WHY HAS THE PUBLIC SECTOR GROWN SO LARGE IN MARKET SOCIETIES?

THE POLITICAL ECONOMY OF PRUDENCE IN THE UK, *c.* 1870–2000

Based on an Inaugural Lecture delivered before the University of Oxford on 13 November 2001 by

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Great Clarendon Street, Oxford OX2 6DP

Oxford University Press is a department of the University of Oxford.
It furthers the University's objective of excellence in research, scholarship,
and education by publishing worldwide in

Oxford New York

Auckland Bangkok Buenos Aires Cape Town Chennai
Dar es Salaam Delhi Hong Kong Istanbul Karachi Kolkata
Kuala Lumpur Madrid Melbourne Mexico City Mumbai Nairobi
São Paulo Shanghai Taipei Tokyo Toronto

Oxford is a registered trade mark of Oxford University Press
in the UK and in certain other countries

Published in the United States
by Oxford University Press Inc., New York

First published 2003

British Library Cataloguing in Publication Data

Data available

Library of Congress Cataloging in Publication Data

Data available

ISBN 0–19–951435–6

1 3 5 7 9 10 8 6 4 2

Typeset by Hope Services (Abingdon) Ltd
Printed in Great Britain
on acid-free paper by
Oxuniprint
Oxford University Press
Oxford

The public sector allocates about 40 per cent of expenditure in Britain. Why do affluent consumers acquire so much welfare outside the market? If choice is affected by myopic bias, optimization is costly, consumer choice is fallible, and collective consumption provides a 'commitment device'. For a century after 1870, collective investment gave superior payoffs, and collective consumption grew faster than the economy. Public/private standoffs were resolved against entrepreneurs. By the 1970s prudential saturation had set in, as public investment soared. Rising incomes, new goods, and falling prices shifted consumer preferences towards market provision, and crowded out the public sector. This shift supported investor capture of government, privatization, and deregulation. Consumer expenditure increased, while prudential investment declined sharply. In consequence, Victorian-style public/private standoffs have emerged again, with prudential crises in pensions, education, health, communications, and transport.

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THE public sector is very large in developed countries. In the late Victorian period governments administered less than 10 per cent of GDP, since when levels have risen to between 30 and 55 per cent.[1] Some of the wealthiest countries spend the most: low taxes seem neither necessary nor sufficient to produce affluence. Why is so much economic welfare acquired outside the market?[2]

In standard economic theory, consumers are the best judges of their own welfare. They are consistent, informed, and far-sighted. They optimize consumption over the life-cycle by buying, borrowing, and saving in appropriate markets.[3] In contrast, an emerging view argues that actual consumer choice may have a myopic bias. In this 'hyperbolic discounting' model, value declines sharply with

The issues continue to unfold, but the text was frozen in April 2002. Participants at presentations in Cambridge, Dublin, Oxford, and Rome made helpful comments. Katerina Bantinaki and Siobhan McAndrew gave invaluable research assistance. James Foreman-Peck, Robert Millward, and George Peden, provided guidance without assuming liability. Footnote references to newspapers and magazines are to electronic versions and thus do not supply page numbers. They can be searched with each periodical's own search facilities or standard search tools such as Lexis/Nexis. The author has copies.

[1] Tanzi and Schuknecht, *Public Spending*.

[2] Offer, 'Between the Gift and the Market', evaluates non-market reciprocity as a source of welfare.

[3] Deaton, *Understanding Consumption*, ch. 1; Browning and Crossley, 'Life-Cycle Model'.

delay, and long-term preferences are reversed, so that smaller-sooner dominates larger-later.[4] Taken literally, a 'myopic trap' keeps the delayed reward for ever out of reach. The implications are important: Overcoming myopia is difficult and costly; and consumer choice is not entirely reliable as a measure of welfare. Viewed from this aspect, collective non-profit provision serves as a 'commitment device' which helps individuals and society to escape from 'myopic traps' and to allocate resources better over time.[5]

Immediate and delayed rewards correspond with two categories. The first is 'visceral goods', such as food, alcohol, or entertainment.[6] The reward is immediate: it satisfies basic human drives, and helps to control the level of arousal. Decisions are discretionary, delay is short, transactions are simple. In markets, delivery and payment coincide. Visceral goods are compelling by definition, and give rise to self-control problems. For example, when food and psychoactive substances are relatively cheap, it is tempting to consume them in excess, even to the point of addiction.[7] Behavioural drives are swamped by stimulation: for example, exposure to dance music induces tolerance for decibels.[8] As sensory arousal is habituated, novelty is sought.[9]

The second category is 'prudential goods'. When households rose out of indigence, time horizons typically expanded in a quest to reduce uncertainty. Social co-operation gave rise to a sequence of institutions, including governance, the capacity for war, physical infrastructures, education, health, and social insurance. The goods were not the visceral reward itself, but a promise, a contract, an option, or a durable institution. To secure the future, large costs were sunk in advance. Delivery was remote, staged, or incremental. Over long time spans, transactions generated difficult agency

[4] Ainslie, *Picoeconomics*; id., *Breakdown of Will*; Loewenstein and Elster, *Choice over Time*; Elster, *Ulysses Unbound*, 24–34; these contain guides to an extensive literature.

[5] Laibson, 'Golden Eggs', 444–6; Barro, 'Ramsey Meets Laibson', 1136–7; also Becker and Mulligan, 'Time Preference'. More fundamentally, commitment may be regarded as the function of the Hobbesian state. On constitutions as commitment devices, see Elster, *Ulysses Unbound*, pt. II.

[6] The concept is derived from Loewenstein, 'Out of Control'; id., 'Visceral Account'.

[7] Elster, *Strong Feelings*; id., *Addiction*; Elster and Skog (eds.), *Getting Hooked*; Offer, 'Body-Weight and Self-Control'.

[8] Ainslie, *Picoeconomics*, 252–9.

[9] Scitovsky, *Joyless Economy*, chs. 2–3.

problems: contracts are difficult to specify and negotiate, and it is hard to monitor and enforce quality, cost, payment, and delivery.[10] Controlling the future is costly: for example, the costs of individual pension products typically absorb up to 45 per cent of contributions in the UK, and reduce the final pension by 20 per cent and upwards in the USA.[11]

In Victorian Britain, prudential goods were initially provided by private investors for profit, and by non-profit voluntary 'clubs' of exclusive constituencies. Politicians, responding to electoral incentives, acted to extend the benefits to the community as a whole, and entered into standoffs with private providers. Increasingly these standoffs were resolved in favour of universal provision by means of public regulation, control, or ownership. For more than a century, between the 1870s and the 1970s, consumers gave priority to prudential goods, and collective provision grew faster than the economy. By the 1970s this preference was being satiated at the margin. Under the influence of rising incomes, technological change, and habituation, consumers shifted towards visceral goods. Markets delivered novelty and variety more effectively than governments, and visceral priorities facilitated political realignment against prudential provision. By the 1990s, prudential parsimony had given rise to a new crisis of public provision, with contractual standoffs like those of the late Victorian period.

POLITICS AND PRUDENCE

The consumer's marginal outlay is either visceral or prudential (though some outlays, such as mortgage payments, contain elements of both). In the absence of myopia, there are notional textbook 'golden rules' for allocating social resources between consumption and investment, for example to invest until the rate of return on capital declines to the rate of economic growth. These

[10] Eggertsson, *Economic Behaviour*, 13–20.

[11] Murthi, Orszag, and Orszag, 'Administrative Costs'; Aaron, 'Social Security', 68–81; for the USA, see Panel on the Privatization of Social Insurance, *Evaluating Issues*, 25–35; Diamond, 'Administrative Costs'; Barr, *Welfare State as Piggy Bank*, 117.

rules are both stylized and ambiguous.[12] Under myopia, there is no such 'golden rule'.

Prudence is not *a priori* superior to gratification. Myopic preferences are legitimate. John Donne writes of his beloved, 'I had rather owner bee | of thee one houre than all else ever'.[13] The statement is hyperbolical, but credible. Some rewards cannot be measured in money. Future selves may have different tastes, new opportunities may arise, quite apart from the 'insurable' risks of health, life expectation, and market volatility. Even in retrospect, it is difficult to say whether the best combination has been achieved, let alone in advance.[14] The case for prudence is that if choice is myopic, then some rewards will be under-provided, for example those of family, education, old-age pensions, public sanitation, health, energy, transport, social obligation, the arts, or public spaces. All of them require long-term commitment.

Resolving the visceral/prudential dilemma is a task for politics. 'The political marketplace is the only known method of making choices between different types of collective spending, or between the collective and private variety', wrote an experienced politician.[15] Politics provides a 'discovery procedure' for determining the balance of gratification and prudence, and a mechanism for imposing it. In the absence of coercion, it is widely agreed that individual preferences cannot be aggregated fairly.[16] An exception is made, however, if preferences can be arrayed on a continuous single dimension (more/less) and voters have a single-peaked preference distribution. This is an early finding of public choice theory.[17]

The level of taxation is just such a unique equilibrium trade-off between individuals' discretionary consumption, and collective prudential provision. Competing politicians promise levels of taxation that will maximize their chance of election, with strong

[12] Atkinson, 'Strange Disappearance', 197–201.

