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SOBER ASSESSMENT

CHRISTOPHER SNOWDON ON THE UNEXPECTED EFFECT OF MINIMUM ALCOHOL PRICING

A minimum price for alcohol is viewed by some as a boon for Britain's struggling pub industry.

When David Cameron was weighing up the policy in 2013, the chief executives of several pub chains publicly urged him to go ahead with it.

Minimum pricing involves setting a floor price of around 60p on every unit of alcohol. The idea is to take 'cheap' drink off the market to protect heavy drinkers from themselves.

Since alcohol is almost invariably sold for more than 60p per unit in pubs and clubs, some people assume that narrowing the price gap will increase sales in the hospitality industry.

This logic is appealing because a drink bought in a supermarket is a substitute for a drink bought in a pub, but economic analysis suggests that minimum pricing could have quite the opposite effect on pubs.

To see why, we must consider the counter-intuitive finding that low income consumers in China buy more rice when the price of rice goes up, as shown by Jensen and Miller (2008)*.

A rise in price should lead to fewer sales, so how do we explain this 'Giffen behaviour'?

Like most economic issues, it comes down to limited resources. If your budget for food is tightly constrained, you need to get the most calories for your dollar. Carbohydrates such as rice are the cheapest sources of energy in many countries.

When times are good, the poor can afford to buy meat as well, but if the price of carbohydrates rises, they have a choice between eating less meat or eating less food.

Let's say that 50 cents buys you rice containing 2,000 calories or meat containing 500 calories. If you have a food budget of one dollar a day, you can buy both, but if the price of rice suddenly rises by 50 per cent, what do you do?

2,000 calories of rice now costs you 75 cents. If you keep buying your 50 cents of meat, you will have to buy a third less rice and go hungry. It makes more sense to sacrifice the relative luxury of meat.

This may seem an extreme example that has little to do with the pub trade in wealthy countries, but it is really just a question of budgeting. If you have a set budget and fixed preferences, a rise in prices is likely to push you towards the cheapest option.

Assume a particular individual wants to drink ten beers a week and has £20 to spend. You have one beer a day from the supermarket at £1 each but on Saturday you go to the pub and have four beers at £3.50 each.

The effect of minimum pricing is to raise the price of your supermarket beer to £1.50. If you want to keep drinking ten beers a week, without spending anymore, you will have to cut down to two bottles in the pub and buy an extra two bottles from the supermarket.

In practice, that is only one option reflecting one set of preferences. A consumer might instead decide to increase their beer budget or to do without a couple of beers mid-week.

But of all the options available, surely the least tempting is to cut down to five or six beers a week and buy them all in the pub - and yet that is what the consumer would have to do for minimum pricing to benefit pubs.

In the same way, if the price of food in supermarkets rose by 50 per cent, it is unlikely that people would flock to restaurants. They may well eat out less to save money for groceries. So it may well be with alcohol.

Minimum pricing will leave people who buy cheap alcohol in supermarkets with less disposable income. Alcohol, as a commodity, is unlikely to be a Giffen good.

Minimum pricing is unlikely to increase overall alcohol consumption, and it is possible that people who only buy cheap alcohol from supermarkets may drink less overall.

But for consumers who have a particular desired consumption level and are quite indifferent as to where they drink it, buying more of the cheapest option and less of the pricier option is a rational response, even though the cheapest option is more expensive than it used to be.

When budgets are tight, we cut down on the luxuries first●

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* Jensen, R. and Miller, N. (2008) Giffen behaviour and subsistence consumption. *American Economic Association* 98: 4 (1553-77)

GIG ISSUE

JAMIE WHYTE ON THE PERILS OF REGULATING THE GIG ECONOMY

Matthew Taylor was a policy advisor for Tony Blair from 1998 to 2006.

The current Conservative-led government commissioned him to write a *Review of Employment Practices in the Modern Economy*, which was published in July this year.

In it, Taylor recommends laws aimed at giving workers in the "gig economy", such as Uber drivers, a better deal.

Specifically, he says the law should guarantee them many of the same rights as regular employees, including holiday pay, sick leave and the equivalent of a minimum wage.

There is nothing unusual about this. Regulating to give people a better deal has become the main occupation of politicians, and recommending such regulations the main occupation of their advisors. Alas, the endeavour is doomed to failure.

The reason is entirely general but let's stick with employment law.

Imagine you were negotiating an employment contract. After haggling with your would-be employer, you settle on a salary of £30,000. Then you surprise her by saying you want six weeks' holiday rather than four.

She will, obviously, revise her pay offer. The most she was willing to pay for 48 weeks' work was £30,000. Now it turns out she will get only 46 weeks' work from you: 5 per cent less. So she will cut your salary – by 5 per cent most probably.

In short, you face a trade-off. You can have more money and less leisure or less money and more leisure. The choice is yours.

Except … it isn't. Employment contracts that do not provide at least 5.6 weeks' paid holiday are illegal in the UK. You are required by law to take the less-money-and-more-leisure option.

