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CentrePiece

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Elderly Britain

CentrePiece Volume 4 Issue 2 Summer 1999

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The fruits of learning

Education is highly valued, especially in developing countries. But what economic benefits does it bring? Specifically, are more educated workers more productive? The author reports on her findings from a study of employees in Ghana.

Education is widely believed to play an important role in economic development. Countries with better educated work forces tend to have higher incomes, less poverty and slower rates of population growth than those with less well educated workforces. These are attractive goals for developing countries and in pursuit of them they spend, on average, about 10% of their national income on education. One reason why public policy-makers are willing to invest so much in education is because they believe that education makes workers more productive. But are they right?

More school means more pay?

Since the early 1970s much research has been devoted to measuring what economists call the returns to schooling, that is the proportional change in earnings which comes from one additional year of schooling. There is now overwhelming evidence that education and earnings are closely linked. Workers in low-income countries, for example, earn just over 11% more for each additional year they spend at school. Similarly, workers who have completed primary school can expect to earn 35% more than those with no formal schooling.

Does it mean more work?

But while there is little doubt that more educated workers are paid higher wages, it is not so clear whether they are also more productive. The first step towards answering this question would be to determine whether firms actually pay workers according to their productivity. Easier said than done, however. Finding data which provide information both about the wages of individual workers and how much they contribute to a firm's output is next to impossible. But there is a unique set of data from Ghana which does just that: it combines information on individual workers with information on the firms where they are employed. The figures come from a survey of 200 manufacturing firms organized under the World Bank's Regional Programme for Enterprise Development (RPED) and were collected during the summers of 1992, 1993 and 1994.

The data collected are extremely rich for an industrial survey and provide numerous indicators of how firms in Ghana have performed since the early 1990s. Most important, these data also include information on a sub-sample of workers employed by the firms in the RPED sample. Up to twenty workers were interviewed from each firm. While this number may seem small by developed country standards, the average size of a firm in the RPED sample is only eighteen: in other words, the sub-sample could often include all workers employed by the firm. Workers who were interviewed for the survey were asked about their educational background, work experience, on-the-job training, wages, benefits and numerous other personal characteristics.

Learning from Ghana

The World Bank data enabled us to establish, first of all, whether educated workers in Ghana are more productive than those with no formal schooling. We found strong

By Patricia Jones

evidence that in the Ghanaian manufacturing sector the more educated the worker, the more productive they are. Workers with secondary schooling, for example, are approximately 46% more productive than workers with no formal schooling. Specifically, a one-year increase in the average level of education within a firm is associated with a 7% rise in worker productivity. Remarkably, this rise in labour productivity is almost identical to the estimated returns to schooling for manufacturing workers in the RPED sample. The average Ghanaian worker receives a 7.1% pay increase for each additional year of education acquired.

We also found clear evidence that this productivity improvement holds between groups of workers with different levels of education, with those workers with higher levels of education having higher levels of productivity. Workers who completed tertiary education are approximately 25% more productive than those who only went as far as secondary school.

The richness of the RPED data meant we could also investigate the value of vocational training. In Ghana vocational training is run almost entirely outside the formal educational system. In 1991 there were approximately 1100 vocational schools, of which 160 were public, 250 were private and about 700 were unregistered, private institutions. More than 95% of the 634,233 students who chose to acquire vocational training chose private schools run entirely outside the public school system. So it is worth asking whether these schools are making a significant contribution to Ghana's national income by raising the quality of the labour.

Again, we found that the answer is yes: vocational training in Ghana does significantly raise the productivity of manufacturing workers. On average, the productivity of workers who have acquired vocational training qualifications is between 72 and 78 percentage points higher than workers with no formal schooling. These results are striking and encouraging, given the current controversy over the usefulness of vocational training in developing countries.

Do the workers benefit?

One of the most consistent results in applied economics is the very large returns to educational investments. On average, workers in OECD countries gain approximately 7% in earnings for every additional year of schooling they acquire. The payoff to educational investments is even greater for workers who work in developing countries. Workers in sub-Saharan Africa gain 13%, while workers in Latin America and the Caribbean, and Asia (non-OECD) gain 12% and 10%, respectively. But what do these returns mean? Much controversy has arisen over how to interpret the returns to schooling estimated by standard econometric techniques. In particular, researchers have questioned whether the estimated returns reflect the true *productivity-enhancing* effects of education or whether they simply reflect other factors, like ability, which closely match a worker's level of education.

While there is a growing consensus that such problems do not significantly affect the estimated returns to education for workers in OECD countries, there is still a great deal of scepticism over the accuracy of such estimates for workers in developing countries. In particular, sceptics have criticised the usefulness of estimated returns to schooling in countries where a majority of the labour force does not earn wages but instead makes a living by non-wage activities like trading in goods or subsistence farming. In our study, we cannot resolve this issue but we have found new evidence on the extent to which the estimated returns to schooling for workers in the manufacturing sector of Ghana

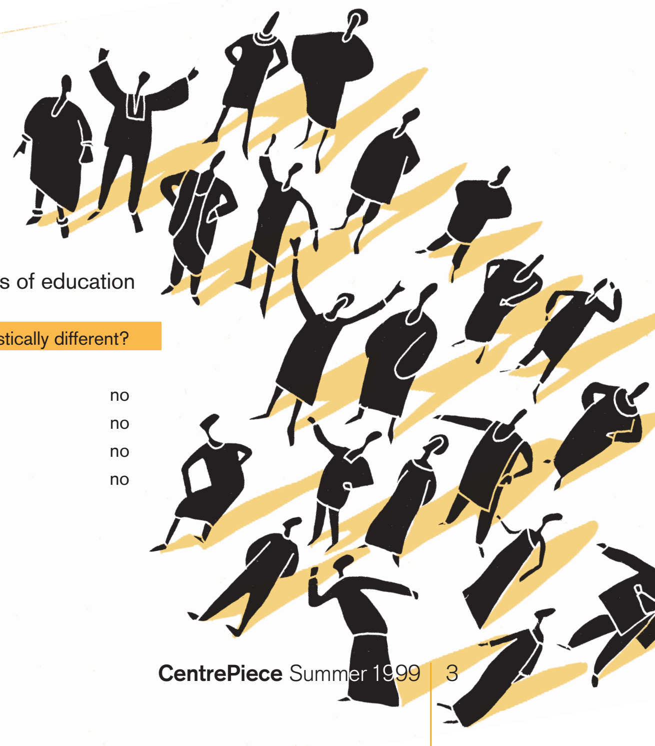
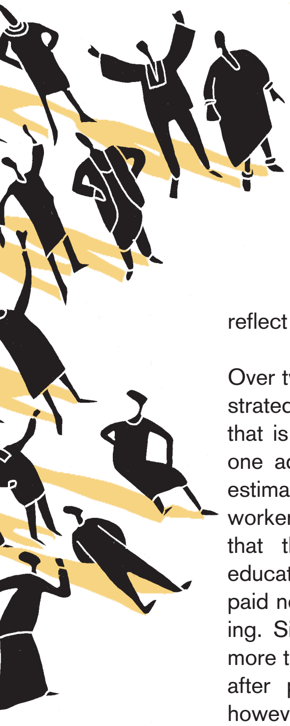


Table 1 The returns to schooling and changes in productivity at different levels of education

Education	The private returns to schooling		Changes in productivity		Statistically different?
Years of education**	7.0*	–	7.1*	–	no
Primary School	–	7.9	–	29.7*	no
Secondary School	–	53.8*	–	55.5*	no
Tertiary School	–	78.9*	–	90.7*	no

Source: RPED data. * indicates that the coefficient is statistically significant. All catagories indicate the rise in earnings (or productivity) compared to workers with no formal schooling. **These coefficients reflect the rise in earnings (or productivity) associated with one additional year of schooling.



Ghanaian firms, at least those in the manufacturing sector, do pay competitive wages and therefore act in much the same manner as manufacturing firms in the developed world.

reflect real differences in the productivity of these workers.

Over twenty-five years ago, Jacob Mincer (in 1973) demonstrated a method for estimating the returns to schooling: that is, the proportional change in wages associated with one additional year of education. We used his model to estimate the private returns to schooling for Ghanaian workers in the manufacturing sector. The RPED data reveal that there are large monetary rewards to becoming educated in Ghana. Workers with secondary schooling are paid nearly 30% more than workers with no formal schooling. Similarly, workers with secondary schooling are paid more than 25% higher wages than workers who left school after primary education. The greatest jump in wages, however, occurs for workers who have completed tertiary education. These workers earn approximately 35% more than workers who left school after secondary education. In other words, educated workers are not only more productive than workers with no formal schooling: they also earn higher wages.

Are Ghanaian wages competitive?