[13] Donne, 'A Feaver', in *A Selection of his Poetry*, 35.

[14] Ainslie, *Picoeconomics*; id., *Breakdown of Will*, 154–5; other psychological biases may further complicate the issue: cf. Kahneman, 'Experienced Utility'; id., 'Evaluation by Moments'.

[15] Lawson, *View from No. 11*, 186.

[16] Heap et al., *Theory of Choice*, 209–15.

[17] Mueller, 'Public Choice in Perspective', 4–6; Black, 'Rationale of Group Decision-Making'; Cornes and Sandler, *Theory of Externalities*, 205–10.

incentives to get it right. The choice between more or less taxes frames the prudential dilemma in a meaningful and legitimate form, albeit one that is less than perfectly efficient or equitable. Competing parties (or potential coalitions) converge on the same tax equilibria in their competition for the median voter. And because governments cannot fully bind their successors, they try to design policies that will not be easily undone.[18] This does not even require democracy. Authoritarian or paternalist governments may be seen as 'contestable monopolies', which need to pre-empt 'market entry' or 'takeover bids', possibly violent, from their rivals (as in Wilhelmian Germany).

Victorian cities were dark, dirty, congested, and unhealthy.[19] There was a strong incentive to alleviate suffering by means of prudential projects.[20] At the outset, technologies were untested and demand uncertain. But high risk held out the promise of high returns. The opportunities of canals, water supply, gas, railroads, tramways, telegraphs, telephones, underground railways, and electricity have all driven capitalists into 'manias' of over-investment. In surges of 'excess entry', facilities were duplicated, and after a shakeout a good deal of capital would be wiped out in investor 'panics'.[21] A reprise has occurred in the recent rush into mobile and broadband telecoms.[22] After shakeout, the new monopolies retained only a transient advantage. As technologies settled down, proprietary knowledge leaked out, investors were 'locked in', and the bargaining advantage shifted to the side of the community.

As a consequence of successful private enterprise, 'The luxuries of one age become the necessities of the next.'[23] A role for government emerged when prudential goods acquired universal appeal, when compulsion was required, or when (as in the case of natural monopolies), there were large economies of scale or spillovers.

[18] Moe, 'Politics of Structural Choice', 124, 136–46; Dixit, *Making of Economic Policy*, 57–8, 73.

[19] Williamson, 'Coping with City Growth'.

[20] e.g. Great Britain: Chadwick, *Sanitary Condition*.

[21] Newbery, *Privatization*, 107, 393–4.

[22] Roberts, 'Glorious Hopes'; id., 'How the World Caught Third-Generation Fever'; id., 'Tangled Legacy'.

[23] Robson, 'Public Utility Services', 300.

Universality came to be seen as a matter of entitlement, akin to equality before God, the law, and the ballot box. It implied access for all at a level which most could afford and none were denied. An early example was the British penny post of 1840. Universal provision often allows redistribution. If the median voter is less wealthy than the average voter, politicians will have a motive to support it,[24] though more so in a unitary state like Britain than in a federal one like the USA.

A private company which provides universal necessities is exposed to political opportunism. If politicians restrict the rate of return, they can lower the cost to their voters. If one set of politicians did not do it, their rivals would: 'Marginal seats count for more than marginal costs.'[25] Hence, from the 1840s onwards, there was a prolonged standoff between investors and the community.[26] Governments restricted rates of return, and imposed price caps, service standards, and taxation.[27] If investors were pressed too hard, they would no longer invest, and government regulation or takeover became the default.

In the water industry, for example, nominal rates of return were initially capped at 10 per cent, and were forced down during the course of the century to 4 per cent. Water distribution, which began as private enterprise, was largely in local government hands by 1914.[28] The Board of Trade regulated railway rates, while towns regulated tramways, and began to take them over in the 1890s. London Underground railways, built by private capital from the 1860s onwards, passed into public ownership in 1931, the railways, road, and air transport in the 1940s. Most electricity supply and distribution was publicly owned by the 1920s, although less than half of

[24] Lindert, 'What Limits Social Spending?', 6; Meltzer and Richard, 'Rational Theory of the Size of Government'.

[25] Lawson, *View from No. 11*, 186.

[26] The technical term is 'hold-up', in the sense of extortion rather than delay. See Ricketts, 'Bargaining with Regulators', 151; Hart, *Firms, Contracts*, 27–8. For a game-theoretical analysis, see Newbery, *Privatization*, ch. 2.

[27] In the USA and Europe as well: Priest, 'Origins of Utility Regulation', 301–20; Toninelli, *Rise and Fall*, *passim*.

[28] Robson, 'Public Utility Services'; Falkus, 'Municipal Trading'; Hassan, 'British Water Industry'; id., *History of Water*.

the gas industry. Telegraphs were nationalized in 1866, telephones in 1911, and electric transmission in 1926.

Regulated private monopolies have the advantages of making no claim on tax money, and more management discretion.[29] They became the norm in the United States, although by the inter-war years they were increasingly regarded as failures in the UK.[30] When a technology was pervasive and stable, as in electricity or railways, such monopolies had the advantage of relative simplicity. Rate-of-return regulation gave no incentive to cut costs, but also not to cut corners.[31] A less benign view is that regulators are easily captured by their charges.[32] This was common in the United States, and occurred in Britain as well.[33]

SOCIAL INSURANCE AND WELFARE

In contrast, social welfare provision began with 'clubs' and voluntary associations, rather than capitalist investors. The term 'club' is used here in its economic sense, as a collective, not-for-profit association, which provides prudential services to an exclusive community.[34] Local government areas can also be seen as 'clubs': levels of service and tax differ from one to the other, and it is possible to join or leave by moving.[35] Seen from this aspect, the Poor Law, Britain's prime system of social security, operated as a network of local 'clubs', with differential access and benefit levels.[36] The better off joined private clubs, namely mutual insurance companies, friendly societies, and trade unions. Education was initially provided for profit by small private schools, and for fees by voluntary organizations.[37] Medical treatment was pervasively organized on a

[29] Newbery, *Privatization*, ch. 3.

[30] Millward, 'State Enterprise'; Jacobson and Tarr, 'Ownership and Financing of Infrastructure'; Priest, 'Origins of Utility Regulation'.

[31] Joskow and Schmalensee, 'Incentive Regulation'; Bannerjee, 'Con Ed'.

[32] Stigler, 'Theory of Economic Regulation'.

[33] National Civic Federation, *Municipal and Private Operation*, i. 126–7; Offer, *Property and Politics*, 297–308; Millward, 'State Enterprise', 329.

[34] Cornes and Sandler, *Theory of Externalities*, pt. IV.

[35] Ibid. 365–9.

[36] King, *Poverty and Welfare*.

[37] West, 'State Intervention'.

club basis by general practitioners, and most hospitals were 'clubs' in voluntary or municipal hands.

'Clubs' are easier to co-ordinate than universal provision: They match resources and preferences locally, while restricting redistribution. As with infrastructure, in late Victorian Britain the movement was away from 'clubs' and towards universal provision. Education became compulsory in 1870, state pensions began in 1908, the 'national insurance' of 1911 provided 'club'-based health and unemployment benefits. After 1945, universal centralized provision predominated.

In the United States the 'club' system has endured. Primary and secondary education is organized by local governments, and differential access is controlled by means of zoning and taxation. Higher education is either a territorial state university 'club', or a private non-profit university, which is a 'club' for the better off or exceptionally able. Medical insurance (mostly not-for-profit) is primarily through the workplace. Consequently, the voluntary sector accounted for 6.5 per cent of national income and 10.6 per cent of employment in 1992.[38] Primary pensions and medical treatment for the aged are the universalist exceptions, as well as health care for the old and the truly indigent.

Collective authorities, whether governments or clubs, typically deliver the service themselves. Why not contract with private providers? The main reason is that long-term market contracts are 'incomplete', i.e. difficult to specify, expensive to monitor and enforce, and uncertain in their effect.[39] The 'principal', who contracts out the service, has imperfect control of the 'agent', who provides it, and the difficulties increase over time. Principals lose control over quality and costs, and agents are exposed to exploitation. When co-operation is important, the solution is 'integration', making the agent directly accountable as an employee. Information is more transparent, and costs are controlled directly. Effort is more

[38] Including voluntary labour, but excluding financial institutions. In the UK, it is about two-thirds as high comparing paid employment alone, but Britain has a much smaller voluntary health sector. Rose-Ackerman, 'Altruism, Nonprofits, and Economic Theory', 705; Saxon-Harrold, 'Voluntary Sector'.

[39] Hart, *Firms, Contracts*, 21–8, and ch. 4; Salanié, *Economics of Contracts*, ch. 7.

easily monitored, and compliance enforced. Principal and agent are less overtly in conflict, and interests are easier to align. Learning and innovation are not discouraged by costly renegotiation. If mishaps occur, it is a matter for engineers, not lawyers. When the most efficient scale of operation is a single provider (a natural monopoly) or when users cannot be excluded (a public good), the benefits of competition are limited. Integration was pervasive in the twentieth century, and the giant corporation has risen in parallel with the public sector.