This law cannot help employees. If this is an employee's preferred option, then he is no better off, since he was already free to negotiate it. If he would prefer more money and less leisure, the law positively harms him.

Trade-offs are economic realities. If you take more holidays you produce less and are, therefore, worth less to your employer. No act of parliament can overcome this fact. It can only force you to take one trade-off rather than another.

Uber does not now provide sick leave, holiday pay and so on. If the government forces it to, it will need to claw back the cost of these things by worsening the deal drivers get in other respects – probably by reducing the share of fares they keep.

Some will suggest that further regulations should prevent Uber from responding in such a way. Uber would then have to pass the extra cost onto customers through higher prices. These higher prices would reduce demand for the labour of Uber drivers, whose incomes would therefore decline.

The trade-offs we face are a consequence of nature and the state of technology.

Some trade-offs are unlikely ever to change. If you are in London you cannot simultaneously be in Paris. The cost of being in one place is not being in the next best place you could have been, and I guess it always will be.

But other trade-offs have improved. Smoking increases your chance of getting lung cancer from 0.3 per cent to 7 per cent. Some people are willing to accept this increased risk for the sake of the pleasure smoking gives them.

But, if what they like about smoking is simply inhaling hot nicotine infused air, they can now get a much better deal. Vaping technology allows you to inhale such air while increasing your chance of getting cancer by much less. Vaping has improved this trade-off.

Every advance in the efficiency of production improves the trade-offs we face.

Televisions once cost 20 times what they cost today. In today's money, buying a TV in 1970 meant forgoing £3,000 worth of other stuff. Now you need forgo only £150 worth of other stuff to have a TV.

In 1700, most human labour went into producing food. Modern agricultural techniques have reduced this to less than 5 per cent, leaving us free to do other things.

It is such advances, not regulation, that provide us with better deals. Regulations merely limit our choices among the deals that are available to us.

In employment, they make it harder for employers and employees to find mutually agreeable terms. This is why countries with highly regulated labour markets, such as France and Spain, have high rates of unemployment.

In his *Review*, Taylor notes that the UK has a low rate of unemployment because its labour market is lightly regulated. Then he recommends regulating it more heavily.

It's perverse but unsurprising. Having accepted a commission to tell the government how to regulate us into better jobs, what's a man supposed to do? Say it can't be done?●

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PRODUCTIVITY PUZZLE...

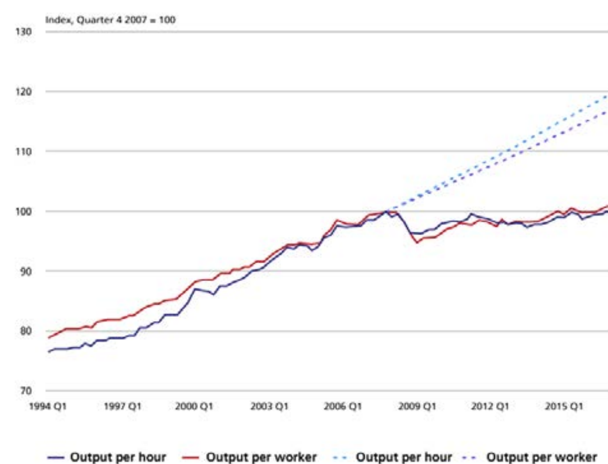
JULIAN JESSOP CONTEMPLATES AN ECONOMIC CONUNDRUM

As the US economist Paul Krugman once famously remarked, 'productivity isn't everything, but in the long run it is almost everything'.

Gains in productivity are the surest way to boost real wages and living standards. At face value, then, the UK has a major problem: output per hour and output per worker have both stagnated since the recession of 2007-08 (see Figure 1).

What's more, the UK's productivity performance appears to be much worse than its peers. In 2015, output per hour worked in the UK was nearly 16% below the average for the rest of the G7, with particularly large shortfalls relative to France (23%) and Germany (27%).

The gap is narrower using the alternative measure of output per worker (due to longer hours and shorter holidays in the UK), but it is still large. And while productivity growth has slowed in almost all countries since the mid-2000s, the deterioration relative to the previous trend has been more severe in the UK.



There are several plausible explanations. It is always worth asking first whether the data are reliable. One possible failing is the under-recording of output. Improvements in the quality of goods produced or increases in the output of service sectors (particularly the digital economy) are not always accurately captured in the official statistics.

However, it is unlikely that these measurement problems have become significantly worse since the recession, or that they are that much greater in the UK than in other major economies.

Averages could also be misleading. For example, a country suffering from high unemployment, and where only the most productive people have jobs, might report a higher average level of productivity than a country nearer full employment.

However, people in comparable jobs in these two countries might still be equally productive. This could help to explain the differences between the UK and France, where unemployment is much higher.

A further issue is the sectoral pattern. The UK's poor recent performance can partly be explained by declines in sectors where productivity has traditionally been highest – notably finance & insurance and oil & gas – and by shifts in economic activity towards labour-intensive service sectors where the scope for productivity improvements is generally lower.

