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WHY HAS THE PUBLIC SECTOR GROWN SO LARGE IN MARKET SOCIETIES? THE POLITICAL ECONOMY OF PRUDENCE IN THE UK, C.1870–2000

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Abstract

The public sector allocates 40 percent of expenditure in Britain. Why do affluent consumers acquire so much welfare outside the market? If choice is affected by myopic bias, optimisation 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 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, privatisation and de-regulation. 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. These will need to be resolved once again by means of political competition.

Why has the Public Sector Grown so Large in Market Societies? The Political Economy of Prudence in the UK, c. 1870–2000[1]

The public sector is very large in developed countries. In the late-Victorian period governments administered less than 10 percent of GDP, since when levels have risen to between 30 to 55 percent.[2] 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?[3]

In standard economic theory, consumers are the best judges of their own welfare. They are consistent, informed, and far-sighted. They optimise consumption over the life-cycle by buying, borrowing and saving in appropriate markets.[4] In contrast, an emerging view argues that actual consumer choice may have a myopic bias. In this 'hyperbolic discounting' model, value declines sharply with delay, and long-term preferences are reversed, so that smaller-sooner dominates larger-later.[5] Taken literally, this 'myopic trap' keeps the delayed reward forever 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.[6]

Immediate and delayed rewards correspond with two categories. The first is 'visceral goods', such as food, alcohol, or entertainment.[7] The reward is immediate: it sat-

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[1] Katerina Bantinaki and Siobhan McAndrew gave excellent research assistance. Participants at presentations in Cambridge, Dublin, Oxford and Rome made helpful comments. I am grateful for guidance from James Foreman-Peck and Robert Millward; George Peden saved me from error. The text is the author's alone.

[2] Tanzi and Schuknecht, 2000.

[3] This study complements Offer, 1997, which evaluates non-market reciprocity as a source of welfare.

[4] Deaton, 1992, ch. 1; Browning and Crossley, 2001.

[5] Ainslie, 1992; Ainslie, 2001; Elster and Loewenstein, 1992; Elster, 2000, 24–34; these all contain guides to an extensive literature.

[6] Laibson, 1997, 444–6; Barro, 1999, 1136–7; also Becker and Mulligan, 1997. More fundamentally, this may be regarded as the function of the Hobbesian state. On Constitutions as commitment devices, Elster, 2000, pt. II.

[7] The concept is derived from Loewenstein, 1996; Loewenstein, 1999b.

isfies 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.[8] Behavioural drives are habituated by stimulation, e.g. exposure to dance music induces tolerance for decibels.[9] As sensory arousal is swamped, new experiences are sought for.[10]

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 is remote, staged, or incremental. Over long time spans, transactions generate difficult agency problems: contracts are difficult to specify and negotiate, and it is hard to monitor and enforce quality, cost, payment, and delivery.[11] Controlling the future is costly: for example, the various costs of individual pension products typically absorb up to 45 percent of contributions in the UK, and reduce the final pension by 20 percent and upwards in the USA.[12]

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 satiated. 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

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[8] Elster, 1999a, 1999b; Elster and Skog, 1999; Offer, 2001.

[9] Ainslie, 1992, 252–259.

[10] Scitovsky, 1992, chs. 2–3.

[11] Eggertson, 1990, 13–20.

[12] Murthi, Orsazag, and Orszag, 2000; Aaron, 1999, 68–81; For the USA, see Panel, 1998, 25–35; Barr, 2001, 117.

1990s, prudential parsimony gave rise to a new crisis of public provision, with contractual standoffs like those of the late-Victorian period.

i. Politics and prudence

The consumer's marginal outlay is either visceral or prudential. 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 rules are both stylised and ambiguous.[13] 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'.[14] 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 '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.[15]

The case for prudence is modest: if choice is myopic, then some rewards will not be adequate, e.g. those of family, education, old-age provision, 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 a veteran politician.[16] Politics provides a 'discovery procedure' for determining the balance of gratification and prudence, and a mechanism for imposing it. In the absence of dictatorship, it is widely agreed that individual preferences cannot be aggregated fairly.[17] 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.[18]

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[13] Atkinson, 2001, 197–201.

[14] 'A Feaver', Donne, 1950, 35.

[15] Ainslie, 1992, 2001, passim; e.g. 2001, 154–5; Quite apart from other psychological biases, cf. Kahneman, 2000a, 2000b.

[16] Lawson, 1992, 186.

[17] Heap, 1992, 209–215.

[18] Mueller, 1997, 4-6b; Black, 1948, cited by Mueller, 1997a; Cornes and Sandler, 1996, 205–210.

The level of taxation represents just such a unique equilibrium trade-off between discretionary consumption, and prudential provision. Competing politicians promise levels of taxation that will maximise their chance of election, with strong 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, which they offer to the median voter. And because governments cannot fully bind their successors, they try to design structures that cannot be easily undone.[19] 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.[20] There was a strong incentive to alleviate suffering by means of prudential projects.[21] 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'.[22] Manias (and panics) have recurred in the recent rush into mobile and broadband telecoms.[23] After shakeout, the new monopolies acquired only a transient advantage. As technologies settled down, proprietary knowledge became public, 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'.[24] 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. Universality came to be seen as a matter of entitlement. It was akin to equality before God, before the law, and before 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

[19] Moe, 1990, 124, 136–146; Dixit, 1996, 57–58, 73.

[20] Williamson, 1994.

[21] For example, Great Britain, 1842 [1965].

[22] Newbery, 1999, 107, 393–4.

[23] Roberts, 2001a, 2001b, 2001c.

[24] Robson, 1935, 300.

than the average voter, politicians will have a motive to support it,[25] though it is more likely in a unitary state like Britain than in a federal one like the USA.

A private company which provides such necessities is exposed to political opportunism. If politicians restrict investors' 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.'[26] Hence, from the 1840s onwards, there was a prolonged standoff between investors and the community.[27] Governments restricted rates of return, and imposed price caps, service standards, and taxation. If investors were pressed too hard, they would no longer invest, and the default was government takeover.