We decided to go even further in our inquiry, by trying to establish whether firms pay competitive wages: that is, wages that reflect how much the worker contributes to firm output. Although this assumption forms a crucial cornerstone of microeconomic theory, there is little empirical evidence to support its validity, and none from a developing country. Indeed it is often assumed that firms in poor countries operate under a different set of rules to those in rich countries. Our analysis, however, provides strong evidence that Ghanaian firms, at least those in the manufacturing sector, do pay competitive wages and therefore act in much the same manner as manufacturing firms in the developed world.

We first needed to determine whether firms actually pay workers according to their productivity. While standard economic theory assumes this to be the case, a number of competing theories of wage determination present counter arguments as to why it may be optimal for firms not to pay competitive wages. They may, for example, find it profitable to pay workers lower wage rates when the workers are in training or relatively young. In addition, it may take firms some time to assess the productivity of new workers, resulting in new recruits being paid wages which are either higher or lower than the value of the goods and services which they produce. Any of these scenarios could result in a differential between the value of wages a worker receives and the value of output that he or she produces.

Only empirical research can resolve the issue of how firms set wages. Unfortunately, little research has been carried out on this issue because of a lack of basic data on firms' wage-setting practices. To assess whether workers are paid the value of their output, one needs information on both the level of workers' wages and the exact value of what they produce. Collecting such data is not easy, given the problems involved in most business environments with measuring the output of any single individual. The data we had for Ghana, however, provided information both on the education of workers in each firm and the average value of output produced by those workers. With this information we are able to estimate how much workers at each level of education contribute to firm output using a technique known as *production function analysis*.

It is often assumed that firms in poor countries are less competitive than firms in rich countries. One way of assessing the competitive nature of firms is to determine whether or not they pay their workers competitive wages. In perfectly competitive product and labour markets, firms that do not pay competitive wages will eventually go out of business because they will be unable to compete with firms that do pay competitive wages. To find out what Ghanaian firms do, we compared the results obtained in the earnings analysis to those obtained in the production function analysis.

From the earnings analysis we derive estimates of the private returns to schooling: that is, the proportional change in earnings associated with different levels of schooling. Likewise, from the production function analysis we obtain estimates of the average rise in productivity associated with different levels of schooling. Theoretically, the two sets of results should be identical when firms pay workers competitive wages. Table 1 (previous page) shows that they are indeed very similar. For example, workers with secondary schooling earn 56% more and produce 54% more than workers with no formal schooling. Likewise, workers with tertiary schooling earn 91% more and produce 80% more than workers with no formal schooling. (This gap is not so wide as it first appears.)

Lessons for others

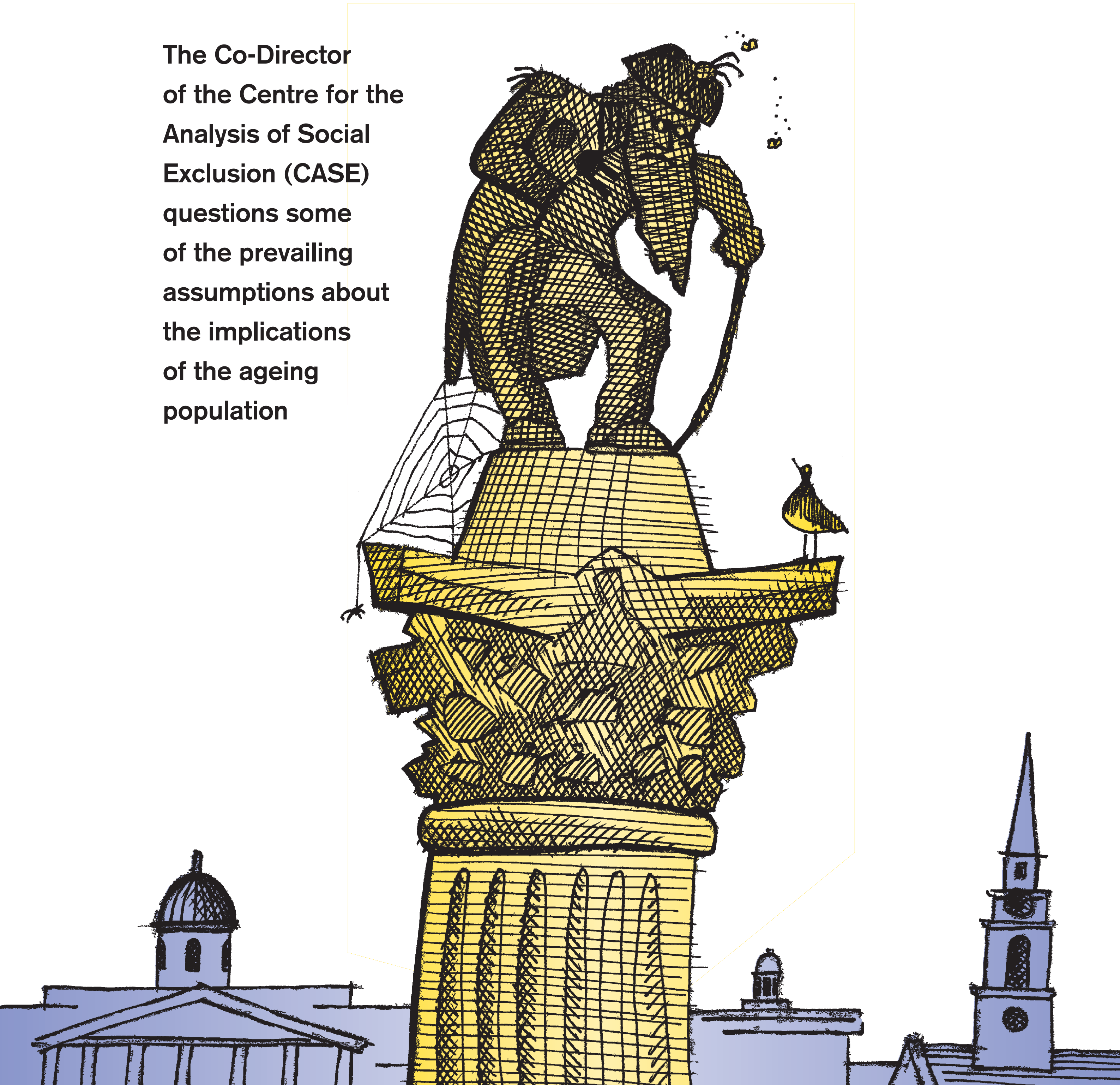
Our findings unequivocally show the importance of education in the Ghanain manufacturing sector. They also show that the Ghanaian labour market works remarkably well, even by developed country standards, with clear evidence to suggest that firms pay their workers competitive wages.

Perhaps most important, though, our results suggest that the estimated returns to schooling based on Mincer's model provide a relatively good estimate of the productivity-enhancing effects of education (at least, for workers in the manufacturing sector). The clear lesson for public policy-makers who often rely on such estimates when judging the value of different educational investments, is that these estimates reflect increases in productivity as well as earnings. In Ghana, at least, education pays handsome dividends: for workers, firms and the state.

Patricia Jones is a member of the CEP's Labour Markets Programme

The Elderly:
A Burden on the Economy?

The Co-Director of the Centre for the Analysis of Social Exclusion (CASE) questions some of the prevailing assumptions about the implications of the ageing population



By Howard Glennerster

Media stereo-typing would have us believe that the United Kingdom economy is doomed to suffer the crippling effects of ageing. *An ageing society*, the *demographic time bomb*, the *burden of the elderly* – all these somewhat alarming phrases are trotted out at regular intervals. There has been a particular spate of such references recently with the publication of several reports and government policy documents. Most prominent of these were, first, last year's Government green paper on pensions, and second, the report of the Royal Commission on Long-Term Care, published earlier this year. There has also been a study on the effect of demographic change on social spending during the next century by the National Institute for Economic and Social Research. But are those who would have us believe a crisis is imminent right? Or is the picture less gloomy than the doom-mongers like to think?

One clue might lie in a report which was largely ignored in the UK, produced by the Brookings Institution in Washington, DC. This compares the impact of ageing on the major economies of the developed world. Its basic message is that in comparison with its major competitors, the UK is remarkably well placed to cope with the demographic transition to an older society. One particular advantage the UK may have in the next century is the restraint we have shown by not promising high pensions we cannot afford. The UK has also gone further than most countries down the road of relying on private pensions; and proposes to go even further. This may produce a higher level of savings available for productive investment and, in turn, a higher growth rate.

But economists are by no means agreed on the prognosis; nor is it clear what the results will be for the elderly population, as opposed to the economy as a whole. We are in uncharted waters, where the voyage itself is of considerable importance. The lessons from the UK's experience will be carefully watched in other countries. The study of pension provision, social exclusion, labour markets for older people, and their impact on economic performance more generally, have come together to be one of the most important areas of study in applied economics.

Is ageing a problem?