And these shifts have been more important in the UK than in most other countries, exacerbated since 2008 by the hugely increased regulation of the financial sector and the particular way in which green energy has been promoted in this country.

But accepting that there is still something more to explain, there are two other factors behind the UK's poor productivity.

First, an important difference between low-productivity and high-productivity countries is usually (though not always) the level of investment. Here it is surely no coincidence that investment accounts for a relatively small share of UK GDP and that this share has yet to recover fully from the slump during the recession.

One interpretation is that the low rates of investment in the UK are largely the fault of austerity in the public sector and of short-sighted managers in the private sector, and that the answer is therefore more public investment and more state intervention.

However, market-oriented solutions are likely to be more effective. It is far from clear that the state is any better at making investment decisions than the private sector. Indeed, there is a danger that the government simply diverts resources to relatively uneconomic projects, undermining productivity further, the close to £100bn that is being spent on HS2 and Hinkley Point being important examples.

An alternative approach would focus on lowering barriers to investment, whether public or private, including by further reform of corporation tax and investment allowances, reductions in energy costs and liberalisation of planning laws – from fracking to housebuilding.

The second distinguishing feature of the UK is its relatively flexible labour market. This may have allowed the UK to settle into what the National Institute of Economic and Social Research has called a 'low wage – low productivity – high employment equilibrium'.

In a nutshell, it has been more attractive for firms to employ people at relatively low wages (and even keep them on when they might otherwise have been let go) rather than invest in more capital. This is good for jobs, but potentially bad for productivity.

Our benefits system also provides some incentives to work, but does not reward progression to more productive jobs because of the high rate at which benefits are withdrawn.

Nonetheless, it would be perverse to conclude from this that the solution is more regulation, with all the damaging side-effects.

Real wage growth should still pick up of its own accord provided the labour market remains tight and price inflation drops back.

If the government attempts to kick-start this recovery – for example by further large increases in minimum wages – the result is only likely to be a large increase in unemployment, especially among younger people. Achieving higher productivity 'the French way' would be a hollow victory●

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GDP: An A to Z

PIERRE LEMIEUX ON WHY THE NUMBERS DON'T ALWAYS ADD UP...

Gross domestic product (GDP) pops up everywhere in the news.

In the summer of 2016, for example, the news that Ireland's GDP had increased by 26.3 per cent in 2015 had people scratching their heads.

The 3 September 2016 issue of The Economist raised the perennial question of whether GDP figures released by the Chinese government are reliable.

Then Japan began revamping its GDP calculations after some contradictions appeared in official statistics. This is not counting the routine articles that follow the periodic releases of official estimates.

There is much to be debated in relation to the use and misuse of GDP. But among the many forms of GDP misuse, one is obvious, frequent, and dazzling.

One of the main accounting identities used in national income accounting and basic economics courses states that GDP is equal to the sum of consumption, investment, government expenditures (excluding transfers) and exports.

In other words, it is the sum of domestic production flows to domestic consumers, domestic purchases of investment goods, domestic governments, and foreign importers. In still other words, the production side of GDP is equal to its expenditure side: everything that is produced is purchased.

This is an accounting identity, which means that it is true by definition and cannot be false. It is necessarily true because anything produced that is not purchased by domestic consumers, businesses, governments and foreign importers will pile up in inventories. Inventories are a form of unintentional business investment.

Investment, in GDP numbers, is defined as including such inventories as well as fixed capital investment. This is how accounting identities are necessarily true in the real world: a residual adjusts as a matter of definition.

We could write our accounting identity as:

GDP = consumer expenditures + business investment + government expenditures + exports

This is true provided that we take consumer expenditures, business investment, and government expenditures as including only goods and services produced domestically. As its name indicates, gross domestic product is made of domestic production only.

In the statistics that are actually collected, however, consumer expenditures (normally represented by C), business investment (I), and government expenditures (G) include some imported goods and services.

The Chinese-made football you bought at Sports Direct was captured in C; the printing press a newspaper company bought from Germany was part of I; and the salary of the foreign consultant hired by the government was included in G.

Consequently, it would not be correct to write our accounting identity as $GDP = C + I + G + X$ (where X represent exports), because spending on imports is captured in the right hand side of the equation (in C, I and G).

To solve this statistical problem, the accounting identity is written as:

$$GDP = C + I + G + X - M$$

The term –M cancels the imports that are hidden in C, I, and G. It does not mean that imports are a subtraction from national income.

It is easy to be misled. The problem is compounded by the fact that X – M is often grouped inside parentheses so that the accounting identity is remembered as:

$$GDP = C + I + G + (X - M)$$

For the non-expert, the last equation can easily suggest that (X – M) is the balance of trade. This interpretation error is further encouraged by experts who call (X – M) "net exports".

To repeat, it is only "net exports" if you forget that –M is used only to cancel the imports that, in the process of data collection, were included in C, I and G. In other words, the term –M is a statistical trick•

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