In the water industry, for example, nominal rates of return were initially capped at ten percent, and were forced down during the course of the century to four percent. 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 of electricity supply and distribution was publicly owned by the 1920s, although less than half of the gas industry. Telegraphs were nationalised in 1866, telephones in 1911, and electric transmission in 1926.

Regulated private monopolies have the advantage of making no claim on tax money, and more management discretion.[29] They became the norm in the United States, and were found quite widely in Britain too, although by the inter-war years they were increasingly regarded as failures.[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]

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[25] See Lindert, 1996, 6.

[26] Lawson, 1992, 186.

[27] The technical term is 'hold-up', in the sense of extortion rather than delay. See Ricketts, 1989, 151; Hart 1995, 27–8. Game-theoretical analysis, Newbery, 1999, ch. 2.

[28] Robson, 1935; Falkus, 1977; Hassan, 1985.

[29] Newbery, 1999, ch. 3.

[30] Millward, 2000a; Jacobson and Tarr, 1993.

[31] Priest, 1993; Joskow and Schmalensee, 1996; see Bannerjee, 2001.

ii. Social insurance and welfare

In Victorian Britain, 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 schoolmasters, and for fees by voluntary organisations.[37] Medical treatment was pervasively organised on a 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 dominated.

In the United States the ‘club’ system has endured. Primary and secondary education is organised 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 percent of national income and 10.6 percent of employment in 1992.[38] Primary pensions and medical treatment for aged are the universalist exceptions, as well as health care for the truly indigent.

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[32] Stigler, 1971.

[33] National Civic Federation, 1907, vol. 1, 126–7; Offer, 1981, 297–308; Millward, 2000a, 329.

[34] Cornes and Sandler, 1996, pt. iv.

[35] Cornes and Sandler, 1996, 365–369.

[36] King, 2000.

[37] West, 2000.

[38] Including voluntary labour, 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, 1996, 705; Saxon-Harrold, 1993.

Collective authorities, whether governments or clubs, typically deliver the service themselves. Why not contract with private providers? The main reason arises because long-term market contracts are difficult to specify, expensive to monitor and enforce, and uncertain in their effect: they are 'incomplete'.[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 extortion. 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 easily monitored, and compliance enforced. Principal and agent are not overtly in conflict, and their interests are easier to align. Learning and innovation are not discouraged by costly re-negotiation. If a train derails, 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 restricted. Integration is pervasive, 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 on the part of users. Education pays off, but myopic youngsters 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 a certainty 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 out of peer approbation.[40] Professionalism also underpins impartiality, which makes it feasible to monitor both staff and students credibly.

A teacher or doctor who is locked into a specialised skill faces a similar standoff with the community as a utility entrepreneur. Once the professional has locked into a career and a pension, voters and politicians are inclined to underinvest and to underpay, in myopic disregard for the future. 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 is a 'commitment device' which helps individuals overcome myopic preferences. Mandatory participation overcomes the temptation to free ride or underinvest. In the absence of compulsion, about 17 percent of the USA population (some

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[39] Hart, 1995, 21–28, ch. 4.; Salanié, 1997, ch. 7.

[40] See also Glaeser and Shleifer, 1998.

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 like 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. Health insurance administration cost about 12 percent more of the total health outlays in the USA in 1983 (about 1.5 percent of GDP), than 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 a myopic point of view, 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 probability 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 ill, workers and unemployed. When circumstances changed, the contributions and benefits were renegotiated.[49] Pay-as-you-go carries political risk: stingy 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.

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[41] Aaron, 1991; Kilborn, 1999; Steinhauer, 1999.

[42] Aaron, 1999, 70–83; Panel, 1998, 23–31; Diamond, 1999, 15–16. This is not offset by higher returns (Orszag and Stiglitz, 2001, 24–28). See also Shoven, 2000.

[43] In 1983. Aaron, 1991, 30, citing Himmelstein and Woolhandler, 1986.

[44] Becker, 1983, 1985; Feldstein, 1996.

[45] Lindert, 1996a, 21–28; Lindert, 1996b; Dilnot, 1995, 8–9.

[46] Baldwin, 1990, ch. 1; Barr, 2001, ch. 6.

[47] Lindert, 1996b, 16–18, 31.

[48] As implied by James, Smallhouse and Vittas, 2001, 255–256.

[49] Shoven, 1999, 1.

Quite apart from their extra cost, Private pension entitlements, carry their special risks: consumer choice is illusory, since savers are poorly informed, are locked in early, can suffer from management incompetence and default, while payoffs are exposed to stock market fluctuations and annuity risk.[50] Since private pensions rely on tax concessions and implicit government guarantees, they are not immune to 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 American government has insured depositors since 1933. Savings and Loan banks were bailed 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. By the 1970s governments were bailing 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 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, Oxbridge 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 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 spend to uphold national security. They supported World Wars One and Two, and the Cold War on a generous

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[50] Aaron, 1999, 62–67; Barr, 2001, 112–116; On Choice, Aaron, 1999, 63, Diamond, 2000, 151–152; Loewenstein, 1999; Barr, 2001, 116–118; more optimistically, the authors in Campbell and Feldstein, 2001.

[51] Eltis, 2001.

[52] Calavita, Pontell and Tillman, 1997.

[53] Henderson, 1980; http://www.votenader.org/press/Corporate/Contents.html; as well as railway companies, banks, and, most recently, airlines.

[54] Gillon, 2000, ch.2; Shorter, 1997, 277–281; Rogers and Pilgrim, 1996, chs. 5, 10; Great Britain, 'Town and Country Parks', 1999.

scale. Unlike other prudential goods, wars have been paid for mostly in arrears, by servicing the debts, and honouring implicit obligations by extending welfare entitlement. In Continental Europe, strategic and economic catch-up considerations motivated a good deal of public enterprise.[55]

Integration into the public sector does not resolve the choice between visceral and prudential goods. The standoff between community and capitalists is is merely replaced by one between voters in their role as consumers, and 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 onto 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 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

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[55] Peacock, Wiseman and Veverka, 1967, 25–34, 53–68; Andreski, 1968; Toninelli, 2000.