It is true that, in the next half century, the number of very elderly people in the UK (those who are 85 and over) will treble, while the number of those aged between 75 and 84 will nearly double. The numbers of young elderly (those between 65 and 74) will rise by half in the early part of the century and then fall back as the lower birth rates of recent years feed through. Some demographers believe all these figures may prove to be underestimates, as we find new ways to extend life.

It is also true that a larger non-working population has important implications for the economy. The total amount produced by those in work has to be shared between workers and more non-workers. That is true however we choose to finance pensions or health or long-term care. Workers may resist the slower rise in their take home pay needed to pay for pensions by pressing for higher wages. This may happen whether the slower rise in their wages is the result of social security taxes or enforced private pension contributions. The same applies to health and long term care costs.

In young countries workers may be saving for their old age, producing a high savings ratio. In mature elderly economies the elderly are running down their savings. Young economies with highly educated work forces will be more productive and generate more innovation.

So we *should* be concerned about the structural issues that ageing raises. The need to support a larger elderly population makes the case for raising the productivity of those in work even more pressing. It makes the waste of unemployment and premature retirement even more unacceptable. It makes the case for lifelong learning even more persuasive. But we should not panic either. Remember that during the present century the age structure of the UK population changed much more dramatically than it will probably do in the next. The number of those over 85 has risen fifteen times as fast as the numbers aged less than 65 – it's only expected to triple in the next fifty years! The number of those over 75 rose seven times as fast and the number of those between 65 and 74 went up three times as fast as the rest of the population.

Most of these changes happened after 1931. Yet this was the period in which we introduced universal pensions and health care for all. So the really rapid and large fiscal adjustments to the population structure have already been made. The UK industrialised first, extended its life expectancy and reduced its fertility early, and has therefore come to terms with the prospects of an ageing population to a greater extent than any other nation. It has also sustained its fertility more successfully than many other European countries, thus reducing the impact of an ageing population.

The really serious problems will arise in nations that are currently promising their future elderly populations state pensions that cannot be remotely met from present taxes and social security contribution rates. That goes for much of continental Europe and Japan. It is less true in the USA but adjustments will be needed even there and especially to cover the rising medical and long term care costs that are falling on the federal and state budgets. The recent Brookings Institution report concluded that: "the fiscal challenge associated with population ageing is astonishingly small in the United Kingdom" (see Table 1 overleaf).

The really serious problems will arise in nations that are currently promising their future elderly populations state pensions that cannot be remotely met from present taxes and social security contribution rates.

Table 1 Present value of net public pension liabilities as a percentage of GDP

France	115
Germany	110
Japan	105
USA	25
UK	5

Source: Bosworth and Burtless Ageing Societies 1998

By contrast with other industrial countries successive British governments have made minimal promises to future pensioners and imposed tight limits on spending on health and long term care. The main danger for the UK therefore lies in inadequate and uncertain pension and long term care provisions that may cause a political backlash from a frustrated and increasingly powerful grey electorate. The recent Royal Commission Report on Long-Term Care and the pensions green paper should be read in this light.

Long-term care

Royal Commissions may be appointed in the hope that everyone will have forgotten the issue by the time that they report, or that the report will so muddle the issues that politicians are let off the hook. No such luck with the Sutherland Commission on long-term care. A fine report has impaled the Government on a highly visible spike. The problem is soluble – but at a price.

The Sutherland Commission concludes that private insurance by individuals to pay for the risks of expensive care in old age is not going to provide the major source of funding as it will do for ordinary pensions. Not even in the United States, with its highly developed market for private health insurance, has the long term care insurance market taken off. Only 5% of Americans have long-term care insurance, much of it with major exclusions and from which many drop out before their policies mature. The reasons are well understood by economists. Long-term care is subject to high uncertainty – not predictable risks. The technology of care forty years hence is impossible to predict. So is the nature of disability and medical advances. Risks are linked. A great deal of care is undertaken by partners and children today, so that even a tiny shift in partners' and families' willingness to care would produce big changes in a company's liabilities. To safeguard themselves private insurers significantly limit the scale of benefits they offer, make them discretionary and make their products expensive. Few want to buy this distant product when they are young and the insurance is affordable. Since the state is obliged not to abandon the very old and frail so people naturally gamble on the state supporting them if all else fails. All the classic elements of market failure are present in even more powerful forms than with health care.

So the case for some kind of social funding is powerful, at least for the personal and medical care elements of long-term care where most of the market failure effects are felt. That leaves open whether the provision of services themselves should be publicly provided or not. In many cases care will be provided by private and voluntary organisations as it is now. However, it is not clear why the State should provide food and housing free simply because an individual is receiving nursing care. Most people can and do afford these from their retirement income or the housing assets they have acquired during their lives. Consumers' tastes for rooms of their own, large or small rooms, TV, good food or rose gardens are best left to the market to sort out. Here there is ample scope for the pensions and mortgage and special housing markets to develop, once the state has secured the largely uninsurable risks associated with long term personal and health care at a basic level. Thus the Royal Commission proposed that these functions should continue to paid for by individuals where they were able.

But a separate group of Commission members signed a Minority Report: they would confine state support to medical and nursing care, not extending it to personal care. This is unsustainable. Research many years ago at the LSE and elsewhere showed that the range of personal functions performed for people in residential homes overlapped massively with that performed in so called nursing homes by nurses. It would prove impossible to define nursing care more narrowly than the functions nurses currently perform. If such care carried state funding anything done in residential homes would get redefined as nursing care. In 1948 the boundaries of the National Health Service were drawn in an illogical way to distinguish health care from what came later to be called social care. If someone suffers from an incurable and lasting condition like Alzheimer's disease they must pay for their care and sell their house to do so if necessary. If they suffer from cancer the NHS will pay. The Commission extends the boundary of free health care to include personal care like washing, bathing, feeding, administering medication, managing incontinence and ensuring personal safety. This is done in residential care and in people's own homes and can often be done by families.

Ordinary people involved in our Kafka-like care system cannot understand why if someone employed by the NHS baths them and gets them up in the morning they receive such services free. If someone paid by the local authority does the same they must sell their house. If they suffer from cancer they are cared for free. If they suffer from Alzheimer's they pay. About certain things ordinary people are simply right.

Is the extra cost sustainable? The authors of the Minority Report called it a "Croesian flood of expenditure". One can only conclude that their journalistic pens ran away with their sense of judgement here. The Majority Report's claims its

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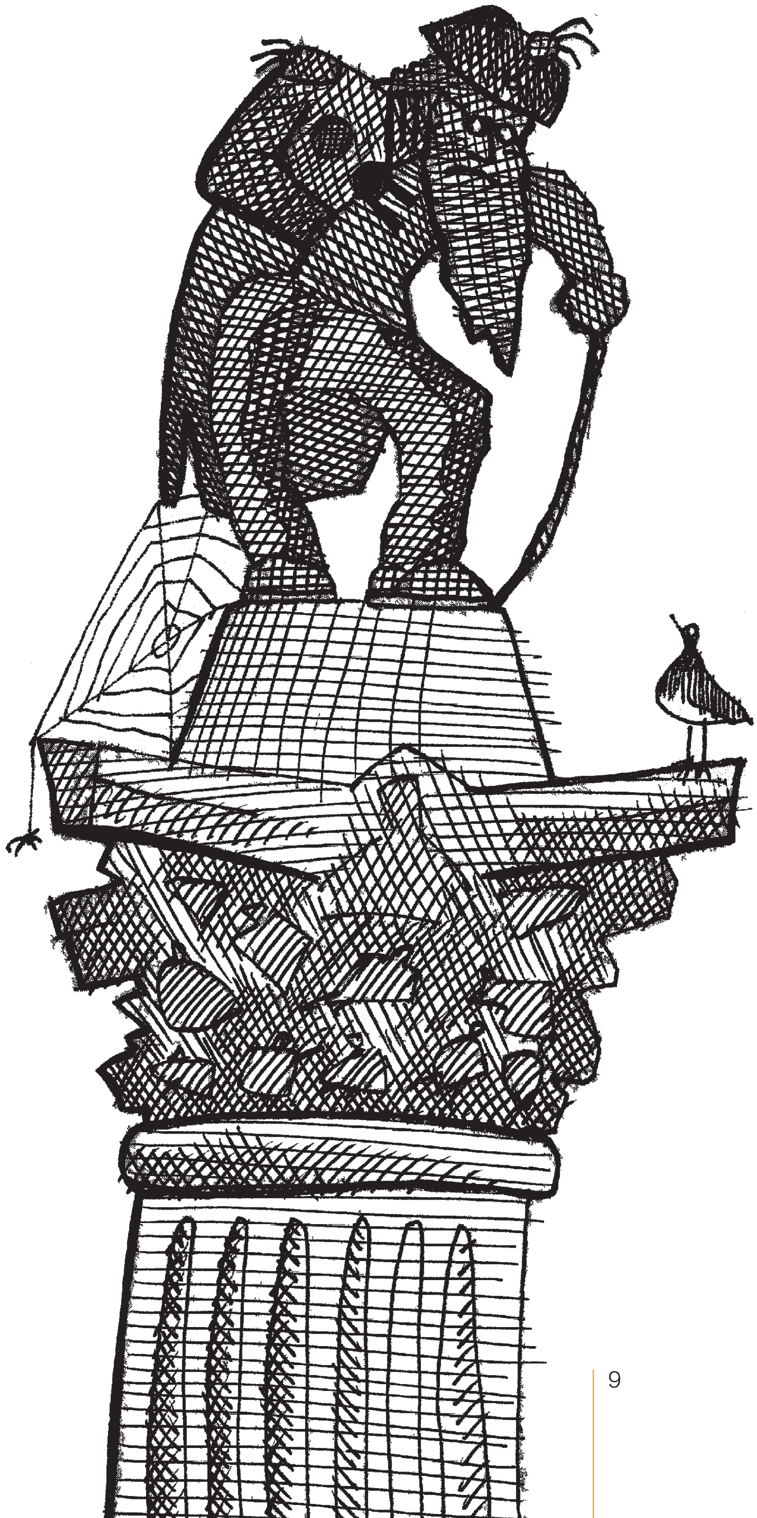
proposals would increase the percentage of the GDP devoted by the Government to this activity from 1.2% of the GDP to 1.4% by the year 2051. The report does not entirely adjust its calculations to take account of the possible additional offers of support families might claim for their own provision of personal care. However, even if the Commission were wrong in its projections by a factor of 100% we would be talking about 1.6% of the GDP going on the public sector costs of long-term care instead of 1.2%. The Government's pensions proposals (see below) are designed to shift the cost of funding pensions from the Exchequer to the individual. They decrease the future tax liability of government far more than the Royal Commission's plans would increase it. Governments should do what they do best and leave markets to do what they do best. Provision for income in retirement is something markets do moderately well. In the case of long term care they do not. In this sense the Pensions Green Paper and the Royal Commission Report could be seen to be complementary, not, as some have suggested, moving in opposite directions.

