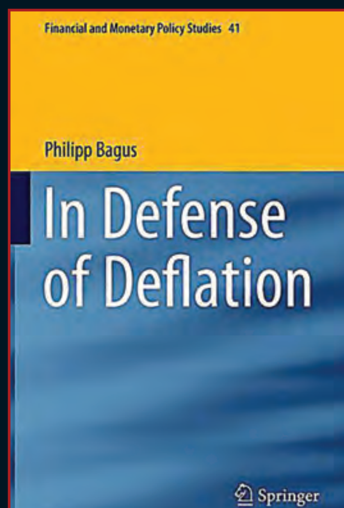
Full version at:www.iea.org.uk/blog/the-apprenticeships-levy-and-apprenticeship-targets-the-economics-of-the-cargo-cult

IN DEFENSE OF DEFLATION

PHILIPP BAGUS
SPRINGER 2015



The world often seems to be scared of deflation. For example, at the beginning of the 21st century, after the dotcom crash, there was widespread fear of deflation in the US. The response to this fear was several years of loose monetary policy which, arguably, contributed significantly to the financial crash of 2008.

In much of the commentary in the UK in recent years, we have at least come to accept so-called "good" deflation. The fall in the price level (or, strictly speaking, the fall of inflation to below target) in recent times has been caused by the fall in commodity prices and so is an adjustment to supply-side conditions that only brings benefits in terms of lower prices for consumers and lower costs for businesses.

But, Philipp Bagus' book, *In Defense of Deflation*, deals mainly with what is widely believed to be "bad" deflation. This would involve a continuing fall in the price level caused by monetary deflation. The book is excellent and timely.

Bagus begins by noting that there was very little concern about deflation amongst economists before the 20th century despite the fact that happened relatively frequently. In the current era, we are fearing something that we have not experienced whereas, in the past, the reality did not seem worth writing about.

After this discussion of the historical context, there is an excellent section on the functions of money balances which is accessible to any student of economics (though I disagree with the author on the apparent "legal privileges" of fractional reserve banking). Indeed, this section could be applied to help our understanding of fluctuations in the value of digital monies such as Bitcoin.

The book moves on to knock down the theoretical arguments against deflation. Bagus also shows how the losers when prices fall unexpectedly are powerful interest groups (generally firms for which the value of debt rises in real terms) who are able to lobby against deflation.

Perhaps in knocking down the arguments against deflation the pudding is over-egged. The impression is sometimes given that monetary disturbances are part of life that entrepreneurs and other households can deal with.

If that is so with deflation, then it is also the case when it comes to inflation. But the same author would argue that inflation distorts investment decisions and is highly damaging.

The book finishes with excellent case studies. It examines the US between 1865 and 1896. In fact, this was a "growth deflation" whereby economic growth in the context of stable monetary policy allowed prices to fall – in many ways another type of "good" deflation. The German deflation of the 1930s is also discussed. This is interesting in that it followed a bout of inflation.

Bagus argues that the problems arising during the deflation were largely inevitable after the distortions caused by earlier inflation and, in fact, deflation speeded up adjustment, which would have been faster still had labour markets been more flexible.

This is an excellent book. A student e-edition is available now for just €25. Bagus has put together a highly effective defence of deflation in most circumstances.

A second edition (or perhaps a different book by the same author) would benefit from a discussion of, for example, present-day Japan and also the euro zone. In the euro zone, if deflation is not accepted in some countries at some times, there will be a very strong bias towards inflation because the ECB will loosen monetary policy to avoid deflation anytime, anywhere. A sequel would also benefit from more explanation of the economic reforms that would reduce the costs of deflation•

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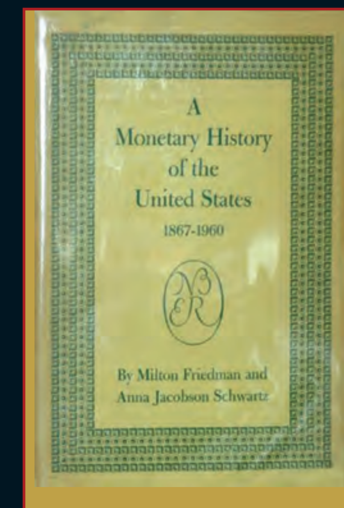
A MONETARY HISTORY OF THE UNITED STATES 1867-1960

MILTON FRIEDMAN AND ANNA JACOBSON SCHWARTZ
PRINCETON UNIVERSITY PRESS 1963



It can be easily claimed that Friedman and Schwartz's *A Monetary History of the United States* is one of the two books that most influenced economic policies in the twentieth century, the other being Keynes' *General Theory* (1936).