[56] Contrary to Niskanen, 1971; Buchanan and Tullock, 1962; and following Musgrave, 1981, and Wittman, 1995. Empirical confirmation, Lindert, 1996a, 24–28.

[57] Musgrave and Peacock, 1958, 8.

[58] Without country and period fixed effects. Lindert, 2001, 11; Peacock and Scott, 2000, table 1, p 6–7; Ram, 1987, for developed countries since 1945 in time-series, excluding transfer payments.

[59] 64 percent.

[60] Offer, 1981, 1983.

[61] Salisbury in 1881, quoted by Feuchtwanger, 1985, 120; Harcourt's quip was repeated by the Prince of Wales, 5 Nov. 1895.

[62] Middleton, 1996, table 3.14, 119.

another.[63] Lindert (1996), a comprehensive study of welfare expenditure, does not include it at all.

iii. A case study: The housing standoff

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 implied rate of return of 8.5 per cent gross at the top of the cycle in 1896, and 13.5 percent at its bottom in 1912.[65] This implied a payback period of 12 years at the top of the cycle, and 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 constituted a major social standoff, which generated a great deal of anguish. 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. Tenants expropriated investors. Once rent control had been imposed, it was politically difficult to repeal, even by Conservative governments. The regulated rate of return gave little incentive to invest in new houses, and the rented sector went into decline.[71]

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63 Hicks, 2001, 172–173, 179–180; Lindert, 2001, 5.

64 In 1910. Feinstein, 1972, table 46, t104.

65 Offer, 1981, fig. 17.9; *Inland Revenue Annual Report*, n. 23 in *ibid*., 112.

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 (*Inland Revenue Annual Report*, 1906), table XC, 110–111; (1914), table 28, p 32–33. Net returns were much lower (see Offer, 1981, 290–292) 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. See Offer, 1981, table 7.6, 134.

69 Gauldie, 1974; Wohl, 1977; Morris, 2001.

70 Wohl, 1977; Offer, 1981; Gauldie, 1974; Englander, 1983; Daunton, 1983, Holmans, 1987, ch. 2. But see also Thompson, 1988, ch. 5 and Morris, 2001.

71 Holmans, 1987, 85–87, 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

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 stock ran down physically towards the 1970s, while public housing increased to about 30 percent 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 conventional equity owners. They accepted deposits from members, and lent to them for house purchase. By a process of trial and error, 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 twenty-five 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 about 83 percent higher than in the previous housing cycle, of 1890 to 1910.[75]

Figure 1 follows the course of housebuilding, 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 to levels of absolute provision so low that they had 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.

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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, 1987, 316.

[73] Holmans, 1987, table V.1, 169–170.

[74] Speight, 2000, 61–62.

[75] Mitchell, 1988, table 5, 390. Modelling housing supply as a whole would require a major research effort, and has not been undertaken even for recent years.

The fiscal aspect is a web of subsidies, benefits and taxes.[76] Interests rates rose. Institutionally, housing finance was privatised 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 professionals like teachers, nurses and policemen from housing in core areas.[77]

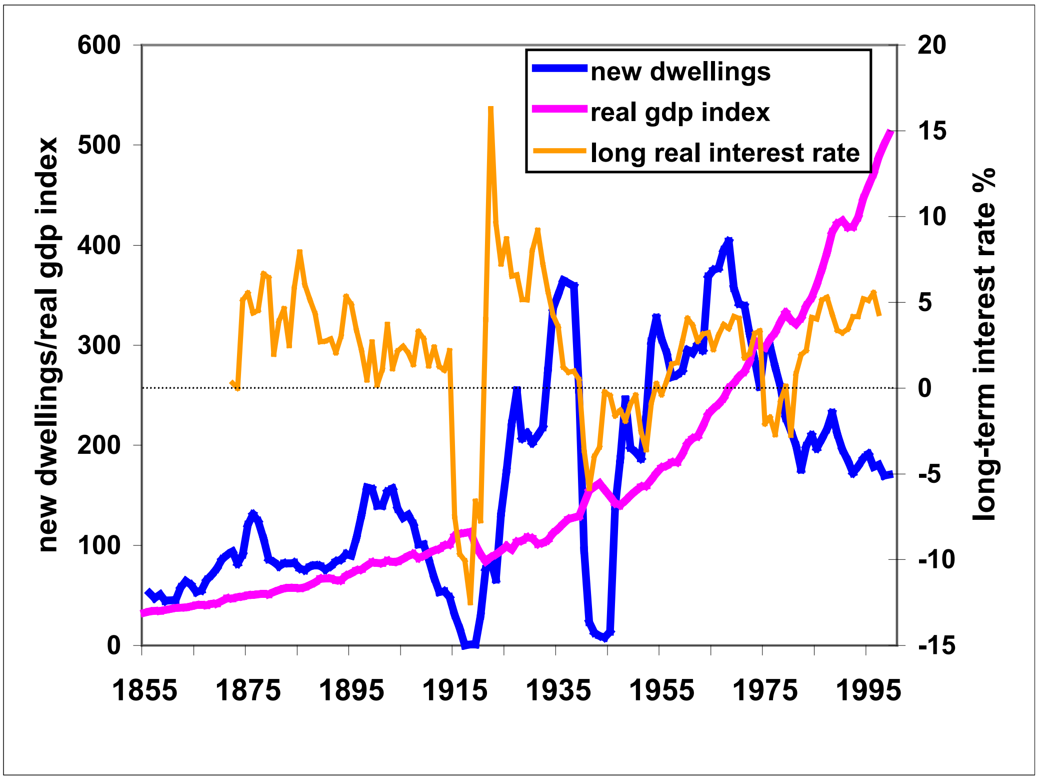

Figure 1. New Dwellings, Economic Growth, and Real Interest Rates in the UK, c. 1856–1999

Sources: Mitchell, *British Historical Statistics* (1988), pp. 390, 392, 678. Feinstein, *National Income, Expenditure and Output of the United Kingdom* (1972), table 6, pp. t18–t20. Office for National Statistics*, Economic Trends*, series 5.4. Dwelling House Completions. Chadha and Dimsdale, 'Long View of Real Rates' (1999).