New Labour, new pensions policy

Ever since the Second World War the United Kingdom has been following a different path to financing retirement than most other advanced industrialised countries. It began with a flat rate pension which was originally set below the basic poverty line and never raised above it. That encouraged large numbers of the population to take out occupational pensions: the Conservative governments of 1979-97 also encouraged people to take out personal private pensions. This approach enabled those Governments steadily to reduce the value of the state basic pension relative to earnings so that it is worth today only about 15% of average earnings for a single person.

The latest Government proposals take the UK even further down the road to private self-sufficiency while at the same time concentrating more public funds on pensions for the poorer sections of the community. The Green Paper proposes:

- To allow the basic Beveridge pension to wither. Now worth 15% of average earnings it will fall to 7.5% on reasonable assumptions by 2050.
- To raise the level of income support for the over 65s in line with the earnings of those in the labour force.
- To abolish the State Earnings Related Pension Scheme (SERPS) introduced by the Labour Government of 1974-79 and replace it with a new State Second Pension (SSP). This will provide improved second pensions for people earning below £9,000 a year and those who are caring for children or the old or the disabled. Those earning between £9,000 and £18,000 will also benefit but not as much.
- Private stakeholder pensions will be introduced to provide a cheaper, more regulated and simpler form of saving for old age for those on low incomes.



The main danger for the UK therefore lies in inadequate and uncertain pension and long-term care provisions that may cause a political backlash from a frustrated and increasingly powerful grey electorate.

The overall effect will be to shift the balance of funding for pensions: from the present ratio of 60:40 public to private funding to the reverse,40:60, by mid-century. The intention is to raise the incomes of the poorest lifetime earners above the limits of means tested income support by mid-century.

Given that the state has performed so badly in providing financial support for the elderly, and that the average voter has opted out into the private sector, there was probably no other politically sustainable route. However, the Green Paper at no point attempts to justify aiming for a 60:40 private-public balance of funding, or to weigh the costs and benefits. There may well be macro-economic advantages in encouraging moderately paid workers to take out personal pensions but there are also risks.

The new stakeholder pensions will be individual, defined contribution, funded schemes. The amount of an individual's pension will depend on:

1. The amount and timing of the contributions;
2. the performance of the pension fund which depends in its turn on the management of the fund and the performance of financial markets;
3. the value of the annuity the contributor will have to purchase on retirement;
4. age at retirement;
5. the state of the annuities market;
6. inflation during retirement;
7. ignorance of the complexities of the capital market.

Such defined contribution schemes are open to considerable risks under each heading, especially in the case of women who act as carers or simply wives and mothers. Given these risks, why is the Government so keen to see a continuing shift to private pensions?

In common mythology since private schemes are funded you are sure to get the pension you paid for. The Pru can be trusted, governments can't. Given the poor deal British governments have handed out in the past, this may seem persuasive. But private schemes are only as good as the fund managers, the market and the performance of the economy will allow. All pensions are a claim on the resources of the economy when people reach old age. All pensions are a claim on the then workers. The easiest way for future workers to keep the fruits of their labour is to generate wage-induced inflation that private pension schemes cannot match. Financial markets are volatile. An annuity purchased last August was worth a lot more than one purchased last December. What matters above all is the future level of output in the economy and its capacity to meet not just the rising aspirations of workers but of past workers too.

The Brookings Institution study summarised the balance sheet concisely:

> *The United Kingdom will face a smaller increase than in the other G-5 countries in public spending on the elderly and will accumulate substantially greater reserves in its (increasingly private) pension system. If its budget deficit is kept low, the growing accumulations in private pension accounts can help boost national saving, which in turn can increase the rate of economic growth. These policies may, however, expose workers to greater risk of low retirement incomes. Workers who invest their retirement funds recklessly or in excessively conservative, low yield securities may be forced to accept pensions that are low in comparison to their net incomes while at work. And if workers should retire after a lengthy period in which private markets yield low or negative returns, an entire cohort of them may be faced with the prospect of low retirement incomes. It is tempting to say that a shortfall in retirement income is solely a problem for the unfortunate workers, but it also might be a problem for the public budget if voters demand that public pensions or pension guarantees assure workers of good incomes in retirement.*

Even if all the Government's plans to secure the worth of private pensions succeeded there would remain a large problem for women, for those whose marriages break up, and for those who spend periods out of the labour market. That applies even for those in the Government's Second State Pension. The main recipients of pensions are women. The reforms do something for women but nothing like enough. The Second State Pension does provide credits for those bringing up children under five or looking after disabled relatives. Those who cannot or do not want to enter the labour force when their children pass five will end up with a reduced pension. This is more pronounced because the new pension system works on the assumption that the normal working life is full-time for 40 years – even though this is rarely true for either men or more especially women. There is no provision for the 2 million women who earn under the lower earnings limit. Periods of unemployment; long term sickness; extended periods of caring for children; periods of low pay below the earnings limit; periods lost to work after divorce or separation; time out for education: these can all reduce pension entitlements. For all these reasons many women, especially those who cannot rely on a husband's pension, and many men will end up drawing a pension below the income support level, despite having paid contributions throughout their lives. Many will experience retirement at the margins of income support levels. This is also made worse by the fact that the state provided pension will continue to fall in relation to earnings while the level of income support will not. Many who are not dependent on income support when they retire will soon fall back onto it as the pension is overtaken by income support levels.

Some of these design faults could be addressed reasonably simply. Others would need more radical changes. The coverage of the Second State Pension could be made more comprehensive by extending the scope of credits for

The need to support a larger elderly population makes the case for raising the productivity of those in work even more pressing.

non-paid work in the home and for caring and including periods of genuine unemployment. The period of eligibility for a pension could be reduced. Second State Pension rights could be made inheritable, with at least 50% of the deceased partner's rights passing to the survivor. Benefits for older pensioners will need to rise if the costs of long term care are to fall more on the individual. More radically the basic pension, or a new elder citizens benefit, could be linked to earnings but taxed away for richer pensioners as happens in Australia. The costs of some of these reforms could be met by capping the value of the tax reliefs for private pensions as the Government are proposing to do for Stakeholder pensions.

Early retirement

The focus on the ageing of the population has tended to distract attention away from a much more immediate problem: the early movement out of the labour force, whether voluntarily or through enforced job loss. Recent trends are striking and disturbing. At a time when people are living longer and more healthy lives in old age, men's attachment to the labour market is ending earlier and earlier. So too are their contributions to their own old age.