Similar considerations drove the integration of welfare. Education and health require durable institutions and infrastructures, a co-operative workforce, and many years of commitment. Education pays off, but myopic youngsters still require external disciplines to commit attention and time. Poor households cannot afford to invest even if the return is high. Most families cannot teach or cure by themselves. And while the payoff is unreliable for any individual household, it is certain for the community.

When quality has many dimensions, it is difficult to monitor. In the absence of a profit motive, teachers, doctors, and engineers can commit credibly to professional standards, and get their reward from the approbation of their peers.[40] Professionalism underpins impartiality, which makes it feasible to monitor both staff and students credibly.

Teachers or doctors who invest in specialized skills face a similar standoff with the community as does a utility entrepreneur. Once a professional is locked into a career and a pension entitlement, voters and politicians are tempted to underpay and under-invest. This might even be rational: poor voters have more urgent visceral priorities than rich ones. This is one reason why the better off choose exclusive health and education 'clubs', which provide them with better services.

The tax system forms a 'commitment device' which helps individuals overcome myopic preferences. Mandatory participation overcomes the temptation to free ride or under-invest. In the absence of compulsion, about 17 per cent of the USA population

[40] Compare Glaeser and Shleifer, 'Not-for-Profit Entrepreneurs'.

(some 40 million people) remains without health insurance, and many with adequate incomes fail to subscribe.[41]

Mandatory taxation reduces the cost of prudential contracts by avoiding them altogether. In the case of universal benefits such as old-age pensions, mandatory defined-benefit provisions financed directly from tax can be up to an order of magnitude cheaper to administer than private individual accounts.[42] Non-profit 'clubs' are also more costly than universal provision. It was estimated that health insurance administration cost about 12 per cent more of the total health outlays in the USA in 1983 (about 1.5 per cent of GDP), in comparison with a single payer system.[43]

Opponents of collective provision argue that the 'deadweight' cost imposed by distorting market choices would choke off growth.[44] But this prediction is not borne out by historical research.[45] From the point of view of time-preference, welfare payments are not altruistic transfers, but should be seen as either insurance outlays or arrangements for life-cycle income smoothing.[46] Indeed, welfare provision varies inversely with 'social distance', i.e. directly with the likelihood of the better off having to use it.[47] For these purposes central provision is the cheapest arrangement. It is no puzzle that it has been the socially preferred choice, and provides the foundation of old-age provision even in the market-oriented United States. It is the cost of financial market intermediation which constitutes the deadweight.[48]

Pay-as-you-go does not require contracting over time. The deal is a current one between today's young and today's old, healthy and

[41] Aaron, *Serious and Unstable Condition*; Kilborn, 'Uninsured in US'; Steinhauer, 'No Medical Insurance'.

[42] Aaron, 'Social Security', 70–83; Panel on the Privatization of Social Insurance, *Evaluating Issues*, 29–34; Diamond, *Privatizing Social Security*, 15–16. This is not offset by higher returns (Orszag and Stiglitz, 'Rethinking Pension Reform', 24–8). See also Shoven, *Administrative Aspects*.

[43] Aaron, *Serious and Unstable Condition*, 30, citing Himmelstein and Woolhandler, 'Cost without Benefit'.

[44] Becker, 'Competition among Pressure Groups'; id., 'Public Policies'; Feldstein, *How Big Should Government Be?*

[45] Lindert, 'Does Social Spending Deter Economic Growth?', 21–8; id., 'What Limits Social Spending?'; Dilnot, 'The Assessment', 8–9.

[46] Baldwin, *Politics of Social Solidarity*, ch. 1; Barr, *Welfare State as Piggy Bank*, ch. 6.

[47] Lindert, 'What Limits Social Spending?', 16–18, 31.

[48] As implied by James, Smalhout, and Vittas, 'Administrative Costs', 255–6.

ill, workers and unemployed. When circumstances change, the contributions and benefits are renegotiated.[49] Pay-as-you-go carries political risk: parsimonious governments might alter terms for the worse, and generous ones can make unsustainable commitments. But it is underpinned by norms of obligation which in Britain, for example, maintain means-tested income support as a fallback in the absence of pension entitlements.

Quite apart from their extra cost, private pension entitlements carry their own special risks: consumer choice is illusory since savers are poorly informed, are locked in early, and are exposed to management incompetence and default, while payoffs are subject to financial market risk.[50] Since private pensions rely on tax concessions and implicit government guarantees, they are not insulated from political risk.

Governments safeguard not only collective prudence, but also individual thrift. Implicitly, the taxpayer has guaranteed the financial system as lender of last resort since Victorian times.[51] British governments set up the Post Office Bank, underpinned the Trustee Savings Banks, and regulated banks and building societies. The United States federal government has insured depositors since 1933. Savings and Loan banks were rescued expensively in the 1980s,[52] and the Continental Illinois Bank was deemed 'too big to fail'. The American Treasury facilitated bailouts in Mexico, Russia, and East Asia. In the 1970s governments bailed out corporations as well, Rolls-Royce and British Leyland in Britain, Lockheed and Chrysler in the USA.[53] Policy is also sensitive to the macroeconomic effects of public expenditure on employment and income.

High culture, especially museums and the performing arts, is largely inherited from the past, and will continue to pay off in the

[49] Shoven, 'Social Security Reform', 1.

[50] Aaron, 'Social Security', 62–7; Barr, *Welfare State as Piggy Bank*, 112–16; on choice, see Aaron, 'Social Security'; Diamond, 'Administrative Costs', 151–2; Loewenstein, *Is More Choice Always Better?*; Barr, *Welfare State as Piggy Bank*, 116–18; more optimistically, see the essays in Campbell and Feldstein (eds.), *Risk Aspects*.

[51] Eltis, 'British Monetary Orthodoxy'.

[52] Calavita, Pontell, and Tillman, *Big Money Crime*.

[53] Henderson, 'A Step Toward Feudalism'; <http://www.votenader.org/press/Corporate/Contents.html>; as well as railway companies, banks, and, most recently, airlines.

future. Individuals cannot capture all the value, and are unlikely to cover all the cost. Britain supports it mostly out of taxation, the United States mostly by means of tax benefits for donors. In both countries, a host of prudential 'clubs', including housing associations, private schools, universities and colleges, medical insurance, theatres, symphony orchestras, football clubs, and opera companies, benefit from the principle that exemptions are less visible than expenditures. When prudential goods are no longer perceived as universal, nor demanded by an active minority, they can fall by the wayside. This has been the fate of mental health care in the USA and Britain since the 1970s, and, more modestly, of school playing fields, public parks, and public toilets in post-Thatcherite Britain.[54]

Governments are never more popular than when they uphold national security. Unlike other prudential goods, wars have been paid for mostly in arrears, by servicing the debts, and honouring implicit obligations through welfare entitlement. In Continental Europe, competitive strategic and catch-up considerations have motivated a good deal of public enterprise.[55]

But integration into the public sector does not resolve the choice between visceral and prudential goods. The standoff between community and capitalists is merely replaced by one between voters in their role as consumers, and in their role as investors. Contrary to much of the public choice literature, elections provide politicians and officials with a strong incentive to manage public services well.[56] But they also have myopic incentives to produce at a loss, to under-invest, and to shift costs to the future.

Adolf Wagner, a right-of-centre German economist, wrote in 1883 that the relative and absolute expansion of public, and particularly state, activities, was driven by 'the desire for development of

[54] Gillon, *That's Not What We Meant To Do*, ch. 2; Shorter, *History of Psychiatry*, 277–81; Rogers and Pilgrim, *Mental Health Policy*, chs. 5, 10; Great Britain: House of Commons, *Town and Country Parks*.

[55] Peacock, Wiseman, and Veverka, *Growth of Public Expenditure*, 25–34, 53–68; Andreski, *Military Organization and Society*; Toninelli (ed.), *Rise and Fall*.

[56] Contrary to Niskanen, *Bureaucracy*, and to Buchanan and Tullock, *Calculus of Consent*; and following Musgrave, 'Leviathan Cometh?' and Wittman, *Myth of Democratic Failure*. For empirical confirmation, see Lindert, 'Does Social Spending Deter Economic Growth?', 24–8.

a progressive people'.[57] For the century after 1870, Wagner's law has been a truism, for Britain and other advanced countries.[58] The growth of the public sector responded to electoral preferences and economic opportunities more than to ideology. Between 1870 and 2000, the Conservative Party governed Britain for two-thirds of the time;[59] the late Victorian Liberal Party was even less friendly to government expenditure.[60] Lord Salisbury, the Conservative leader, did not mind being called 'socialist', and Harcourt, his Liberal adversary, famously declared, 'we are all socialists now'.[61] The correlation of public expenditure with Left wing government is positive but weak, in one study,[62] and of welfare effort with Left wing cabinet participation (in international comparison) altogether absent in another. Lindert, in a comprehensive study of welfare expenditure, does not include it at all.[63]

A CASE STUDY: HOUSING STANDOFFS

Housing is not a public good, but it is definitely a prudential one. Dwelling houses in the late Victorian period amounted to a quarter of the net domestic capital stock.[64] The prudential risk was undertaken by small investors, who purchased houses from speculative builders. About nine-tenths of housing in Britain was rented out to tenants. The market was competitive and volatile, and was in serious decline during the late Edwardian period. Freehold houses in London sold for an implicit rate of return of 8.5 per cent gross at the top of the cycle in 1896, and 13.5 per cent at its bottom in 1912.[65] This implied a payback period of 12 years at the top of the cycle, and

[57] Musgrave and Peacock, *Classics*, 8.