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[76] Hills, 1991, ch.1, and passim.

[77] Böheim and Taylor, 2000; *Labour Research*, Dec. 2001, 9–11.

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 ten to twenty five and eventually to thirty 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 an unlimited tax deduction on mortgage interest. Much housing finance has been provided by quasi-clubs, namely the Savings and Loan associations, which were regulated and guaranteed by government.[79]

iv. Prudential boom and satiation, c. 1950s–1970s

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 percent up to the late 1930s, to below 60 percent in the mid-1960s, recovering to only slightly higher levels today.[82] Capital formation, which had hovered around 8 percent for most of the interwar period, was about twice as high in 1950, and touched a peak of over 25 percent 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 nine percent of the labour force, and total public sector employment reached 27 percent. 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

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[78] Bryant, 1962, 278–284, 382–392; Jackson, 1985, ch. 11.

[79] Bryant, ibid; Haar, 1960, ch. 1; Klaman, 1961, chs. 3–6.

[80] Suggested, among other factors, by Toniolo, 1998, 259.

[81] An encompassing survey of interpretations, Crafts and Toniolo, 1996.

[82] Calculated from Feinstein, 1972, table 2, t8–9; Great Britain, Office for National Statistics, ser. ABPB, e.g *Economic Trends Annual Supplement*, no. 26, 2000, table 1.3, 15.

[83] Millward, 2000a.

[84] Peacock and Scott, 2000, 10–13; Millward, 2000b, 169, 174–5.

matched the private sector.[85] But by the 1990s, after the energy and water utilities were privatised, it proved possible to shed a large proportion of the workforce.

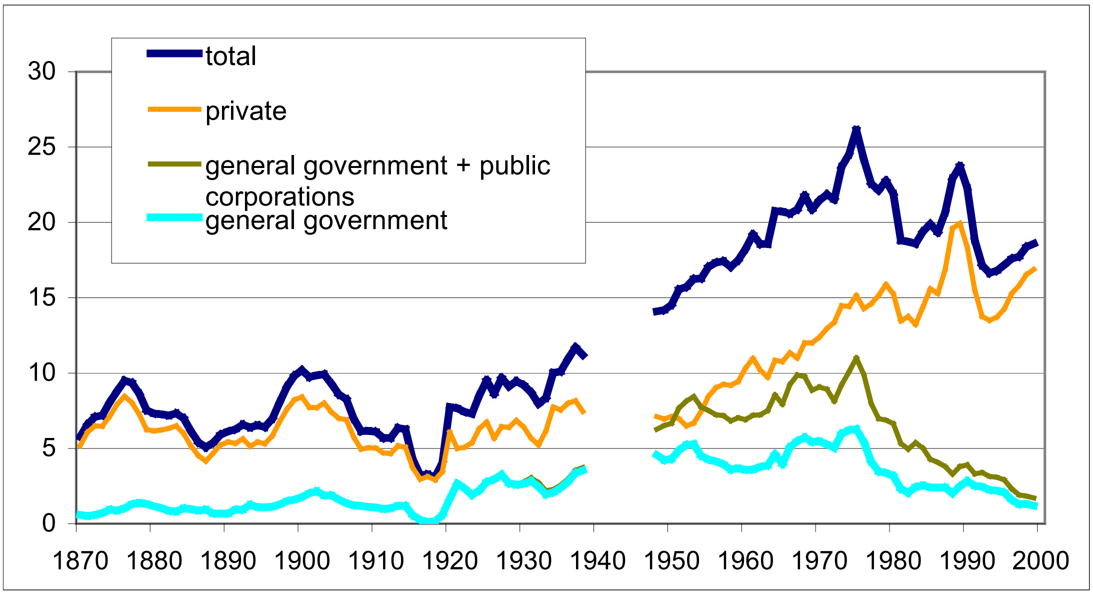

Figure 2. Capital formation by sector, UK 1870–2000, as percentage of GDP

Sources: Feinstein, *National Income, Expenditure and Output of the United Kingdom* (1972), pp. t85–t87; Office for National Statistics, UK National Accounts, series NPQX, NNBF, NSSU, FCCJ, ANSQ, ANSS, DFDK, http://www.statistics.gov.uk/statbase/timezone.asp

A new infrastructure was laid down: motorways, telecoms, natural gas, comprehensive education, universities and polytechnics, electricity generation, hospitals and primary health care, basic science, income and disability benefits, old-age pensions, and also missile submarines and nuclear power plants. Economies of scale arose from uniform, 'one-size-fits-all' facilities and services. In the absence of competitive and rate of return disciplines, there was a tendency towards over-specification and 'gold-plating', as in the great projects of the advanced gas-cooled reactor, and the Concorde supersonic airliner. Marginal income tax rates had risen over 80 percent, 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. It the objective is security, then increments become more costly, and prudence delivers di-

[85] Foreman-Peck and Millward, 1994, 218–219; Millward, 2000b, 170–173.

[86] For the UK, see the Institute of Fiscal Studies, 2001; for the USA, see Taxplanet.com for its report of the Congressional Joint Committee on Taxation.

minishing returns. This can be shown by relating prudential outcomes to levels of income. Figure 3 demonstrates it in a cross section distribution of (mostly prudential) social indicators against income in 109 countries.

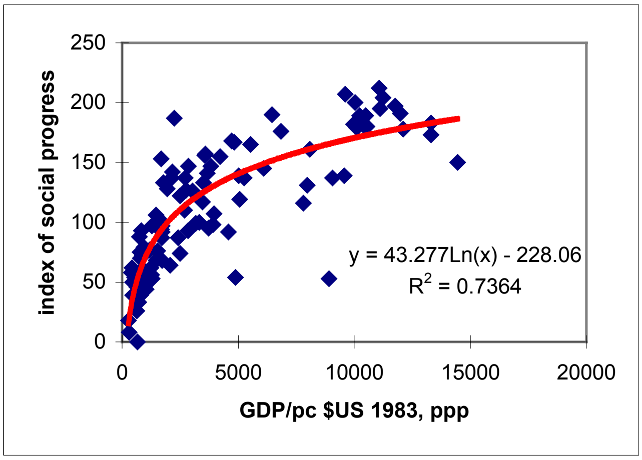

Figure 3. Social Indicators and income per head, cross section, c. 1983

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 dollars.