During the 20 years or so that preceded the publication of the *General Theory*, the Great War, the Russian Revolution and the Great Depression not only caused the destruction of the prevailing liberal order, but also destroyed many of its underpinning beliefs.

Keynesianism became the accepted wisdom guiding fiscal and monetary policy of the post-war financial order, with plenty of wiggle room for inflationary policies in a world where the money in your pocket was many degrees apart from the gold notionally anchoring the US Dollar that anchored the international monetary system established in Bretton Woods in 1944.

When *A Monetary History of the United States* was released, it made public a wealth of data showing the relationship between the stock of money and other economic phenomena clarifying many theoretical questions.

Milton Friedman's treatment of the demand for money and the Great Depression is a good example of the different policy conclusions elicited from the economic data.

At the time *Studies in the Quantity Theory of Money* was published (Friedman, 1956), influenced by Keynes, the demand for money was considered to be very elastic in response to changes in the interest rate, and the propensity for consumption was considered rigid.

From that came the idea that "the Great Depression was the result of a collapse in investment, amplified by the multiplier, and monetary policy had been powerless to offset it". But that changed with Friedman and Schwartz's research. As pointed out by David Laidler in a 1994 essay:

> *Friedman's theory of the Consumption Function (1957) would soon challenge the idea of a stable marginal propensity to consume out of current income, and hence of a stable multiplier, and in 1956 he was suggesting that it was the demand for money function which was the stable relationship in the economy.*

This had drastic implications. Leading economists came to regard the business cycle as a largely monetary phenomena and the quantity of money as having more explanatory power than autonomous expenditure variables.

Eventually, a new synthesis was developed and it is safe to say that today the differences between monetarists and Keynesians are more political than methodological; and the authoritative data presented in *A Monetary History of the United States* was key for that development to happen.

Another important aspect of Friedman and Schwartz's research is the evidence they brought to light of the inflationary expansion of money and credit in the US as part of American war financing.

In the words of Friedman and Schwartz, "The Federal Reserve became to all intents and purposes the bond-selling window of the Treasury, using its monetary powers almost exclusively to that end.

Although no 'greenbacks' were printed, the same result was achieved by more indirect methods using Federal Reserve notes and Federal Reserve deposits" (216).

During World War I, the Fed also expanded the money supply and the cost came in the form of post-war inflation of roughly the same magnitude as the variation in the money supply.

There are many lessons to learn from Friedman and Schwartz's account of monetary history.

Chief among these is the role of central banking in war finance. Their research continues to influence current economic understanding and policy in many different ways•

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SOUNDBITE

FOR PROFIT: Better than NO PROFIT

GABRIEL HELLER SAHLGREN ON THE PROFIT MOTIVE IN EDUCATION

In the past decades, an increasing number of governments have pursued reforms to increase choice, competition and autonomy in education.

Research indicates that these reforms have generally had mildly positive effects, despite often being poorly designed. In other words, reformers could do better.

A common problematic feature is the lack of a profit motive, which remains banned in most education systems, partly due to fears that for-profit firms would cut costs at the expense of quality.

Such firms are also said to be especially prone to compete by 'cream skimming' the best pupils. Rather than generating higher outcomes, it is argued that allowing profits would leave us worse off.

Yet the same fears are often voiced against profit-making firms' behaviour on other markets – where they clearly play an essential role in improving outcomes. And, in fact, there are good reasons to believe that allowing the profit motive in education would also improve outcomes.

As long as parents are informed and can exercise choice, for-profit providers have incentives to increase quality per pound spent.