[58] Without country and period fixed effects. Peacock and Scott, 'Wagner's Law', table 1 (pp. 6–7); Ram, 'Wagner's Hypothesis', for developed countries since 1945 in time-series, excluding transfer payments.

[59] 64%.

[60] Offer, *Property and Politics*; id., 'Empire and Social Reform'.

[61] Salisbury in 1881, quoted in Feuchtwanger, *Democracy and Empire*, 120; Harcourt's quip was repeated by the Prince of Wales, 5 Nov. 1895.

[62] Middleton, *Government vs. Market*, table 3.14 (p. 119).

[63] Hicks, *Social Democracy*, 172–3, 179–80; Lindert, 'Postwar Social Spending', 5.

[64] In 1910. Feinstein, *National Income*, table 46, t104.

[65] Offer, *Property and Politics*, fig. 17.9; Inland Revenue Annual Report, cited ibid. 112 n. 23.

a mere 7.4 years at the bottom,[66] for an asset that can last a hundred years or more.[67] Landlords operated on a small scale, and therefore faced a high risk.[68] For those on low incomes housing was shoddy and expensive.[69] This social standoff generated a great deal of anguish and debate. Victorian housing reform strove to reduce investment risks by several means, none of which was effective on the scale required.[70]

In the First World War, government capped working-class rents. The interests of tenants took priority over those of investors. Once rent control had been imposed, it was politically difficult to repeal, even for Conservative governments. The regulated rate of return gave little incentive to invest in new houses, and the rented sector went into decline.[71]

The old prudential system having collapsed, a new one came into being. This demonstrated some advantages of collective over private contracting. Local governments began to build, assisted by Treasury subsidies. They could borrow more cheaply than landlords, and could spread the risks over larger pools. They provided much better houses for slightly higher rents.[72] Rent control was never entirely lifted before the old private stock ran down physically towards the 1970s, while public housing increased to about 30 per cent of the housing stock by 1981.[73]

The rest of the vacuum was filled by building societies. These were 'clubs': not-for-profit mutual finance institutions, with no

[66] i.e. Years Purchase.

[67] Death duty valuations indicate a payback period of 13–16 years, but these were not responsive to market prices: Great Britain: Inland Revenue Annual Reports (1906), table XC (pp. 110–11); (1914), table 28 (pp. 32–3). Net returns were much lower (Offer, *Property and Politics*, 290–2), but gross rates are appropriate for comparison with the inter-war years.

[68] 60% of house property and business premises belonged to small owners, valued at up to £10,000 at death: Offer, *Property and Politics*, table 7.6 (p. 134).

[69] Gauldie, *Cruel Habitations*; Wohl, *Eternal Slum*; Morris, 'Market Solutions'.

[70] Wohl, *Eternal Slum*; Offer, *Property and Politics*; Gauldie, *Cruel Habitations*; Englander, *Landlord and Tenant*; Daunton, *House and Home*, Holmans, *Housing Policy*, ch. 2. But see also Thompson, *Respectable Society*, ch. 5, and Morris, 'Market Solutions'.

[71] Holmans, *Housing Policy*, 85–7, rejects this political argument, and argues that the post-war hiatus in construction was due to high costs. But the house landlords whose revenues had been taken were scarcely in a position to build again, and rent control greatly restricted demand. Alternatively, Holmans argues that health standards could not have been met by private landlords. That rather supports the view presented here.

[72] Holmans, *Housing Policy*, 316.

[73] Ibid., table V.1 (pp. 169–70).

conventional equity owners. They accepted deposits from members, and lent to them for house purchase. During the nineteenth century, they had discovered that it was safe to lend on dwelling-house collateral. In the absence of shareholders, depositors received more and borrowers paid less. The risk was integrated: lenders and borrowers both owned the institution. Borrowing rates were not necessarily lower: societies competed for deposits and built up reserves. The current cost to borrowers was reduced by extending repayment periods from 10–12 years up to 25 years and more, and by lowering deposits from around one-third before the war, to almost nothing by the 1930s.[74] Over the period 1920 to 1940, the number of new homes constructed was 83 per cent higher than in the previous housing cycle, of 1890 to 1910.[75]

Figure 1 follows the course of house-building, and also the long-term pattern of prudential provision. Before 1914, private provision was cyclical and low. An index of real GDP serves as a proxy for population and income growth, representing demand. Between the wars, new construction surged high above this curve, supported by municipal and building society 'clubs'. New construction continued at a high but relatively lower level during the post-war 'golden age'. From the late 1960s onwards, construction fell below the GDP trend, down to levels of absolute provision not seen since the 1890s. The reasons for this downturn would be complex to unravel statistically. Demographics point two ways, with family size and formation declining, but household numbers and incomes (especially single-person ones) rising. The fiscal aspect is a web of subsidies, benefits, and taxes.[76] Interest rates rose. Institutionally, housing finance was privatized in the 1980s: public construction was halted, and lending moved to corporate banks. The main outcome was a decisive retreat from prudential provision. This, as we shall see, happened in other sectors as well. Among the consequences were house-price inflation and volatility, negative equity, housing repossessions, and lately the crowding out of lower-level professionals

74 Speight, 'Building Society Behaviour', 61–2.

75 Mitchell, *British Historical Statistics*, table 5 (p. 390). Modelling housing supply as a whole would require a major research effort, and has not been undertaken even for recent years.

76 Hills, *Unravelling Housing Finance*, ch. 1, and *passim*.

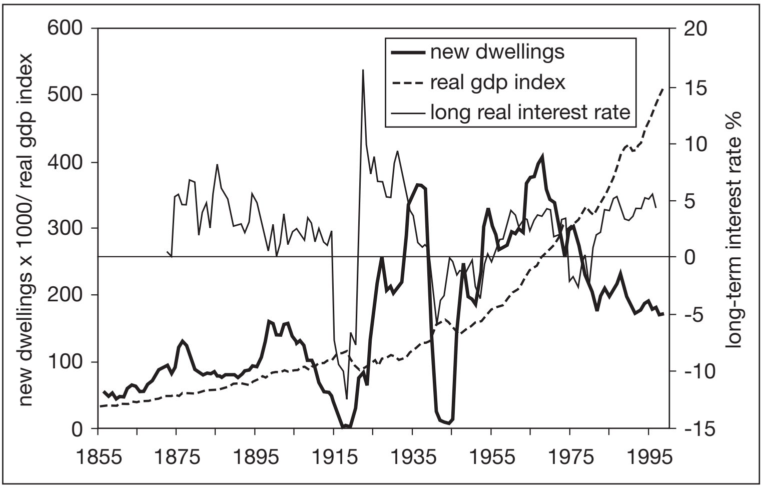

Fig. 1. New dwellings, economic growth, and real interest rates in the UK, *c.*1856–1999

Sources: Mitchell, *British Historical Statistics*, 390, 392, 678; Feinstein, *National Income, Expenditure and Output of the United Kingdom*, table 6 (pp. t18–t20); Great Britain: Office for National Statistics, *Economic Trends*, ser. 5.4: *Dwelling House Completions*, downloaded from the ONS Statbase <http://www.statistics.gov.uk/statbase/TSDtimezone.asp>. Chadha and Dimsdale, 'Long View of Real Rates'.

such as teachers, nurses, and policemen, from housing in the affluent south-east.[77]

In the United States as well, access to housing finance was extended by collective action. The New Deal's Federal Housing Administration began to guarantee home loans in 1934. In 1939 it endorsed the extension of borrowing terms from 10 to 25, and eventually to 30 years.[78] Mortgage guarantees expanded after the war. The federal government implicitly guarantees mortgage lending by means of special agencies (Fannie Mae and Freddie Mac), and provides unlimited tax deductions on mortgage interest. Much housing finance has been provided by quasi-clubs, namely the Savings and

[77] Böheim and Taylor, 'My Home'; *Labour Research*, 9–11.

[78] Bryant, *Mortgage Lending*, 278–84, 382–92; Jackson, *Crabgrass Frontier*, ch. 11.

Loan associations, which were regulated and guaranteed by government.[79]

PRUDENTIAL BOOM AND SATIATION

The post-war 'golden age' is sometimes perceived as a consumption-driven boom.[80] It is more accurate to regard this period of growth and full employment as driven by prudential investment.[81] Consumer expenditure actually declined considerably as a share of GDP, from more than 80 per cent up to the late 1930s, to below 60 per cent in the mid-1960s, recovering to only slightly higher levels today.[82] Capital formation, which had hovered around 8 per cent for most of the inter-war period, was about twice as high in 1950, and touched a peak of over 25 per cent in the early 1970s (Fig. 2).