An analysis of the Labour Force Survey data by Nigel Campbell, on leave from H.M. Treasury with CASE, shows the changes. Men born in the early 1920s were still predominantly at work in their 60s: but each successive cohort since has been leaving the labour market earlier. In 1979 90% of men were in work until nearly 60. By 1997 the fall in male employment seemed to be beginning at 50! (see Figures 1 and 2 below)

The picture is rather different for women. Their participation has grown over the past twenty years but still declines sharply after the age of fifty. (see figures 3 and 4 overleaf). With most of the population heading for some form of

Figure 1 Male employment rates (percentage) by age

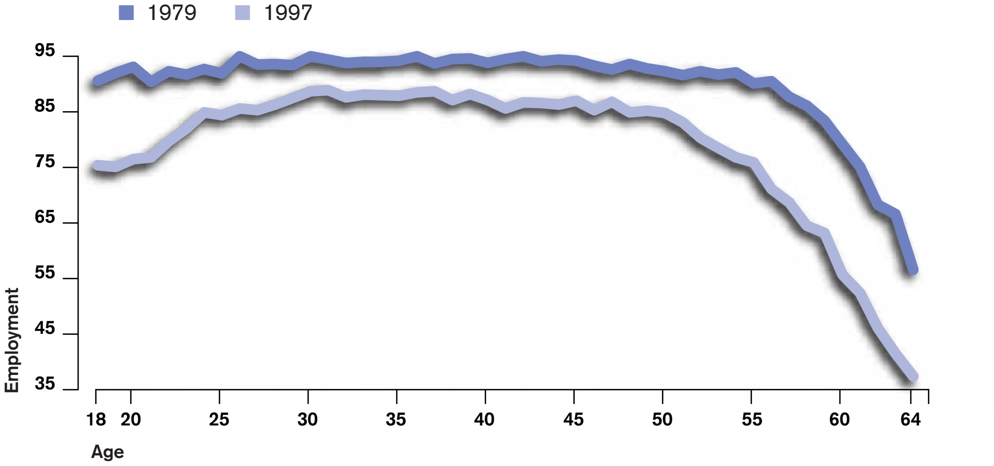
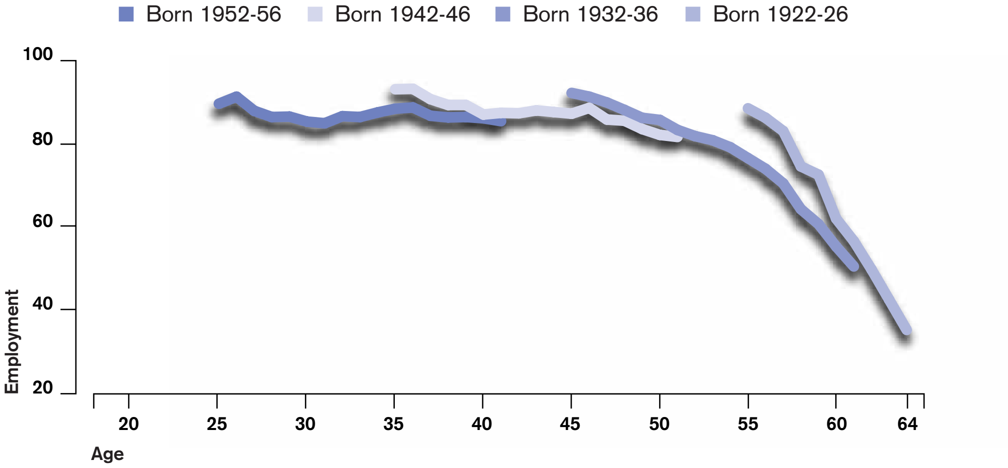


Figure 2 Male unemployment rate for different cohorts



At a time when people are living longer and more healthy lives in old age, men's attachment to the labour market is ending earlier and earlier. So too are their contributions to their own old age.

Figure 3 Female employment rates (percentage) by age

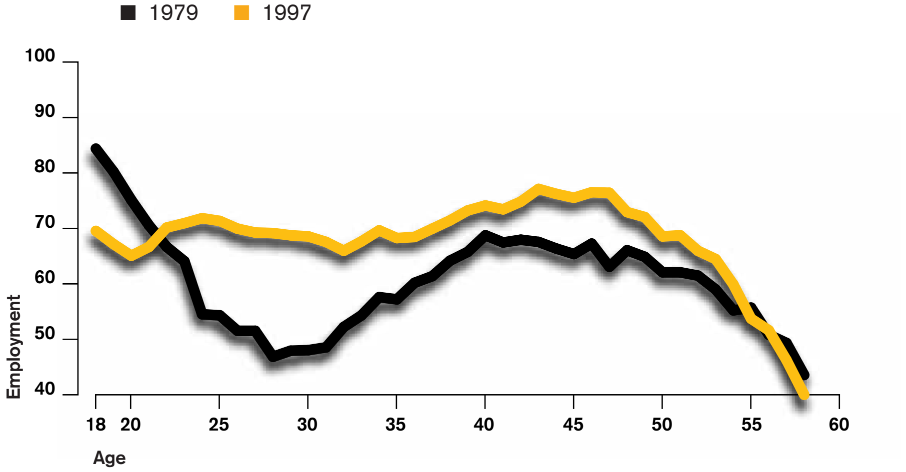
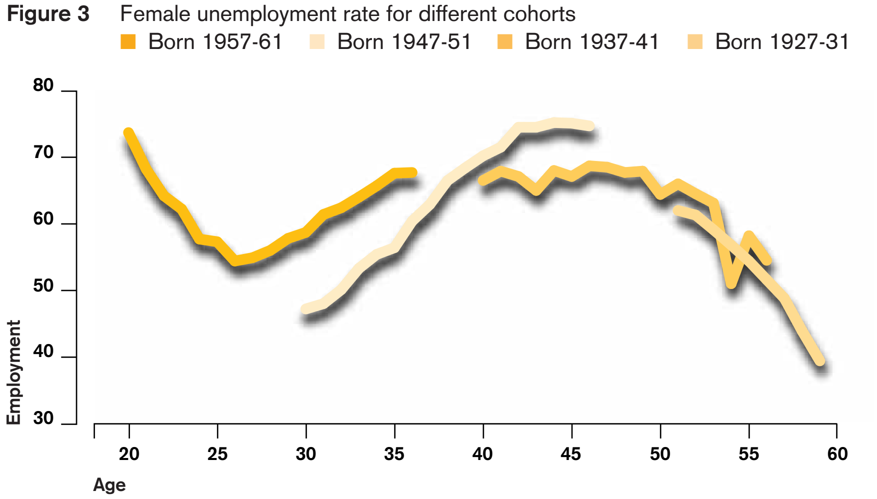


Figure 3 Female unemployment rate for different cohorts



education until their early twenties, and living until their late seventies, less than thirty years in work will make their retirement very difficult to finance. The pensions they will be able to buy on a money purchase basis at age fifty will be very small.

Yet the structure of pensions and benefits in the past, as well as the labour market may have been one of the reasons for early retirement: more educated people working in the public sector with pensions linked to their final salaries were easily tempted by early retirement packages. The incentives to go onto Invalidity Benefit in the past may have been another factor.

All this underlines the extent to which policy must be informed by a clear understanding of the factors at work, and how they relate to each other. It is crucial to understand the relative importance of the factors at work to inform policy. The Government has set about this and the 1999 Budget began the process of encouraging older workers to return to work and giving employers incentives to employ them.

The ageing population does present big challenges for policy-makers. Britain may be better placed to cope than many other countries, but that doesn't mean that there aren't risks associated with policy decisions: this is, after all, an area of considerable uncertainty. It is one of the central functions of research centres like CASE and the CEP to reduce those areas of uncertainty wherever possible and to ensure that policymakers are properly informed about decisions which by their very nature will have unusually far-reaching implications for all of us.

Howard Glennerster is Professor of Social Policy and Co-Director of the ESRC Centre for Analysis of Social Exclusion at the LSE and Chairman of the Suntory and Toyota Centres for Economics and Related Disciplines.

The new single European currency, the euro, started life on January 1 this year. Eleven member states of the European Union have irrevocably fixed their exchange rates and will abolish their national currencies altogether within three years, when euro notes and coins start circulating. Britain is one of four countries which chose not to join economic and monetary union: the Blair government is sympathetic to the idea of joining at some stage, but has pledged to hold a referendum before committing the UK to membership. The issue remains highly controversial, crossing traditional political boundaries, dividing old colleagues and uniting former political enemies. Emotion often clouds the debate, making it difficult for those undecided to work out where the balance of the argument lies.

In an attempt to clarify the views of those for and against joining, CentrePiece asked **Janet Bush**, director of the New Europe campaign which is pro-Europe but against UK membership of the euro, and **Christopher Johnson**, a leading figure in the Association for Monetary Union in Europe, to engage in debate. We began by asking both to respond to a series of questions.

The euro debate

Can we now say the euro is a success? Why – or why not?

Janet Bush

It is far too soon to judge whether the euro is a success or a failure. All that we have discovered over the past few months is that the European single currency goes up and down – mostly down so far but that will surely change in the future. In short, we have discovered that the euro is a currency like any other. Current weakness is no more proof of the euro's failure than a bout of strength would have signified its success.