Source: Estes, *Trends in World Social Development* (1988), table A2, p. 186–188

A similar pattern of diminishing returns is also evident over time (fig. 4). Here the criteria are education, life expectation, and the Human Development Index, in four developed countries. There is evidence of declining prudential returns during the 'golden age'.

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 un-

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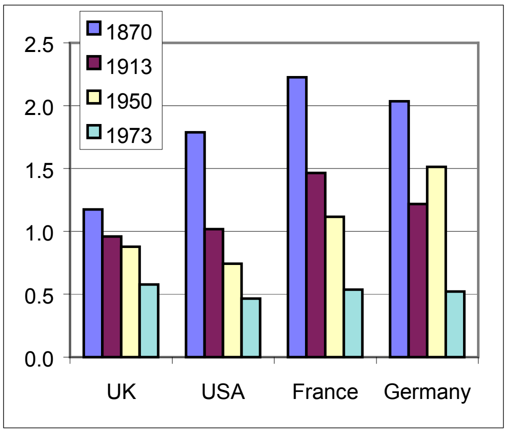
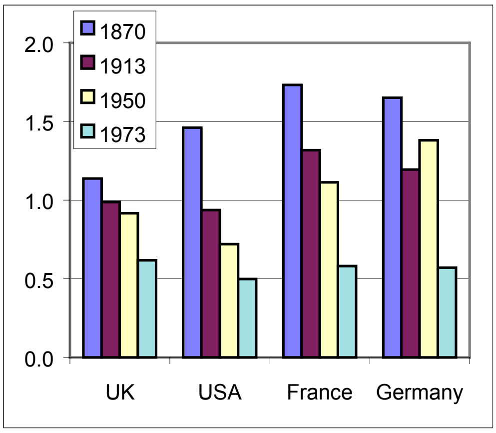
[87] Great Britain, H. M. Treasury, 1979.

[88] Pliatzky, 1982, 130–142.

derinvestment.[89] But there was a good deal of momentum, and the share of public investment, and indeed investment overall, peaked in the 1970s.



Units of welfare per 1990 dollar, 1870–1973 (x100)



HDI* per 1990 dollar, 1870–1973 (x100)

Figure 4. Units of Welfare per 1990 dollar, four countries c. 1870–1973

The welfare index is made up of (percentage school enrolment+life expectation 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.

Source: Calculated from Crafts, 'Human Development Index'. Data in Offer, 2002, table 1.

Academic opinion as well 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 like education and health.[90] In the United States, the 'Leviathan' school of public sector economics, depicted government growth as the outcome of self-interested rent-seeking by 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 infra-

89 Millward, 2000b, 173–175.

90 Baumol, 1967; Beck, 1985.

91 Buchanan and Musgrave, 1999; Musgrave, 1981; Borcherding, 1977.

structure 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 macro-economic disorders or 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 symbolise the purported arrogance and 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 in fig. 2 is perhaps overdrawn. Some investment was taken over by the private sector, some went overseas. Young people were staying longer in secondary and higher 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. Colour television began to diffuse in the late 1960s. It came to dominate free time, and provided a compelling broadband channel for marketing messages.[95] Holidays were spent increasingly overseas, as the cost of air travel fell.[96] A sequence of domestic appliances diffused into households. Transistor radios, portable tape cassettes, video recorders, and latterly CD equipment, home computers the internet, and mobile telephones followed each other in rapid succession.[97] Recorded music fell in price and rose in convenience. Women's clothing fell strongly in unit price, allowing much greater variety and display.[98] 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.[99] Among expen-

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[92] Joskow and Schmalensee, 1996, 16-26; Millward, 2000b, 175–177.

[93] Bacon and Eltis, 1976.

[94] Clark, Elsby, and Love, 2001.

[95] Bowden and Offer, 1994, 735–739; Offer, 1996, 225–227, 232.

[96] Rosenberg, 1982, ch. 1.

[97] Bowden and Offer, 1994, 729, 741.

[98] Majima, 2000.

[99] Offer, 2001.

ditures, recreation and eating out had considerably exceeded household food expenditures by the end of the period.[100] In general, the prices of private goods fell, while those of public goods increased.[101]

In visceral provision, the market has an edge over the public sector. Visceral goods provide immediate gratification, which tends to wear off rapidly. Consequently, vendors can charge a premium for novelty. Big markups stimulate intense competition, and the public sector was not organised to compete.[102] 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, e.g. by means of exclusive education or ancient lineage. High markups attracted risk capital, stimulated innovation, and speeded up the flow of new goods.[103] Visceral competition provided first-mover advantages, which allowed producers of goods like motor cars, women's apparel, and soft drinks to build strong brands and market power.[104]

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 finance ministers.[105] In 1988, public sector real rate of return targets were raised to 8 per cent. Since private enterprise performance was derived primarily from visceral investment, such tests were biased against prudential enterprise.[106]

Personal behaviour became less prudent. Savings rates began to fall in the 1980s in both countries, recovered during the early 1990s recession in Britain, and have continued their decline ever since, turning negative in the United States in 2000.[107] Between 1970 and 1990 personal debt/income ratios doubled to 118% in the UK, and rose from 54% in the USA, to 100%.[108] Credit cards removed liquidity constraints:

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[100] Office for National Statistics, various series: http://www.statistics.gov.uk/statbase/tzgate.asp

[101] Beck, 1985; Holsey and Borcherding, 1997, 568–569; Hatton and Chrystal, 1991, 55.

[102] 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.

[103] Keeley, 2000.

[104] And see Millward, 2000b, 167, citing Bowden, 1995.

[105] Thatcher, 1993, 126–128; Lawson, 1992, 103–105, Pliatzky 1982, 130–163, 196–200; Hoskyns, 2000, 223, 228, 234, 242, 253, 260–264; Hatton and Chrystal, 1991, 71–77.