Government's share of investment, which had doubled after the First World War, doubled again after the Second. Most of the utilities were taken into the public sector after 1945, and state ownership expanded into transport, steel, and coal.[83] GDP underestimates the size of these 'public corporations', since it only measures value-added, and prices were kept deliberately low.[84] Employment is a better measure: in the early 1960s, public corporations employed almost 9 per cent of the labour force, and total public sector employment reached 27 per cent. Hiring disciplines were apparently loosened. At the end of the nineteenth century, municipal utilities had been marginally more productive than private ones, and their post-1945 productivity performance matched that of the private sector.[85] But by the 1990s, after the energy and water utilities were privatized, it proved possible to shed a large proportion of the workforce.

[79] Bryant, *Mortgage Lending*; Haar, *Federal Credit*, ch. 1; Klaman, *Postwar Residential Mortgage Market*, chs. 3–6.

[80] Suggested, among other factors, in Toniolo, 'Europe's Golden Age', 259.

[81] For an encompassing survey of interpretations, see Crafts and Toniolo, 'Postwar Growth'.

[82] Calculated from Feinstein, *National Income*, table 2, t8–t9; Great Britain: Office for National Statistics, ser. ABPB, e.g. *Economic Trends Annual Supplement*, 26, table 1.3 (p. 15).

[83] Millward, 'State Enterprise'; Millward and Singleton, *Political Economy*.

[84] Peacock and Scott, 'Wagner's Law', 10–13; Millward, 'Political Economy', 169, 174–5.

[85] Foreman-Peck and Millward, *Public and Private Ownership*, 218–19; Millward, 'Political Economy', 170–3.

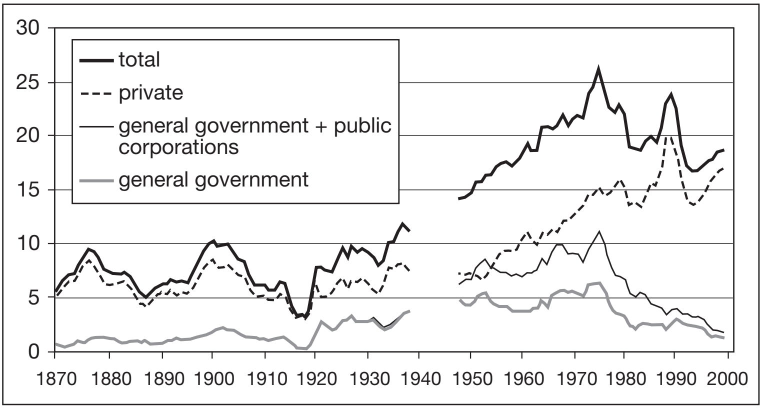

FIG. 2. Capital formation by sector, UK 1870–2000, as percentage of GDP

Sources: Feinstein, *National Income, Expenditure and Output of the United Kingdom*, t85–t87; Great Britain: Office for National Statistics, *United Kingdom National Accounts*, ser. NPQX, NNBF, NSSU, FCCJ, ANSQ, ANSS, DFDK; <http://www.statistics.gov.uk/statbase/timezone.asp>

New infrastructure was laid down: motorways, telecoms, natural gas, schools and universities, power stations, hospitals and primary health care, basic science, income and disability benefits, old-age pensions, and also strategic missile submarines and nuclear power plants. In the absence of competitive and rate-of-return disciplines, there was some tendency towards over-specification and 'gold-plating', viz. the advanced gas-cooled reactor project, and the Concorde supersonic airliner. Marginal income tax rates had risen over 80 per cent, reflecting a social preference for public prudence over private discretionary consumption.[86]

Towards the end of the period, there is evidence of satiation with prudence. If the objective is security, then increments are more costly, and prudence delivers diminishing returns. Figure 3 shows this in a cross-section distribution of (mostly prudential) social indicators against income in 109 countries. Returns also diminished over time, especially during the 'golden age' (Fig. 4). Here the criteria

[86] For the UK, see the Institute of Fiscal Studies computer file 'Tax System'; for the USA, see Taxplanet.com, 'Federal Individual Income Tax'.

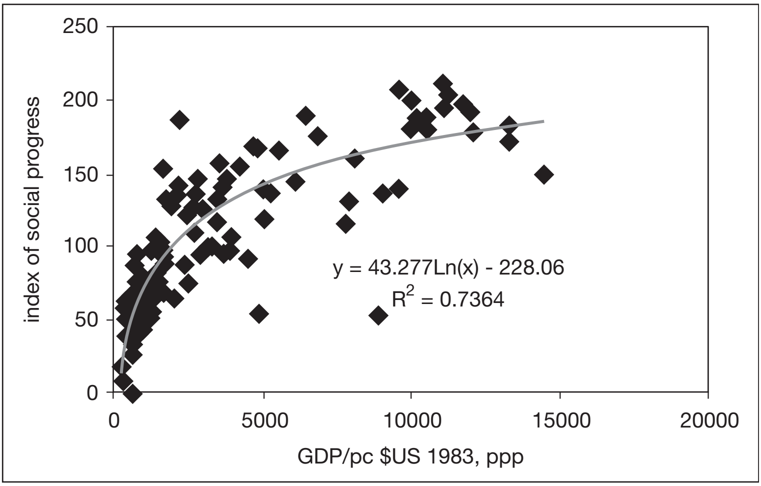

FIG. 3. Social indicators and income per head, cross section, *c.*1983*

Source: Estes, *Trends in World Social Development*, table A2 (pp. 186–8).

* Average of normalized indices of 10 domains, based on 36 indicators, in 109 countries. The domains are: education, health, women's status, defence effort, economics, demographic structure, geographic equity, participation, culture, and welfare effort. Income is in purchasing power parity 1983 $US.

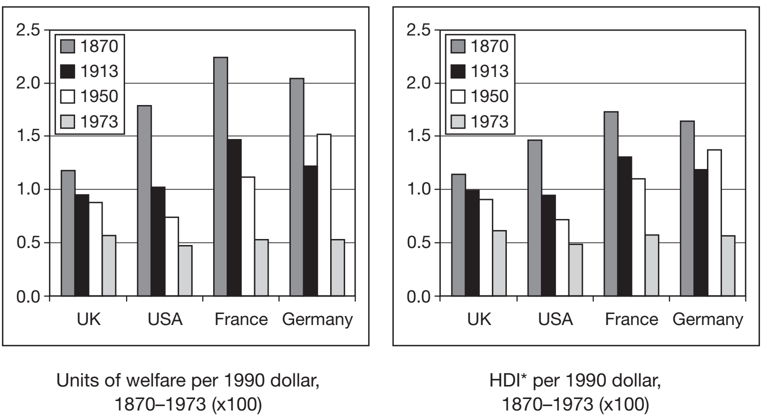

FIG. 4. Units of welfare per 1990 dollar, four countries, *c.*1870–1973

Source: Calculated from Crafts, 'Human Development Index'. Data in Offer, 'On Economic Welfare Measurement', table 1.

The welfare index is made up of (percentage school enrolment + life expectancy at birth)/2. HDI* is the Human Development Index, with the income element untruncated. Index units are multiplied by 100. The indices are bounded variables but are well short of the maxima even in 1973.

are education, life expectancy, and alternatively, the Human Development Index, in four developed countries over a century.

Prudential fatigue gave rise to a public sector standoff, between the taxpayer as consumer and as investor. Starting from 1967, public sector projects were set rate-of-return targets derived explicitly from the private sector.[87] Political appetite for prudential investment was declining, and the Treasury started to brake in the mid-1970s.[88] Governments constrained the public corporations by means of price-capping and under-investment.[89] But there was a good deal of momentum, and the share of public investment, and indeed investment overall, peaked in the 1970s.

Academic opinion also began to sound the alarm. 'Baumol's Law' stated that the cost of public services rises faster than that of market goods because there is less scope for productivity gains in personal services such as education and health.[90] In the United States, the 'Leviathan' school of public finance depicted government growth as driven by rent-seeking officials, politicians, and special-interest groups.[91] Normative economic theory was shifting its emphasis from macroeconomic management to microeconomic efficiency. The new Chicago hegemony took the superiority of market provision as given, and explored new forms of contract between the investor and the community. This provided an economic rationale for evicting the public sector from a good part of the network utility and infrastructure business.[92] In Britain, Bacon and Eltis famously argued that a bloated public sector was crowding out the market sector.[93] Public expenditure was associated with the macroeconomic disorders of the 1970s. The collapse of public investment was instigated by the fiscal crisis of 1976 (which required IMF intervention), and the 'Winter of Discontent' of 1978–9, which came to

[87] Great Britain: HM Treasury, 'The Test Discount Rate'. Chick, 'Approaches to Pricing', argues that the 1960s 'test rate' was designed to contain 'gold-plated' public expenditure.

[88] Pliatzky, *Getting and Spending*, 130–42.

[89] Millward, 'Political Economy', 173–5.

[90] Baumol, 'Macroeconomics of Unbalanced Growth'; Beck, 'Public Expenditure'.

[91] Buchanan and Musgrave, *Public Finance*; Musgrave, 'Leviathan Cometh?'; Borcherding, *Budgets and Bureaucrats*.

[92] Joskow and Schmalensee, 'Incentive Regulation', 16–26; Millward, 'Political Economy', 175–7.