Nevertheless, the euro's slide does appear to reflect deep concerns in the market about how the euroland economy is faring within the straitjacket of Economic and Monetary Union. Germany is sinking into recession while a country such as Ireland is battling to contain an inflationary boom. Neither can do anything about it. Both are being forced to live, quite inappropriately, with the same interest rate. What the euro's first few months have highlighted is the beauty of floating exchange rates, designed as they are to act as a natural restorative when things go badly.

Christopher Johnson

The euro is a success so far by several criteria. Its convergence criteria made not just 11, but all 15 EU countries undertake unprecedented efforts to reduce both inflation and fiscal deficits. It began on time on 4 January 1999. It is starting to be used as a trading currency, and as a financial currency, with euro bond issues exceeding dollar bonds so far this year. It has not yet caught on as an investment currency, because the stock markets of the euro area cannot yet compare with Wall Street, in size, liquidity, or performance.

The fall of the euro exchange rate against the dollar has been a big surprise, but it has benefits as well as drawbacks. The depreciation of the euro could give a boost of up to 1% of GDP to the euro countries, spurring on their hesitant recovery. The cut of 0.5% in the euro interest rate will stimulate domestic demand in the major countries. The idea that the hawks of Frankfurt would pursue a strong euro policy as a proof of machismo was always absurd. Germany more than any country requires a cut in interest rates. It is important that the Germans, more reluctant than others to lose their national currency, should see euro monetary policy as being in their interests.

Should Britain have joined on 1 January 1999? If not, why not?

Janet Bush

Britain would have been mad to join on January 1. In the short-term, it is at a different stage in the economic cycle

Christopher Johnson

By not joining at the outset, the UK has missed the chance of taking part in the euro-11 Council of Finance

The euro debate

JB continued
from most of euroland. At European interest rates, Britain would soon face an inflationary boom that would put Ireland's in the shade. There are, however, many far more fundamental and long-term reasons. While the pro-EMU camp seems to struggle for convincing economic reasons for joining, those opposed to the single currency are spoilt for choice.

Euroland is not an optimal currency area. Its economies are far too different to make monetary union work and the dangers of a 'one size fits all' interest rate is already evident in the cases of Germany and Ireland. The institutional structure of EMU enshrined in the Maastricht Treaty compounds this imbalance. The European Central Bank was conceived in an era when inflation was public enemy number one and its remit is simply to achieve price stability. At a time when the major threat is deflation, the ECB's task is too narrowly defined. The Stability and Growth Pact's strict budget deficit limits, means that fiscal policy is not available as a counterweight to monetary policy.

Even if euroland's prospects were more promising, Britain is still not a suitable candidate for membership simply because it is so different from most continental economies. Take the example of interest rates. Britain has a far greater penchant for variable rate borrowing which means that Britain's GDP is four times as sensitive to changes in interest rates as the average for European Union countries. Britain has the most advanced economy in Europe in high-tech industries. It also has a higher proportion of bio-chemicals, aircraft, scientific instruments and telecommunications industries than France, Germany and Italy. In addition, Britain is an oil economy unlike any other in the EU.

During the 1980s, Britain went through an often painful supply side revolution which took us firmly down the Anglo-Saxon economic route. Having made these choices,

CJ continued
Ministers, and influencing the running of the ECB. The Bank of England may or may not prove to have installed a better standard of openness than the ECB, but it has little chance of influencing the ECB from outside. British influence on other, related EU issues, such as taxation, has been weakened by remaining out. Mr Tony Blair's forward policy on European defence was seen as a gesture of goodwill by the other EU countries. It did not compensate them for the UK's refusal so far to join the most dramatic and central form of European integration since the formation of the EEC in 1958. The City of London has set up markets in euros, but it is likely to lose share in the domestic financial markets of the euro area.

The Government's changeover plan has set out a series of time intervals, but no date for joining. It is unlikely that Mr Blair will decide to join before the election. The most optimistic schedule is then as follows. The election is likely to be held in May 2001, after four rather than five years. The government will announce a decision to join in June 2001, having inevitably indicated during the election campaign that it was about to do so. The referendum will be held in October 2001, and the result will be yes, perhaps by not a very large majority. The UK can then lock the pound to the euro in January 2002 and take two rather than three years over the transition period. Any longer delay would run the risk that the UK and the euro countries might diverge further, and that the single market would begin to break up because of exchange rate instability between the pound and the euro.

All the economic variables will be improved by the UK's entry into the euro, particularly given that 11 other countries will already be reaping the advantages. Economic growth will be faster, thanks to lower interest rates, high business investment, and the scale advantages of buying and selling in a bigger market. Inflation will be reduced, because the ECB will have greater credibility than the Bank of England, prices will become more

JB continued

Britain must resist being dragged backwards. France and Germany are pushing tax harmonisation, arguing that this is necessary to make EMU work. For Britain, it is hard not to be suspicious that this is nothing more than an attempt to hobble an economy which now benefits from the lowest corporation tax of any industrialised country in the world.

More worrying still is Germany's campaign for wage harmonisation. What motivation could there be other than an attempt to force other European economies up to Germany's wage levels. In a fiercely competitive world economy, gravitating towards the least competitive economy in terms of labour costs would be disastrous not just for Britain but for the rest of euroland.

Britain has no need to join the euro in order to thrive. Britain exports around 44% of its goods and services and less than half of that goes to euroland. More than 80% of foreign investment in Britain comes from outside the EU and more than 80% of British investment goes outside the EU.

Britain is exactly the kind of economy that should do well in a global economy where the winners will be high-tech, entrepreneurial, relatively fleet of foot, deregulated, excellent at high value added service industries. Britain certainly isn't a perfect place. Nevertheless, it certainly has no need to lack self-confidence.

CJ continued

transparent, and transaction costs in intra-European trade will be cut. The elimination of different exchange rates will benefit trade, direct investment, and portfolio investment. Both borrowers and savers will have access to wider banking, bond and equity markets, as fragmentation is reduced and competition increased. Fiscal policy will have to remain prudent, and private sector bond issuers will be crowded in to the market vacated by government borrowers. Under independent economic management, Britain has seen its living standards fall below those of the richer European countries, including even Ireland. In EMU, British living standards will have a chance to catch up with the rest of Europe. Europe as a whole will have a chance to catch up with the US, where the advantages of a single currency in a single market are evident.

How important is UK membership of EMU to the UK's role within the European Union? Is Britain now on the fringes of Europe? Can the UK now be at the heart of Europe?

JB

Those who know him say that Tony Blair's main (only apparent) reason for wanting the UK to join EMU is to enhance Britain's influence in European affairs. I think that he might be dismayed were a referendum ever held and won. He would be swapping total domestic control over the levers of economic policy (as well as the sovereignty of Parliament) for one voice out of 12. Some argue that, in a global economy, no nation state enjoys true autonomy over economic policy but this is too glib. Simply contrast the aggressive, growth-oriented programme of interest rate cuts delivered recently by the Bank of England compared with the head-in-the-sand conduct of monetary policy by the ECB.

CJ

The economic advantages of the euro are not sufficient to persuade those eurosceptics who believe that the UK should remain an independent country, sovereign in all respects. For europhiles, the economic advantages are compounded by the political benefits of playing a leading part in the world's second super-power. In fact, political influence *vis-à-vis* the United States also increases Europe's leverage in global negotiations about trade and finance. The UK punches above its weight in defence and foreign policy, and could take a lead, alongside France, in formulating European policies so far lacking in these areas. Britain's role should be, not to bolster US policy, but to influence it as one of the leaders of a European confederation.

EMU and the EU have a better chance of long-run success if the UK is a leading member of both organizations, rather than a fringe player. Euro financial markets need the City of London, and the City needs euro financial markets, if both are to realise their full potential. It is not a zero sum game. Both the UK and its partners will benefit from closer integration. If we do not like the way the rest of Europe is developing, it is up to us to try to change it. Britain is too important to euroland, and euroland to Britain, for the two to stay apart for long.

The euro debate

We then gave both the opportunity to respond to the points each had made:

JB

The deadline of January 1 1999 certainly spurred the 11 countries that joined the eurozone to cut their deficits and bring down inflation. What Christopher Johnson conveniently doesn't mention, of course, is that the Maastricht convergence criteria were widely fudged, outrageously in some cases, in order to meet that deadline.

This has left many of the eurozone countries with unsustainably high debt levels. We shall see how these countries get on during the current economic slowdown. While deficits and inflation have been brought down, Europe's real economic problems – feeble growth and high unemployment – have been neglected.

Christopher Johnson is quite wrong to say that the fall in the euro against the dollar was a big surprise. It was not. It was perfectly obvious before its launch that, far from being an oasis of stability as Wim Duisenberg boasted, euroland would suffer from the implosion of demand in emerging market economies along with others. The slide in the euro will, of course, help to cushion euroland from recession but the conviction of many of euroland's finance ministers and central bankers that the euro would swiftly challenge the dollar's status as the world's reserve currency already looks misplaced.