[106] See Spackman, 1991, 17, pt. 17, 31.

[107] *Economic Report of the President*, 2001, table B-30, 300; Great Britain, ONS, *Blue Book*, 2000, series 6.1.6, RVGL. There is a view that intensified borrowing assists life-cycle consumption smoothing.

[108] Clayton, 2000, table 2.6, 30.

user balances rose from less than 10% of monthly income in the 1980s to 41%-50% for households aged below 50 in 1995.[109]

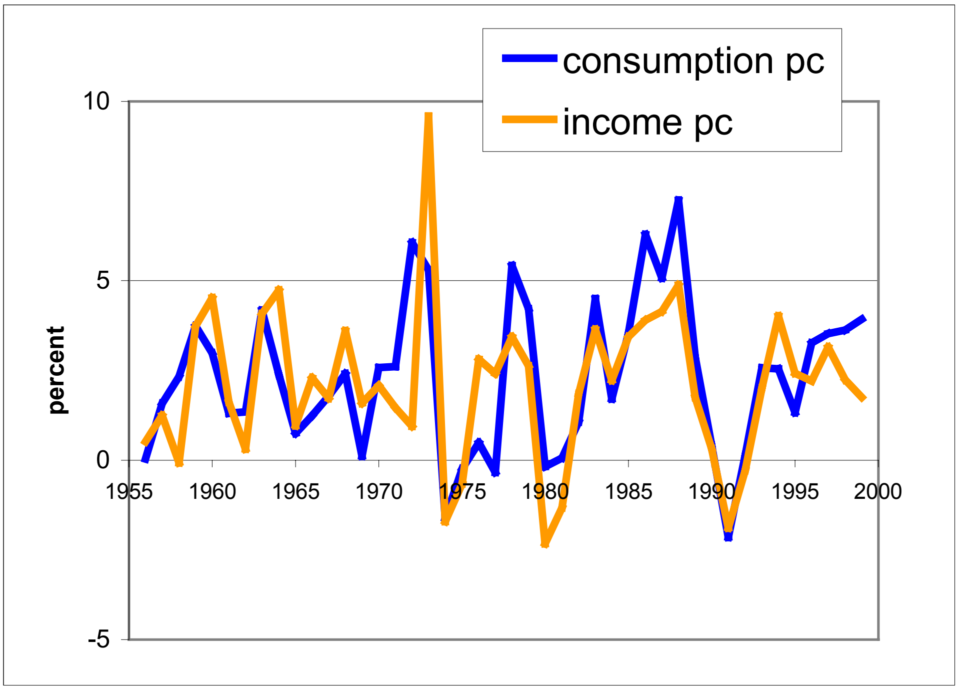

Figure 5. Real Income and Consumption Growth per head, 1956–1999

Sources: Consumption: Household and NPISH Final Consumption per head in constant prices, ONS, *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.

In the UK, the pressures for consumption were rising. Annual real consumption growth per head settled about 25 percent 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 percent a year) generally lagged or matched the level of real income growth per head, at an average of 2.2 percent. In contrast, between 1972 and 1994 consumption grew faster than income for most of the time, its growth rising above seven percent in 1988. Between 1971–1999, average annual consumption growth had risen to 2.5 percent, while the growth of income per head fell behind, to an average 2.0 percent a year. This consumption boom took place against a backdrop of rising unemployment, inequality of pay, and collapsing prudential investment.

[109] Sullivan, Warren, and Westbrook, 1989, 12, 178–190; Evans and Schmalensee, 1999, table 5.2, 98.

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.[110]

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.

vi. 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 mobilised resentment of welfare spending on blacks.[111] In both countries, the opportunities for consumption and status competition, made tax reductions an appealing slogan.[112]

Even the wealthy require collective prudence, in the form of law and order, and collective infrastructure. 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 to Americans. 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 wealthy already.

The 'Leviathan' approach to the public sector attributes plausible self-interested motives to politicians, officials and vested interests.[113] But when privatisation is evaluated, self-interested motives are usually played down, and efficiency is highlighted.[114] The wealthy have strong incentives to capture and control government, since they pay twice over, once for universal provision, and secondly, for private

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[110] Hakim, 2000, ch. 3; Costa, 2000; Joshi, 1996.

[111] Phillips, 1969; Edsall and Edsall, 1992.

[112] Frank, 1999, passim, esp. 11–13, ch. 16.

[113] Buchanan and Tullock, 1962; Buchanan, 1967; Niskanen, 1971.

[114] But see Wittman, 1989, 1995; Vickers and Yarrow, 1991, 120; Vickers, 1998.

health, welfare and education.[115] Universal provision also undermines the positional value of wealth, and the deference it attracts.

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 percent and capped them.[116] 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.[117] Reagan delivered his own tax cuts soon afterwards.[118] In 1987, Mrs. Thatcher turned universality on its head, and introduced a local government 'poll tax', levied equally on everyone, regardless of wealth. This regressive bid re-enacted some Edwardian standoffs between investors and voters.[119] In the United States as well, 1980 marked the resurgence of strong partisanship on the right, which has risen ever since.[120]

The economic and social volatility of the 1970s, and especially the high inflation had discredited the Labour governments. Private profits fell steeply between the 1960s and the late 1970s.[121] The pain of structural change from a manufacturing to a service economy may have been confounded with a perception of secular decline. The windfall of North Sea oil gave some fiscal leeway. The 1980s saw redistribution of rents from community back to investors. In her memoirs, Thatcher called it 'Disarming the Left.'[122] 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 (if at all) to residential consumers.[123] 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.[124]

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[115] Dilnot, 1995, 8–10.

[116] Sears and Citrin, 1982; Lo, 1995.

[117] Atkinson, 2000, 369–370.

[118] Stein, 1996, 266–286.

[119] Butler, Adonis and Travers, 1994; Offer, 1981, 297–308.

[120] McCarty, Poole and Rosenthal, 2001; Poole, 2002.

[121] Great Britain, H. M. Treasury, 1979, table 1, 16. See also fig. 5.

[122] Thatcher, 1993, ch. 10.