[93] Bacon and Eltis, *Britain's Economic Problem*.

symbolize the purported irresponsibility of public sector workers. Thereafter, as in the case of housing, public investment entered a period of steep decline. The trajectory of stagnation after the 1980s shown in Figure 2 is perhaps overdrawn. Some investment was taken over by the private sector, some went overseas. Students were staying longer in education, accumulating human capital. But investment fell sharply in core government activities in education, health, housing, and road-building.[94] By the mid-term of the first New Labour government, fixed capital formation by central and local government had fallen back to levels last seen in the late Victorian period.

Were taxpayers tiring of prudence? With rising affluence, did they feel a surfeit of 'security', and insufficient stimulation? Technological change was working in favour of visceral goods, and against prudential ones. High and stable public investment, rising incomes, and full employment sustained demand for private investment. As incomes increased, old luxuries became affordable, while new ones arrived at an increasing pace.[95] Colour television came to dominate free time, and provided a compelling broadband channel for marketing messages.[96] The cost of air travel fell, and more holidays were taken overseas.[97] A sequence of electronic gadgets diffused into households: transistor radios, audio cassette players, video recorders, CD players, personal computers, the internet, and mobile telephones followed each other in rapid succession.[98] Recorded music fell in price and rose in convenience. Women's clothing fell strongly in unit price, allowing much greater variety and display.[99] In line with Engel's Law, food consumption declined as a share of expenditure, but eating out almost kept pace with the rise of income. In consequence body weight began its alarming increase.[100] Among expenditures, recreation and eating out had

[94] Clark, Elsby, and Love, *Falling Investment.*.
[95] Bils and Klenow, 'Acceleration of Variety'.
[96] Bowden and Offer, 'Household Appliances', 735–9; Offer, 'Mask of Intimacy', 225–7, 232.
[97] Rosenberg, *Black Box,* ch. 1.
[98] Bowden and Offer, 'Household Appliances', 729, 741.
[99] Majima, 'British Fashion Industry'.
[100] Offer, 'Body-Weight and Self-Control'.

considerably exceeded domestic food expenditures by the end of the period.[101] In general, the prices of private goods fell, while those of public goods increased.[102]

In visceral provision, the market has an edge over the public sector. Visceral goods provide an immediate reward, whose effect tends to wear off rapidly. Consequently, vendors can charge a premium for novelty. Big mark-ups stimulate intense competition, and the public sector was not organized to compete.[103] The flow of novelty allows visceral goods to provide effective signals of differentiation, distinction, and status, which prudential investment could only provide after long delays by means of exclusive education or ancient lineage. High mark-ups attracted risk capital, stimulated innovation, and accelerated up the flow of new goods.[104] Visceral competition provided first-mover advantages, which allowed producers of goods such as motor cars, women's apparel, and soft drinks to build strong brands and market power.[105]

Visceral markets crowded out prudential finance, which is sensitive to interest rate levels. Real interest rates rose during the 1980s (Fig. 1). Financing public borrowing became a big constraint on governments.[106] In 1988 public sector real rate-of-return targets were raised to 8 per cent, to match private sector returns. Since private enterprise performance was derived primarily from visceral investment, such tests were biased against prudential enterprise.[107]

Personal behaviour became less prudent. Personal savings rates began to fall in the 1980s in both Britain and the United States, recovered during the early 1990s recession in Britain, and have continued their decline ever since, turning negative in the United States

[101] Great Britain, Office for National Statistics, various series: <http://www.statistics.gov.uk/statbase/tzgate.asp>.

[102] Beck, 'Public Expenditure'; Holsey and Borcherding, 'Why Does Share Grow?', 568–9; Hatton and Chrystal, 'Budget and Fiscal Policy', 55.

[103] The Soviet Union was predominantly a prudential economy, and its crisis and collapse can be understood in terms of its inability to develop visceral goods supply.

[104] Bils and Klenow, 'Acceleration of Variety'; Keely, 'Why Isn't Growth Making Us Happier?'

[105] And Millward, 'Political Economy', 167, citing Bowden, 'Motor Vehicle Industry'.

[106] Thatcher, *Downing Street Years*, 126–8; Lawson, *View from No. 11*, 103–5; Pliatzky, *Getting and Spending*, 130–63, 196–200; Hoskyns, *Just in Time*, 223, 228, 234, 242, 253, 260–4; Hatton and Chrystal, 'Budget and Fiscal Policy', 71–7.

[107] See Spackman, *Discount Rates*, 17, 31.

in 2000.[108] Between 1970 and 1990 personal debt/income ratios doubled to 118 per cent in the UK, and increased from 54 per cent to 100 per cent in the USA.[109] Credit cards removed liquidity constraints: user balances rose from less than 10 per cent of monthly income in the 1980s to 41–50 per cent for heads of household aged under 50 in 1995.[110]

In the UK, the pressures for consumption were rising. Annual real consumption growth per head settled about 25 per cent higher after 1972 than during the 'golden age', while the growth of income per head declined. Figure 5 shows how, between 1956 and 1971, the annual growth of real consumption per head (an average 2.0 per cent a year) generally lagged or matched the level of real income growth per head, at an average of 2.2 per cent. In contrast, between 1972 and 1994 consumption grew faster than income for most of the time, its growth rising above 7 per cent in 1988. Between 1971 and 1999, average annual consumption growth had risen to 2.5 per cent, while the growth of income per head fell behind, to an average 2.0 per cent a year. This consumption boom took place against a backdrop of rising unemployment, inequality of pay, and collapsing prudential investment.

Married couples shifted from the prudential model of lifetime commitment, whose emergence paralleled the growth of the public sector, towards a more visceral model of contingent marriage, with higher emotional expectations, and a higher level of dissolution. Women increasingly shifted their time from unwaged domestic and child-rearing work into paid market labour. Having made prudential investments in education and qualifications, they now earned higher discretionary incomes, which tilted the balance of advantage away from household reciprocity and regard towards the market satisfactions of visceral and positional reward.[111]

[108] United States: *Economic Report of the President*, table B-30 (p. 300); Great Britain: Office for National Statistics, *Blue Book*, series 6.1.6, RVGL. There is a view that intensified borrowing assists life-cycle consumption smoothing.

[109] Clayton, *Global Debt Bomb*, table 2.6 (p. 30).

[110] Sullivan, Warren, and Westbrook, *Forgive Our Debtors*, 12, 178–90; Evans and Schmalensee, *Paying with Plastic*, table 5.2 (p. 98).

[111] Hakim, *Work-Lifestyle Choices*, ch. 3; Costa, 'Mill Town to Board Room'; Joshi, 'Employment and Child-Rearing'.

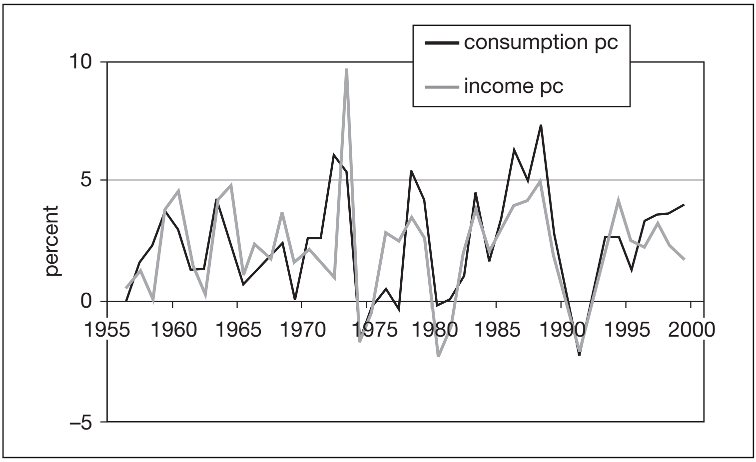

FIG. 5. Real income and consumption growth per head, 1956–1999

Sources: (*a*) Consumption: household and NPISH final consumption per head in constant prices, Office for National Statistics, *Economic Trends Annual Supplement* (2000), table 1.5 (pp. 36–7), table 1.6 (p. 40); (*b*) Income: Gross Domestic Product at market prices per head, at 1995 prices. Ibid.

The quest for consumption was itself a factor in the 1970s macroeconomic crises of labour unrest, high inflation, weak exchange rates, high oil prices, and stagnant productivity. It provided an opportunity for investors' interest groups to regroup for political capture.

INVESTOR CAPTURE

The wealthy do not have many votes. But as consumers shifted their preferences away from prudence and towards gratification, voters also began to press for lower taxes. This was an opportunity to forge a new coalition, an alliance of the wealthy and the myopic. In the United States, it also mobilized resentment of welfare spending on blacks.[112] In both countries, the opportunities for consumption and status competition made tax reductions an appealing slogan.[113]

Even the wealthy require defence, law and order, roads and bridges. But they have their own route to personal security. Where good education, health care, and retirement are expensive and exclusive, only the wealthy are truly secure. This may be why the 'American Dream' of economic independence is so compelling there. But it is an option only for the few, since if everyone is wealthy, no one is. It is understandably promoted by those who are rich already. Universal provision undermines the positional value of wealth, and the deference it attracts.