Even in the warm afterglow of Labour's landslide, Tony Blair would have been hard put to win a referendum. Opinion polls before May 1997 and afterwards have consistently shown a firm majority of the British people against the euro. My bet is that this majority will solidify and grow over the months ahead, particularly as the public become aware that a vote for the euro is a vote for a drive towards political union.

Sometimes, the pro-EMU case smacks of desperation. How many times have I read that we should join because we enjoy holidays in Tuscany or the Alps and glory in

CJ's reply to JB

The euro is not "a currency like any other". Even its detractors admit this when they point out that there is not a single government in charge. It also differs in ensuring exchange rate stability among countries doing well over half their trade with each other, by the simple expedient of abolishing exchange rates. There would have been no "beauty" in keeping floating exchange rates in the EU in the last year or two. Far from being a palliative for misalignment, they cause it. However, the fall of the euro against the dollar was just what Europe needed to regain competitiveness and stimulate the recovery.

A decade is far too long to wait to see if the euro "works". Business cycles are unlikely to have the same amplitude as they did in the 1970s and 1980s, which were exceptional in the postwar period. By 2010, the UK may well have diverged too far – in the wrong direction – to be able to take up its rightful place in EMU.

Britain could have joined on 1 January 1999, if the policy mix had been tilted towards a tighter fiscal policy and a looser monetary policy. Those who want Britain to have monetary independence have blamed the Bank of England for having raised rates too high. Over the years, the UK's inability to manage its own monetary policy has been all too obvious. The cut in interest rates that would have been needed for Britain to join EMU would have meant less of a dip in economic growth, with little inflationary danger. The divergence of the British and European cycles is due mainly to divergent policies, which could have been convergent, not to differences of economic structure.

The OECD (in its *Economic outlook December 1998*) surveyed fourteen models for the UK and other major European countries. In only three of them do interest rates

JB continued

French cuisine? Or that we must join, despite deeply important questions of economic and political sovereignty, because it is "our destiny" or "inevitable"? Or that the only people who argue against the single currency are right-wing, old, backward looking, xenophobic? This debate has got to be lifted to a higher standard if the British people are going to be well informed, as they should be in a mature democracy, in time for a referendum, if one is ever held.

Those who argue for early membership sound panicked as if somehow Britain will wither away and die outside euroland. Why are the British so lacking in self-confidence? Why not enjoy the relative luxury of the opt-out and wait and see patiently to see how things develop in euroland before making a decision? EMU is an unprecedented leap in the dark. It has never been done before. But don't assume, for all its ambition, that EMU is going to be a success. Even its most ardent proponents in Brussels are not, at heart, confident. A high level official from the European Commission expressed fury to me about what he regarded as Britain's lack of courage. However, asked whether he thought EMU would be a success, he said: "It had better be, for all our sakes."

Christopher Johnson makes extravagant claims for the euroland economy. A long list of economic variables, he says, will improve: growth, business investment, inflation, trade, direct investment, portfolio investment. The one economic variable that he doesn't mention happens to be euroland's most damaging and intractable problem: unemployment. The acid test of EMU's success or failure will be whether Europe can end its growth scelerosis and begin to tackle mass unemployment. I remain to be convinced that the ECB will deliver higher European growth rates. Without that, unemployment will remain far too high and EMU will become deeply divisive and politically unpopular.

We would all like to see a European Union that, in a united and competent way, challenged America's virtual monopoly on military and defence questions. Christopher Johnson rightly says that the US does not have a monopoly of wisdom on foreign policy. However, he appears to suggest that Britain cannot play this role outside euroland. Why not? EMU is a choice about monetary policy arrangements. It should have no bearing on foreign policy choices.

Finally, Christopher Johnson rolls out the well-worn argument that, if Britain doesn't like the way the rest of Europe is developing, it is up to us to get in there and work hard to change it. It is a *reductio ad absurdum* to argue that Britain must give up influence in order to gain influence. As a full member of the EU, Britain ought to be able to exert its views outside euroland. If that is not the case, then euroland is a deeply undemocratic beast that we should avoid.

Janet Bush, formerly Economics Editor of The Times, is director of neweurope, 52 Walnut Tree Walk, London SE11 6DN, Telephone 0171 582 1001, www.neweurope.co.uk.

CJ continued

have a bigger effect on output in the UK than in the other countries; in two they have the same effect, and in nine they have less effect. Interest rates have varied more in the UK than elsewhere, but this means that moderate interest rate changes are less effective, and that large ones are needed.

Few existing uninational monetary unions are optimum currency areas. The UK and the USA would both fail the test. But the EU is moving in the right direction, with policies to speed up the movement of capital – already free in many respects – and of employees. So this is no reason for not joining.

The ECB has to operate within the general EU policy framework, so it cannot ignore objectives such as employment and living standards. Its relaxed attitude to the fall in the euro, and the 0.5% cut in the refin rate to 2%, show that it is not skewed towards deflation.

The UK's industrial structure cannot, in general, be more modern that that of other leading European countries, because their productivity is higher. The mix of industries is remarkably similar, more so than across the United States. Oil and gas extraction accounts for 2.2% of British GDP, so this is not a sector in which any important asymmetric shock could occur.

The idea that Britain would lose competitiveness by joining EMU does not stand up. By most yardsticks, the UK is way down the league. Greater competition within EMU would improve competitiveness, not damage it.

It is a fallacy that the UK's 31% corporation tax rate means a low tax burden for industry. UK taxes on corporate income and property are 6% of GDP, compared with 2% in Germany. The UK's effective rate of tax on capital is, according to the OECD, the highest in Europe. Let us by all means harmonize business taxes, if that means bringing them down to the German level. Let us level up to German wages – provided that we can emulate German productivity and flexibility of working hours.

Britain does not have too little self-confidence, but too much. Smugness about the economy is the besetting sin of successive British Governments. New Labour had an unusual bout of frankness in its first year, when it exposed the depleted legacy of 18 years of Conservative Government. Now, the espousal of Thatcherism by New Labour is hardly the best basis on which to improve its economic inheritance. Only a firm decision to join EMU will break the mould.

Christopher Johnson is UK Adviser to The Association for Monetary Union of Europe and author of 'In with the euro out with the pound' (Penguin, £7.99).

Nations, firms and their workers

Why, in a global market, is there so much variation in the way firms are organised and in the way they manage their workers? Howard Gospel suggests that there is a wide range of factors at work – and that while some have perhaps been overlooked in the past others are less important than traditionally assumed.

It's widely acknowledged that the world of business is more competitive than ever before. Firms across the globe compete fiercely with each other – to fall behind these days is to threaten the survival of the company. Yet in spite of all the talk of a shrinking world, a concept many managers would readily accept, firms themselves continue to be organised in radically different ways. The structure of an American company, for example, is very different from its Japanese competitors; different both in the way it relates to the domestic economy and in the way it is managed. Within Europe, national differences are often surprisingly large.

It's true that as firms interact more and more at the international level, and find themselves facing similar problems and pressures, these differences are likely to diminish: there is already evidence for this. But what is it that makes these firms so very different in the first place? Why is it that in some countries, employees are more heavily protected in terms of pay, job security and fringe benefits than in others? Why do some companies seek to control every aspect of their business while others rely much more heavily on outsourcing and subcontracting?

Market forces...

It's perhaps stating the obvious to point out that the markets – product, labour, and capital markets – in which firms

By Howard Gospel

operate are crucial in determining how they manage their businesses. The size of a market, its geographical boundaries, and the degree of competition within those boundaries are all factors which play a part. Markets play a part in determining how a firm organises its labour. Greater competition – for labour, for instance – might lead large firms to internalise the management of their workers: providing in-house training, company level pay deals and so on.

...aren't the only influence

But other, equally powerful factors are at work. Within the firm itself, what might be termed internal influences are at work. Most obvious is the overall strategy and structure of the firm. How the firm positions itself in the markets in which it operates will have an important influence on how it organises it workers. So too will its managerial structure. A firm which relies on a hierarchy of professional managers will take a different view of its labour force than one which is essentially still run by a tightly knit group at the top – perhaps a family owned firm, for instance. Also important will be the choice of technology a company uses, which in turn will have a direct bearing on the firm's division of labour.

Markets and firms are therefore of central importance: other factors may also play a part at times. The state itself has an important impact. It can, for instance, impose regulatory requirements on the management of workers – hiring and firing at will can be much more difficult in some countries than others. Trade unions, too, are important because of their ability to organise workers across firms and industries: though there has in the past been a tendency to overestimate their role.