[123] For example, Galal, 1994, 95–99; Thomas, 1999; Newbery, 1999, 113, 235–241; Bakker, 2001.

[124] Thatcher, 1993, as reported by Evans, 2001.

The investor backlash was effective. The share of employment in national income declined by about five percentage points, from around 68 percent in the 1960s and 1970s, down to about 63 percent, reaching its lowest point of 61.5 percent in 1996. The share of private corporations increased by about seven percentage points, from about 20 to 27 percent during the same period (fig. 6). In relative terms, the employment income share fell about nine percent, while corporate profits rose by more than a third. This understates the extent of redistribution, since joblessness had tripled while pay inequality also increased.[125]

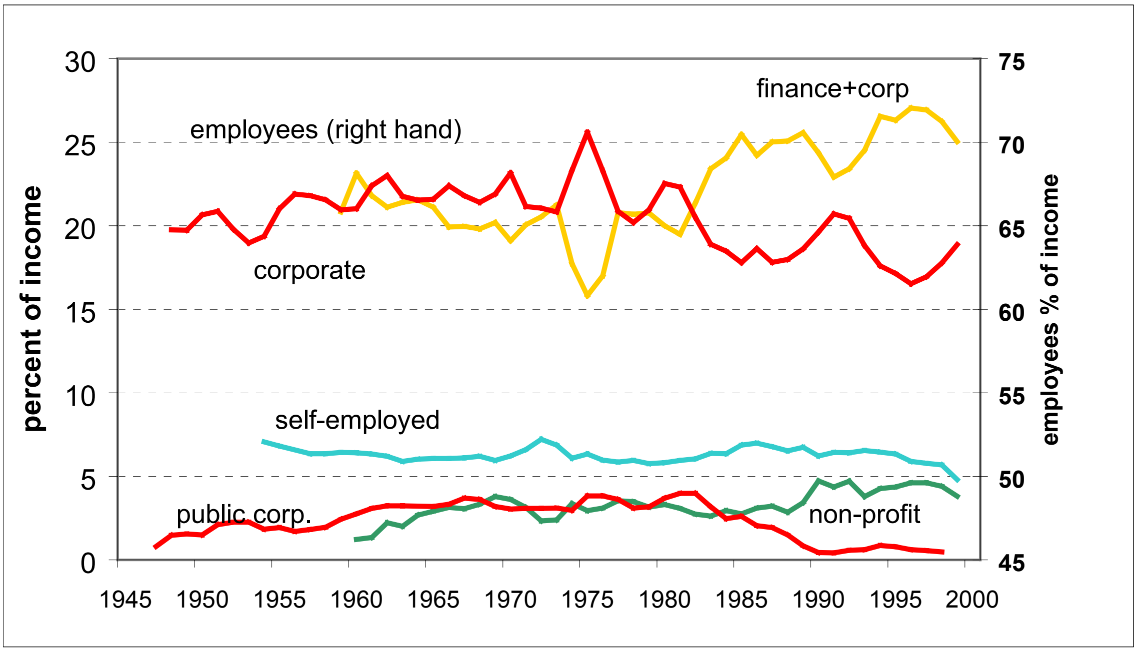

Figure 6. Sector shares of income (or value-added), net of consumption taxes

Source: Great Britain, Office for National Statistics, *Economic Trends Annual Supplement* (London, 2000), table 1.4, p. 29

Employment in the financial sector rose from 10 percent of the labour force in 1978, to more than 19 percent by 1999, while the public sector declined to 17 percent. 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). Privatisation was politically self-enforcing: financial industry workers were largely non-unionists, and their political interest was aligned with the market sector.

[125] Atkinson, 2000, 366–376.

Investors made large windfalls. Privatised assets were offered cheaply, and large mark-ups occurred on the first day of trading – between 25 and 86 percent.[126] Underwriting and flotation fees were large, and the newly privatised companies extended and deepened the capital markets. The politicians who instigated of the reform, if they did not have financial or business connections to begin with, often moved into corporate or financial posts after leaving office.[127] We catch a glimpse of housing again: public housing was sold to tenants well below value, new public dwelling construction fell, while, financial sector salaries drove up house prices throughout the South-East.[128]

The normative economic arguments for privatisation appeared to be compelling. Real price and product competition would increase allocative and incentive efficiency. But the prospect of competition would have deterred investors, so little competition 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-privatisation period has not dramatically exceeded other OECD countries, or the historical British record.[129] Performance in the energy utilities and some of the former public corporations has improved, although this began under government ownership, 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.[130] But, 'sales of public enterprises financed consumption, not capital formation.'[131]

vii. A new standoff

Even after large flotation mark-ups, privatised assets were still traded at a substantial discount. After a week, the water companies were priced at one-seventeenth of current-cost valuation of their assets. Gas was valued at about one-third.[132] This might

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[126] Vickers and Yarrow, 1988, table 7.2, 177. Underpricing was typical of privatisations everywhere: Megginson and Netter, 2001, 344, 366–368.

[127] Barnett and Newey, 2002.

[128] *Labour Research*, Dec. 2001, 9–11.

[129] Crafts, 1997.

[130] Vickers, 1998.

[131] Newbery, 1999, 15.

[132] Bishop, Kay and Mayer, 1994, 9.

reflect prior underpricing and inefficiency in public sector utilities.[133] 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 privatised industries were given substantial independence. Their terms of reference required a sustainable rate of return for investors. What they typically controlled was prices rather than profits, providing a strong incentive to reduce costs. Initially, this method allowed the companies large profits,[134] 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' of about £5bn on the utilities. Some regulators reinterpreted their mandate to prioritise consumer interests, and drove quite a hard bargain with the utilities. Electricity prices were forced down in 1997, water prices in 1998, and company shares fell in both cases.[135] Investors (including those close to the Labour government) began to complain of excessive regulator independence.[136] 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 water, and other schemes were under discussion.[137] This is also the emerging pattern of railway track and station ownership, both nationally and in London.