The 'Leviathan' approach to the public sector attributes plausible self-interested motives to politicians, officials, and vested interests.[114] But when privatization is evaluated, self-interested motives are usually played down, and efficiency is highlighted.[115] The wealthy have strong incentives to capture and control government, since they pay twice over, once for universal provision, and once for their own health, welfare, and education.[116]

In the United States, visceral developments assisted political capture. The power and cost of television campaigning shifted the balance of advantage back from voters towards wealth. In 1978 Proposition 13 cut California property taxes by 30 per cent and capped them.[117] In Britain in 1979 the incoming Conservative government reduced the top marginal income tax rate by 23 percentage points, and paid for it by almost doubling regressive indirect taxes.[118] Reagan delivered his own tax cuts soon afterwards.[119] In 1987 Mrs Thatcher turned universality on its head, and introduced a local government 'poll tax', levied equally on everyone, regardless of wealth. She re-enacted Edwardian standoffs between investors

[112] Phillips, *Emerging Republican Majority*; Edsall and Edsall, *Chain Reaction*.

[113] Frank, *Luxury Fever*, *passim*, esp. pp. 11–13, ch. 16.

[114] Buchanan and Tullock, *Calculus of Consent*; Buchanan, *Public Finance*; Niskanen, *Bureaucracy*.

[115] But see Wittman, 'Efficient Results'; id., *Myth of Democratic Failure*; Vickers and Yarrow, 'Economic Perspectives', 120; Vickers, 'Privatisation'.

[116] Dilnot, 'The Assessment', 8–10.

[117] Sears and Citrin, *Tax Revolt*; Lo, *Small Property*.

[118] Atkinson, 'Distribution of Income', 369–70.

[119] Stein, 'Fiscal Revolution', 266–86; Campbell, 'Tax Revolts'.

and voters.[120] In the United States as well, 1980 marked the resurgence of strong partisanship on the right, which has risen ever since.[121]

The economic and social volatility of the 1970s had discredited Britain's Labour governments. Private profits fell steeply between the 1960s and the late 1970s.[122] The pain of structural change from a manufacturing to a service economy was confounded with a perception of secular decline. But the windfall of North Sea oil gave some fiscal leeway. The 1980s saw redistribution of rents from the community back to investors. In her memoirs, Thatcher called it 'Disarming the Left'.[123] Trade union immunities were abolished, and labour unrest was suppressed. Workers' bargaining power was weakened by unemployment, and the welfare gains tended to go to managers, owners, and, occasionally, business customers; much less went to residential consumers.[124] Whatever the normative economic arguments, the ideological strain was quite overt—and also covert, as police and the secret service harassed the government's political and industrial opponents.[125]

The investor backlash was effective. The share of employment in national income declined by about 5 percentage points, from around 68 per cent in the 1960s and 1970s, down to about 63 per cent, reaching its lowest point of 61.5 per cent in 1996. The share of private corporations increased by about 7 percentage points, from about 20 to 27 per cent during the same period (Fig. 6). In relative terms, the employment income share fell about 9 per cent, while corporate profits rose by more than a third. This understates the extent of redistribution, since joblessness had tripled while pay inequality also increased.[126]

Employment in the financial sector rose from 10 per cent of the labour force in 1978 to more than 19 per cent by 1999, while the

[120] Butler, Adonis, and Travers, *Failure in Government*; Offer, *Property and Politics*, 297–308.
[121] McCarty, Poole, and Rosenthal, 'Political Polarization'; Poole, 'Polarization'.
[122] Great Britain: HM Treasury, 'The Test Discount Rate', table 1 (p. 16). See also Fig. 5.
[123] Thatcher, *Downing Street Years*, ch. 10.
[124] e.g. Galal, *Welfare Consequences*, 95–9; Thomas, 'Has Privatization Reduced the Price of Power?'; Newbery, *Privatization*, 113, 235–41; Bakker, 'Paying for Water'.
[125] Evans, 'Thatcher Spying'.
[126] Atkinson, 'Distribution of Income', 366–76.

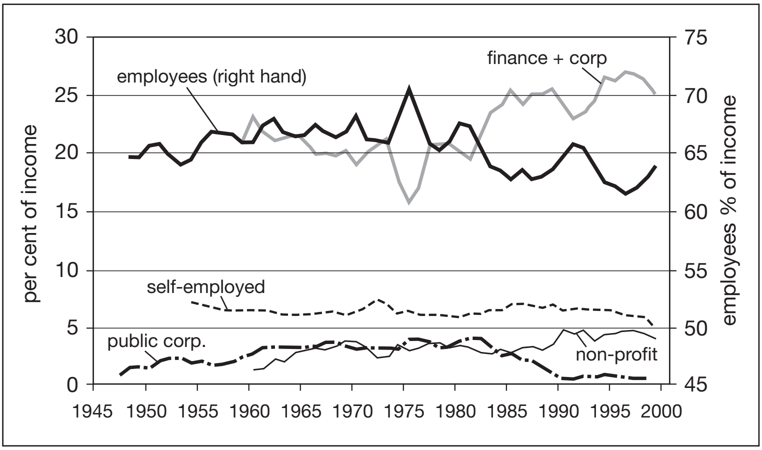

FIG. 6. Sector shares of income (or value-added), net of consumption taxes

Source: Great Britain: Office for National Statistics, *Economic Trends Annual Supplement*, table 1.4 (p. 29).

public sector declined to 17 per cent. The comparison is relevant. Like the public sector, finance is also engaged in prudential contracting. Contracting is costly, and this is captured in rising financial employment (though the City also expanded its international business). Privatization was politically self-reinforcing: financial industry workers were largely non-unionized, and their political interest was aligned with the market sector.

Investors achieved large windfalls. Privatized assets were offered cheaply, and large mark-ups occurred on the first day of trading—between 25 and 86 per cent.[127] Underwriting and flotation fees were large, and the newly privatized companies extended and deepened the capital markets. The politicians who instigated the reform, if they did not have financial or business connections to begin with, often moved into corporate or financial posts after leaving office.[128] We catch a glimpse of housing again: public housing was sold to tenants at a discount, new public dwelling construction

[127] Vickers and Yarrow, *Privatization*, table 7.2 (p. 177). Underpricing was typical of privatizations everywhere: see Megginson and Netter, 'State to Market', 344, 366–8.

[128] Barnett and Newey, '"Lords on Boards"'.

fell, while financial sector salaries drove up house prices throughout the south-east.[129]

The normative economic arguments for privatization appeared to be compelling. Real price and product competition would increase allocative and incentive efficiency. But competition would have deterred investors, so little was in fact introduced. Incentive efficiency, it was argued, could still be achieved by the threat of hostile takeover. It is clear that the Conservative reforms rejuvenated productivity and private sector profits. But economic performance overall in the post-privatization period has not dramatically exceeded that of other OECD countries, or the historical British record.[130] Performance in the energy utilities and some of the former public corporations has improved, although this began under government ownership; it is not easy to separate from the effects of technical progress and energy prices, and has been reversed in some cases. The normative literature is positive, but not entirely conclusive.[131] But, 'sales of public enterprises financed consumption, not capital formation'.[132]

A NEW STANDOFF

Even after large flotation mark-ups, privatized assets were still traded at a substantial discount. A week after flotation, the water companies were priced at one-seventeenth of current-cost valuation of their assets. Gas was valued at about one-third.[133] This might have been due to prior underpricing and inefficiency in public sector utilities.[134] If this was the only reason, it reflected the extent to which consumers as voters had acted against themselves as investors. Another interpretation of the discount might be political risk. To protect against a hostile change of government, the regulators of the privatized industries were given substantial independence. Their terms of reference required a sustainable rate of return for investors. What they typically controlled were prices

[129] *Labour Research*, 9–11.
[130] Crafts, *Relative Economic Decline*.
[131] Vickers, 'Privatisation'.
[132] Newbery, *Privatization*, 15.
[133] Bishop, Kay, and Mayer, *Privatization*, 9.
[134] Ibid. 9–10.

rather than profits, providing a strong incentive to reduce costs. Initially, this method allowed the companies to make large profits,[135] which attracted foreign buyers, or allowed the companies to diversify.

But political risks could not be eliminated. One of the first acts of New Labour in 1997 was a 'windfall tax' on the utilities. Some regulators reinterpreted their mandate to prioritize consumer interests, and drove a hard bargain. Electricity prices were forced down in 1997, water prices in 1998, and company shares fell in both cases.[136] Investors (including those close to the Labour government) began to complain of excessive regulator independence.[137] A movement began to withdraw from regulatory supervision, turning the regulated assets over to non-profit or mutual ownership, and making the profit by operating services under contract. This has already happened in Wales with water, and other schemes were under discussion.[138] It is also the emerging pattern of railway track and station ownership, both nationally and in London.

Privatization unleashed a deluge of regulatory designs.[139] Much of it compares the evolved, imperfect, but robust real-world institutions of regulation with utopian models of self-enforcing contracts. Eventually the fittest may survive, but that stage is still to come. Policy still seems to be dominated by the assumption that contracts are cost-free.

In several prudential domains, a new standoff has emerged between capital and the community. New Labour has maintained a pro-investor bias, mainly, it seems, in order to keep its borrowing and inflation rate low, and to maintain the support of financial markets.[140] In energy and telecoms prudential risks were apparently

[135] Newbery, *Privatization*, 235–41; Summerton, 'British Way', 63; Chennells, 'Windfall Tax', table 1 (p. 280).