They also have stronger incentives to start new schools, close down those in low demand, and scale up those in high demand. In short, profit-making operators have the potential to improve the overall functioning of the education market.

In fact, there is no evidence that profit-making schools underperform. In the US, Chile and Sweden, research indicates that for-profit providers generate either higher or the same results as other types of school. The idea that the profit motive drives down quality cannot be justified by the evidence.

As it happens, profit-making schools do not have to outperform other schools to be useful. If they produce the same results while making a profit, we are better off as profits are subject to taxation, the proceeds of which could be spent on other goals.

Similarly, unlike non-profit organisations, for-profit providers can raise investment funding in the private market to cover their capital investments, thereby reducing government budget pressures.

Ironically, therefore, allowing schools to profit from public funds could enable governments to bring in more money overall (or spend less for the same results).

Furthermore, since profit-making firms have stronger incentives and opportunities to start schools and expand, they also tend to increase competition more significantly than other providers.

And research using international test scores shows that competition from private providers generates higher outcomes in both state- and privately-operated schools.

So profit-making schools themselves do not have to be better to have a beneficial effect on the quality of the system as a whole.

But what about cream skimming? In fact, evidence from Chile and Sweden indicate that for-profit schools enrol more disadvantaged children than non-profit providers.

By expanding choice and competition to cover the less fortunate, for-profit schools can generate greater equality of outcomes.

We should end the ban on profit making in the English state-funded education system. In the name of evidence-based policy, we could start with a large-scale regional randomised trial.

As long as results are not negative, which is the appropriate yardstick, the policy could be rolled out nationwide – not only allowing providers to profit, but pupils and taxpayers as well•

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WHAT IS A SOCIAL MARKET ECONOMY?

RAZEEN SALLY DEFINES A MUCH-MISUNDERSTOOD PHRASE – AND HIGHLIGHTS THE THREAT TO THE GERMAN ECONOMY

"Social market economy" is a vague slogan in European political debate. The term originated in Germany. But what does it really mean?

Most people think it means a mixed economy, combining the "efficiency" of the market with "social justice". The latter requires government intervention to distribute the fruits of the market economy "fairly". This is the social-democratic version of a social market economy, one that is strongly slanted towards "distributive justice".

Alfred Müller-Armack, a German economist and sociologist, coined the term (soziale Marktwirtschaft) in 1945. He sought a "new synthesis" of market freedom and social protection.

His conception of the market economy owes more to mechanical physics than to biology: the policy-maker "engineers" the "free" market to produce the maximum of wealth, which can then be redistributed in the name of social justice.

This view of social market economy became popular in West Germany from the late 1960s. And from Germany it spread elsewhere in Europe. It is seen as a genuine "third Way" between extreme socialism and extreme capitalism.

That is why Tony Blair, backed by his intellectual guru Tony Giddens, talked about the third way so much during New Labour's heyday.

But, from the 1940s to the 1960s, a different view of Social Market Economy held sway in West Germany.

To the public, it was the economic philosophy and programme of Ludwig Erhard, the Federal Republic's Economics Minister from 1949-63, and Chancellor from 1963-66. Erhard is known as the father of West Germany's Wirtschaftswunder – its post-war "economic miracle".

In Erhard's inner circle were economists and lawyers from Freiburg University. Their central concept is Ordoliberalism. Walter Eucken, the Freiburg School's founding economist, outlines a free-market order, constituted and regulated by a "policy of order" (Ordnungspolitik).

Ordnungspolitik maintains the market economy's framework of rules, but it does not intervene in the economic process: price-setting and resource allocation are left to market participants. To use a classical-liberal analogy, the state should be the market's umpire, but not one of its players.

Ordnungspolitik should avoid interventions that impair the free operation of the price system and the market whilst monetary and exchange-rate policies should guarantee price stability.

The state should uphold freedom of contract and freedom to trade; and it should avoid discriminatory interventions to favour particular sectors and firms.

Economic policy should steer clear of erratic changes that cause private actors to shun risk-taking and investment.

Eucken also favoured strong competition rules to prevent public and private restraints on trade.