Privatisation unleashed a deluge of regulatory designs.[138] Much of it compares the evolved, imperfect, but robust real-world institutions of regulation, with utopian models of self-enforcing contracts. Eventually the fittest of the new designs may survive, but that stage is still to come. Policy still seems to be dominated by the assumption that contracts are costless.

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 finan-

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133 Bishop, Kay and Mayer, 1994, 9–10.

134 Newbery, 1999, 235–241; Summerton, 1998, 63; Taylor, 2001; Chennells, 1997, table 1, 280.

135 Chennells, 1997; Wheatcroft, 2001; Taylor, 2001; Bakker, 2001; author's interview with the former water regulator, Sir Ian Byatt, 7 Aug. 2001; *The Economist*, 4 Jan. 2001.

136 Haskins, 2001; Brown, 2001.

137 Author's interview with Sir Ian Byatt; author's interview with Sir Terence Burns, June 2001; Summerton, 1998; *The Economist*, 4 Jan. 1991.

138 Joskow and Schmalensee, 1996, 15–26; Newbery, 1999, chs. 2, 4.

cial markets.[139] It appears to have passed prudential risks successfully to investors in energy and telecoms, 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) have kept exchange rates at levels which are 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 as long as thirty or even longer ahead. 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.[140] The community pays a premium for the risk that it will expropriate, but the high premium makes expropriation more attractive, which requires a higher premium still, in a vicious circle.

The contract specifies the 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.[141] This is not an imaginary issue. Up to the 1960s, mental patients were kept in large public asylums. In the 1970s and 1980s new drugs promised more effective medical 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.[142] PFI would have made it worse: an asylum project started in the 1960s might still be saddled with payments in the 1990s.

Water is 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 monitor its contractors, and to maintain the quality of its track. Ominously, the London private tube contractors 'will be required

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[139] Great Britain, H. M. Treasury, 2002.

[140] IPPR, 2001; Monbiot, 2000, ch. 2; Mathiason, 2001.

[141] Boyle and Harrison, 2000.

[142] For the USA, see Gillon, 2000, ch. 2; for the UK, see Rogers and Pilgrim, 1996, chs. 5, 10.

to meet up to 3,000 performance goals in a 2,800-page manual,' but the project is forging ahead despite almost unanimous condemnation.[143]

Price-cap regulation provides only poor incentives to maintain and improve quality.[144] It provides no incentive to create new services not envisaged in the contract, and no incentive (except for reducing costs, which benefits the contractor alone) for the learning-by-doing that drives innovation and progress.

The main economic argument for privatisation is competition, but actual record is mixed.[145] For example, opening up the energy networks has been successful in Britain, 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 government intervention.[146] The market-maker corporation Enron had a bruising standoff with Indian governments, and doubt was cast on its market model of energy provision when the company collapsed suddenly in 2001. In contrast, civic and regulated electric monopolies elsewhere in the USA have been thriving.[147]

'Excess entry' can wipe out the profits which attract investors. In telecoms, technological innovation, and an open telecoms market, created capacity greatly in excess of demand. The main British firms are in trouble, and more than 28 American telecoms with liabilities over $100m each have failed. During 2001 the telecoms crisis appeared to threaten the stability of capital markets overall.[148] Conversely, if an industry is mature, there is not much to compete with. Price competition pushes down the rate of return to levels which not longer attract the capital market. In Victorian and interwar years, British private railways competed on some routes, as well as with emergent road transport. Excess competition also affected American railways.[149]

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 levels of infection in hospitals in the UK, or ineffec-

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143 *Financial Times*, 2001; *Financial Times,* 2002; *Economist*, 2002.

144 Hart, Shleifer and Vishny, 1997. I owe this reference to James Foreman-Peck.

145 See e.g. Vickers, 1998; Aharoni, 2000.

146 Elstrom and Timmons, 2001.

147 Bannerjee, 2001.

148 Roberts, 2001a; Coy, 2002.

149 Foreman-Peck, 1989; Perelman, 1996.

tive security screening in American airports.[150] Yet another form of imperfect competition is non-comparable product pricing in the privatised utilities, where competition is only real for capital and for well-paid managers.[151]

The reform of old-age pensions bears the hallmarks of investor's 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 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, accumulating on their own account, by means of financial intermediaries. These 'personal pensions' did not penalise 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.[152] Their heavy charges are socially regressive, and benefit well-paid 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.

But private saving exposed voters to a range of new risks. Employers have increasingly withdrawn from final salary schemes, and tended to reduce their contribution.[153] Even if overall pay is unchanged, the market risks were shifted from employers to individuals. Without mandatory saving, they are likely to underinvest. Mismanagement and opportunism are rife. Tax incentives were abused by massive 'misselling', 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 from pension funds 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.[154] The implicit income support guarantee is a pay-as-you-go pension by another name, and its level has been raised in response to voter pressure.

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150 Boseley, 2001; Krugman, 2001.

151 Newbery, 1999.

152 Budd and Campbell, 1998; Murthi, Orszag and Orszag, 2001.

153 Coggan and Buck, 2002.

154 Great Britain, H. M. Treasury, 2002, 252, 254; Budd and Campbell, 1998, 99–100.

viii. Conclusion

An affluent society requires prudential goods. In the 1980s, Britain took a prudential holiday. Old prudential 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.[155] The role of the collective provision, we have argued, is to overcome myopic biases, and facilitate long-term commitment. The norms, institutions and conventions of commitment have been undermined by prudential satiation, and by the compelling flow of visceral rewards under affluence. What sacrifice of discretionary gratification will voters accept in return for prudential outlays? The investments required to catch up with European and American standards in transport, health care, and higher education and provide universal access require increases of taxation that might extend beyond the capacity of current politics.[156] The only way to raise the necessary sums might be in the form of unequal 'clubs', which would safeguard the affluent, but consign the rest to conditions that are even worse. The steady prudential progress from the late-Victorian period through to the post-war years was remarkable, but experience in quite advanced countries in e.g. South America, indicates that failure is a real possibility, if prudential dilemmas are not resolved.[157]

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[155] Clark, Elsby and Love, 2001.

[156] Dilnot, 1995, 8–10.

[157] Spiller and Savedoff, 1999.

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