[136] Chennells, 'Windfall Tax'; Wheatcroft, 'Water Groups'; Bakker, 'Paying for Water'; author's interview with the former water regulator, Sir Ian Byatt, 7 Aug. 2001; *The Economist*, 4 Jan. 2001.

[137] Haskins, 'Over-Mighty Regulators'; Brown, 'Calls to Review Regulation'.

[138] Author's interview with Sir Ian Byatt; Summerton, 'British Way'; *The Economist*, 4 Jan. 1991.

[139] Joskow and Schmalensee, 'Incentive Regulation', 15–26; Newbery, *Privatization*, chs. 2, 4.

[140] Great Britain: HM Treasury, *Reforming Britain's Economic and Financial Policy*.

handed over to investors (time will tell), with only minor declines of service standards. But in pursuit of prudence there is more than one ball to watch. The balanced budget policy (and central bank independence) kept exchange rates at levels which were damaging to exporters. In transport, health, education, and social insurance, there is no durable prudential contract, and services have deteriorated.

One attempt is the Private Finance Initiative (PFI), introduced in 1993. The private sector constructs physical facilities and sometimes manages them, while the public sector contracts to pay an annual fee, for thirty years or even longer. The rate of return is substantially higher than that allowed for the public sector itself. But there is a real question about the extent of the risk actually transferred to contractors, and the ability to monitor it. Some economists argue that public sector investment incurs similar implicit risks. Another view might be that the premiums cover the political risk of revenue flow expropriation, and that a high discount rate reduces the period of contractor exposure. It also raises the cost of the services, so that often the new facilities provide lower levels of service than the ones they replace.[141] The community pays a premium for the risk that it will expropriate, but the high premium makes expropriation more likely, which requires a higher premium still, in a vicious circle.

The contract specifies a flow of future services, but makes little allowance for changing needs, technologies, and modes of provision. PFI contracts protect only against cost overruns, provide few incentives to improve quality, and lock the community into rigid contracts in a time of rapid change.[142] Price-cap regulation provides few incentives to maintain and improve quality, or to create services not envisaged in the contract. There are no rewards for the learning-by-doing that drives innovation and progress, except the reduction of costs, which benefits the contractor alone.[143] As an

[141] Institute of Public Policy Research, *Building Better Partnerships*; Monbiot, *Captive State*, ch. 2; Mathiason, 'Beds Crisis'.

[142] Boyle and Harrison, 'Public Finance'.

[143] Hart, Shleifer, and Vishny, 'Proper Scope'. I owe this reference to James Foreman-Peck.

example of the risk to the community, consider mental health. Up to the 1960s, patients were kept in large public asylums. In the 1970s and 1980s new drugs provided more effective treatment, and more than a hundred asylums were emptied and closed. But adequate facilities for treatment 'in the community' have never been provided, and the incidence of mental disorder has been rising.[144] PFI would have made it worse: a redundant asylum project started in the 1960s might still be saddled with payments in the 1990s.

Water was not difficult to regulate: the product is uniform, the technology mature, and costs can be compared across different operators. In other cases the difficulties were not anticipated. Railtrack was unable to control its contractors. Ominously, the London Underground railway contractors 'will be required to meet up to 3,000 performance goals in a 2,800-page manual', and the project is forging ahead despite almost unanimous condemnation.[145]

The main economic argument for privatization is competition, but the actual record is mixed.[146] For example, opening up the energy networks has been successful in Britain so far (though not without risk),[147] but has thrown up quite dramatic disorders elsewhere. Power suppliers bidding in California electricity auctions manipulated supply and drove prices high enough to create 'brownouts', embarrass politicians, and force federal intervention.[148] Western power-station builders have had bruising standoffs in India and China, while doubt was cast on market models of energy provision when the Enron corporation collapsed suddenly in 2001. In contrast, civic and regulated electric monopolies elsewhere in the USA have been thriving.[149]

'Excess entry' can wipe out the profits which attract investors. In telecoms, technological innovation, and open entry, gave rise to capacity greatly in excess of demand. The main British firms are in trouble, and more than twenty-eight American telecoms

[144] For the USA, see Gillon, *Not What We Meant*, ch. 2; for the UK, see Rogers and Pilgrim, *Mental Health Policy*, chs. 5, 10.

[145] *Financial Times*, 'Down the Tube'; *Financial Times*, 'Railtrack Redux'; *The Economist*, 'London Underground'.

[146] e.g. Vickers, 'Privatisation'; Aharoni, 'State-Owned Enterprises'.

[147] Buckley, 'Fears Grow'.

[148] Elstrom and Timmons, 'Telecom Meltdown'.

[149] Bannerjee, 'Con Ed'; Kripalani, 'Power Play'; Kynge, 'China's Broken Promises'.

companies with liabilities of over $100m each have failed. During 2001 the telecoms crisis appeared to threaten the stability of capital markets overall.[150] Conversely, if an industry is mature, there is not much to compete with. Price competition pushes down the rate of return to levels which no longer attract the capital market. In the Victorian and inter-war years, British private railways competed on some routes, as well as with emergent road transport. Excess competition also affected American railways.[151]

Competitive advantage can be gained by squeezing wages and working conditions, especially of unskilled workers, or those locked into firm-specific skills. This does not increase welfare, but merely transfers it from low-paid workers to managers, shareholders, and customers. It poses a risk to the quality of service, which can take unexpected forms, such as high infection levels in UK hospitals, or ineffective security in American airports.[152] Yet another form of imperfect competition is opaque product pricing in the privatized utilities,[153] where competition might be a reality for investors and managers, but not for consumers.

The reform of old-age pensions bears the hallmarks of investor capture. By the 1970s, Britain had three main tiers: a pay-as-you-go flat-rate state pension linked to average earnings, an earnings-related supplementary pension (SERPS), and (as an optional alternative) broad employee participation in final salary schemes ('occupational pensions'), supported by employer contributions. Both Conservative and Labour governments have since decided to shift responsibility to individuals, by means of financial intermediaries. These 'personal pensions' did not penalize job mobility, and provided an incentive to save. But portability was bought dearly. The first step was to erode the benefits of flat-rate pensions, which continue to diminish. Members of the second tier were given big tax inducements to abandon it, and had their benefits cut. But the new 'money purchase' schemes are expensive to run.[154] Their heavy

[150] Roberts, 'Glorious Hopes'; Coy, 'Deregulation'.
[151] Foreman-Peck, 'Privatization in Historical Perspective'; Perelman, *End of Economics*.
[152] Boseley, 'Ten Dirty Hospitals'; Krugman, 'Paying the Price'.
[153] Newbery, *Privatization*, 407.
[154] Budd and Campbell, 'Public and Private Sectors'; Murthi, Orszag, and Orszag, 'Administrative Costs'.

charges are socially regressive, and benefit advisers, executives, and shareholders. In effect, this reform defaulted on the collective pay-as-you-go scheme, providing a clear demonstration of the political risk of collective insurance.

Private saving exposed voters to a range of new risks. Employers have increasingly withdrawn from final salary schemes, and tended to reduce their contribution.[155] Even if overall pay is unchanged, the market risks were shifted from employers to individuals. Without mandatory saving, they are likely to under-invest. Mismanagement and opportunism are rife. Tax incentives were abused by massive 'mis-selling', in which savers were lured out of solid occupational pensions into inferior private ones. In the late 1980s the tycoon Robert Maxwell stole his companies' pension assets, and more recently the Equitable Life, a large mutual provider, mismanaged its assets and had to cut entitlements. Private pensions also carried political risks, as when dividend tax credit was withdrawn in 1997. The reforms have reduced the pension obligations of the British state, with a consequent improvement for its macroeconomic standing; but this is illusory.[156] The implicit income support guarantee is a pension by another name, and its level has risen in response to voter pressure.

CONCLUSION

In the 1980s Britain took a prudential holiday. Old investments were still paying off, and new ones were not being made. The signs of neglect were beginning to show during the 1990s in education, health, transport, and pensions.[157] The assumption of myopic choice highlights failures of resolve. The purpose of collective provision, we have argued, is to overcome myopic biases, and to facilitate long-term commitment. Examples are mandatory education and mandatory pension saving. But precommitment can become overcommitment, as in the investment overshoot of the golden-age

[155] Coggan and Buck, 'Pension Gamble'.

[156] Great Britain: HM Treasury, *Economic and Financial Policy,* 252, 254; Budd and Campbell, 'Public and Private Sectors', 99–100.

[157] Clark, Elsby, and Love, *Falling Investment.*

period.[158] The undershoot of the following period implicates fallible choice once again. Prudential commitment was undermined by the flow of compelling new goods. What sacrifice of discretionary gratification would voters now accept in return for prudential outlays? To catch up with Europe and America in transport, health care, and higher education could require increases of taxation that might strain the capacity of current politics. The steady prudential progress from the late Victorian period through to the post-war years was remarkable, but experience in quite advanced countries, for example in South America, indicates that failure is a real possibility, if prudential dilemmas are not resolved.[159]

158 Or, in Ainslie's terms, 'compulsive': *Breakdown of Will*, 50–1.
159 Spiller and Savedoff, 'Government Opportunism'.

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