Wilhelm Röpke and Alexander Rüstow were also in Erhard's inner circle. They were concerned with the non-economic – or social -- foundations of a market economy. To Röpke, this is "what lies beyond supply and demand".

Röpke and Rüstow regard the social part of the social market as part of an organic whole, along with the rule of law and free markets – not a redistributive device to correct the iniquities of a mechanical market.

Social cohesion emerges spontaneously from below, nurtured by the traditions and conventions of institutions such as the family, church, workplace, sports clubs and other voluntary associations.

These foster virtues of responsibility, self-help and civic-mindedness – the moral framework that sustains a successful market economy.

Social policy is first and foremost Ordnungspolitik, integrating as many people as possible into market society, with a basic safety net for those who fall by the wayside.

This, then, is a conservative-liberal view of social market economy, not a social-democratic one.

It has more in common with Edmund Burke and Alexis de Tocqueville, and indeed with Smith, Hume and Hayek, than it does with John Rawls, Tony Blair and Bill Clinton. And it was the social market economy Ludwig Erhard believed in when he was in charge of West German economic policy.

What competitiveness Germany has today is a legacy of Erhard's Ordnungspolitik. His free-market reforms transformed the western, non-Communist half of Germany from wartime destruction into Europe's economic powerhouse and a world leader in industrial exports.

But Germany carries the burden of half a century of post-Erhard "social" interventions; the result is high taxes, heavy regulation and a large welfare state.

Today, Germany's economy is ill-equipped to tackle big challenges such as an ageing population and the need for a more services-based economy.

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CASH POINT

CHRISTOPHER SNOWDON ON THE CITIES CREATING THEIR OWN LOCAL CURRENCIES

Last year, Exeter became the latest city in Britain to introduce a local currency. Totnes, Bristol and Lewes had already done so.

Supporters of the Exeter Pound, which can only be exchanged at participating local businesses, say the initiative is designed to improve local residents' 'sense of place, identity, and belonging'.

And so it might, but they also make some strange economic assertions, including claiming that it will help to prevent money 'leaking out' of the city and that it will create a multiplier effect that will enrich the area.

When an ordinary pound is spent in Exeter, they say, 65p 'swiftly leaves the city' whereas, when an Exeter Pound is spent, £1.73 is 'generated'.

Such beliefs demonstrate that age-old misconceptions about how wealth is created linger on in the 21st century.

The idea that a community will become richer if it clamps down on trade with the rest of the world is the fallacy that inspired self-defeating protectionism for centuries.

The discredited system of mercantilism that dominated the global economy from the 16th to 18th centuries depended on the belief that circulating money in the domestic economy, rather than gainfully exchanging it for goods from other countries, was the route to prosperity.

This led to an obsession with the balance of trade, of which Adam Smith said 'nothing could be more absurd'.

The problem with mercantilism, as Smith pointed out, was that it confused wealth with money. Money is a token of exchange. The amount of wealth it brings depends on what you can buy with it.

An Exeter Pound can only buy what an Exeter business is able to sell. If Exeter businesses were able to guarantee the goods Exeter consumers wanted, there would be no need for them to shop online or out of town in, say, Taunton.

Of course, Taunton might also be tempted to 'protect itself' by launching a local currency of its own. This would be self-defeating. The people of Exeter would not be able to buy goods and services from the people of Taunton, in turn, the people of Taunton would now not be able to buy from the people of Exeter.

The point about free trade is that it benefits both parties and, under these policies, trade between Exeter and Taunton would reduce.

Like the mercantile system of old, local currency schemes protect some businesses at the expense of consumers. In the long term, they both lose out because businesses in each town cannot sell to consumers in the other town and businesses are less likely to innovate, specialise and improve.

One only has to imagine what would happen if every town in Britain decided to trade exclusively with local firms to see how inefficient this would be. No place would be able to exploit its comparative advantage and everybody would suffer.

No town and no nation can guarantee the best quality at the lowest prices, nor provide the degree of specialisation and scale of production that leads to a wealthy society.

Hence the need for specialisation and free trade. Money needs to 'leak out' of the economy so that goods can leak in•

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