Labour strategies: internal v external

One useful way of looking at how firms manage labour is to divide approaches into what we might call the internal and external. In approaches to employment relations, for example, some firms may build strong internal systems with extensive training and company-specific wages and benefits; while others may rely more on the market process. In the area of work relations, some firms use subcontracting – they externalise much of their labour management; while others organise their production in-house using an internal division of labour. For industrial relations it's the difference between some kind of bargaining arrangement at the industry level – through employer associations, for instance – and an internal works council or enterprise bargaining approach. It's important to remember, though,

The last twenty years, however, have seen the beginning of a reversion to strategies of externalisation, especially in terms of work and employment relations.

that the distinction between internal and external is rarely clearcut. Firms – and countries – tend to fall somewhere in between the two extremes. What's significant, therefore, is where on the spectrum they fall.

Five countries compared

It's much easier to see how these various factors come together by examining how labour management has worked – and how it has changed over time – in the major industrial countries. In this way we can get some idea of how firms differ across countries and over time; and some sense of the common pressures at work which help shape the modern firm.

Britain

From the late nineteenth century until the Second World War, product markets in Britain were slow-growing, fragmented both nationally and internationally. Labour markets, for the most part, were well-stocked with unskilled and semi-skilled labour. Financial markets were already quite sophisticated, with a large stock exchange and the beginnings of a market in corporate control which resulted in periodic merger waves. Most firms remained small, often family owned and managed. Those large firms which did exist, mainly as a result of mergers, were usually loosely organised holding companies.

As a result, most British firms tended to externalise their labour management: many relied on subcontracting and devolved control to craft workers. They relied on the occupational labour market system of apprentices and were slow to develop in-house training arrangements. They hired and fired as market conditions dictated; fixed wages by the same criteria; and created only the most rudimentary systems of wage differentials, along with minimal benefits systems. They tended to deal with unions through employers' associations which fixed wages for a whole trade or industry and which processed grievances through external disputes procedures.

Of course there were exceptions. Some firms, such as a few large-scale employers in chemicals and mass consumer goods, developed stronger internal systems. These firms operated in larger product markets or where labour was more scarce or where firm-specific skills were important.

Having started out on one path, it tended to be difficult for firms to change course. But after 1945, British employers did start to move, albeit slowly and unevenly, towards a strategy of internalising the management of their workers. They developed much more structured internal labour systems. The challenges posed by tight postwar labour markets and increased competition in product markets acted as spurs to change. The last twenty years, however, have seen the beginning of a reversion to strategies of externalisation, especially in terms of work and employment relations. More competitive product markets, slacker labour markets and greater financial market pressures have all tended to push firms in this direction. Outsourcing, subcontracting and the use of temporary, part-time and contingent working have all become much more common.

France

Perhaps surprisingly, the history of the firm in France has much in common with that in Britain. But French financial markets were much less developed than those in Britain, and the traditional enterprise, small and often family owned and managed, survived much longer as the predominant form. Those large firms which did emerge, however, were more centralised than their British counterpart and more likely to employ graduate engineers as managers. Mergers played less of a role than they did Britain.

French firms tended to externalise their labour management – laying off workers according to the business cycle for instance; though they did this to a lesser extent than in Britain. French employers strongly preferred not to deal with trade unions, but when this was inevitable they chose to bargain through employers' associations, setting wages at the industry level. As in Britain, there were exceptions to the general rule and they tended to be in the same industrial sectors – railways, electricity and some larger steel, chemical and auto companies. Not only did these firms operate in labour markets where new skills were in short supply: they also tended to be those firms which were more centrally coordinated and professionally managed.

For more than thirty years after the Second World War, the management of French firms became increasingly internalised. In industrial relations, however, French employers displayed uncertainty, even ambivalence, about their strategies. Large firms both relied on external multi-employer bargaining *and* also sought to develop company agreements with trade unions. Only in the past twenty years or so has there been an accelerated move towards company-

In contrast with the British and French experience, the movement towards internalisation of labour management started much earlier in the United States. By the late nineteenth century, the markets for many producer and consumer goods had become mass markets

specific systems of labour representation, usually with a diminished role for outside trade unions.

The United States

In contrast with the British and French experience, the movement towards internalisation of labour management started much earlier in the United States. By the late nineteenth century, the markets for many producer and consumer goods had become mass markets. The market for labour, especially skilled labour, was much tighter. Large firms, including those which were the result of mergers, were run increasingly by extensive hierarchies of salaried managers. These firms were international leaders in developing mass production techniques and elaborate internal divisions of labour.

Among small firms in traditional sectors, labour management in the early twentieth century was externalised: based on employment-at-will, apprenticeship training and bargaining with craft unions through employers associations. The big firms, though, increasingly came to impose internalised arrangements on their employees. They developed their own internal divisions of labour, with career, wage and benefit hierarchies based on seniority and in-house training. As unions grew from the 1930s onwards, big firms which accorded them recognition usually insisted on bargaining at plant or company level.

In the last decade or so, however, the drive towards internalisation has been reversed. Increased outsourcing, extensive layoffs and a deterioration of internal benefit systems has been driven by greater product market competition – especially foreign competition; new patterns of demand in labour markets; greater short-term financial market pressures; and a wave of corporate restructuring which has often led to looser forms of organisation.

Japan

Japanese firms went further and faster in the process of internalisation. By the early twentieth century several large companies, operating in protected national markets, had emerged. These, for the most part, were centrally organised. Links to other companies and banks meant firms relied little on the relatively small equity market. As they adopted Western technologies, these firms created in-house training and labour systems to attract scarce labour. Initially, these tended to be restricted to managerial, white collar and some skilled workers; but post 1945, Japanese firms saw a considerable extension of this internalisation, partly as a result of trade union pressure and collective bargaining.

Such structures facilitated training and cooperation within the enterprise, and enabled Japanese firms to move towards so-called lean production systems. In the early twentieth century and again immediately after 1945, Japanese workers sought to create unions on general and industrial lines; they did not succeed. Large employers were the driving force behind enterprise-based unions and bargaining.

It's important to bear in mind, however, that the drive towards internalisation in Japan has been accompanied by related strategies of externalisation. The internal system for some employees is dependent on the use of subcontracting, part-time and temporary working patterns for others. Though there has been some increased use of such techniques of externalisation in recent years, they have not so far been as pronounced as in Britain and the US.

Germany

The German experience falls somewhere between these extremes. As far back as the late nineteenth century, large firms in fast growing product markets introduced elaborate division of labour in industries such as steel, chemicals, and electrical products. These firms were centralised, functionally organised and employed quite sophisticated managerial hierarchies. Unlike the US, where labour generally was in short supply, or Japan, where skilled labour was scarce, in Germany there was a reasonable supply of workers, though with high turnover and some shortages in expanding new sectors. Traditionally, the German labour markets for skilled workers were organised on occupational lines through apprenticeship training. Firms sought new finance from the banking system rather than the equity markets. As a result, firms tended to be insulated from the sort of financial market pressures encountered in other countries.

All this gave large German firms an incentive to internalise

What firms seek – or should seek – is a mixture of internal and external strategies which best meet their needs, those of their workers and, therefore, those of the national economic environment in which they operate.

labour management and this they did: with in-house training and extensive benefits systems common, and with the early introduction in some companies of internal works committees. There were nevertheless some tendencies towards externalisation: in traditional metal working, for instance, most initial training was through occupational apprenticeship.

For thirty years after the war, product markets were buoyant and labour markets tight. Large firms remained centralised. As in Japan – but unlike the Anglo-Saxon countries – company growth was mainly internal and firms were less subject to short-term financial pressures. Big firms went for internalisation with more sophisticated divisions of labour as they moved towards mass production. Such companies offered secure jobs, good promotion prospects and extensive fringe benefits. They also provided internal training beyond the apprenticeship level.

But there are two significant aspects of externalised labour management in Germany: apprenticeship, organised at the occupational level, remains strong; and wage agreements are negotiated on a multi-employer industry basis. Germany thus has a hybrid system of internal and external coordination which, while different from that in Japan, has certain structural similarities. It's true that in recent years there have been pressures on this mix; pressures which have tended to pull in opposite directions. Higher unemployment and greater competition has led to some weakening of internal labour markets, though the legal system combined with union strength means this had not had such a pronounced impact as in the US and the UK. At the same time, multi-employer bargaining has come under pressure, with firms tending to pay more attention to internal works councils and company specific pay deals.

For the most part, then, large firms in these five major countries can be seen fitting along a spectrum: with British and French companies closer to the external end; the US and Germany in the middle; and Japan near to the internal extreme. It's also clear that historical developments in the nineteenth and early twentieth centuries played a significant part in shaping these national differences. Looked at over the long-term, however, it also becomes clear that all five countries have seen some movement towards internalisation, especially in the thirty years or so after the second world war. More recently this trend has become more uneven, with signs of a reversal – though to varying degrees – again, in all five countries.

Does it matter?

One important question is : do these differing strategies for managing workers have any impact on the economic performance both of firms and the national economies in which they operate?

Strategies of externalisation do have some obvious advantages. For the firm, they save on administrative costs and provide flexibility both in terms of the numbers employed and the wage bill. Where employers' associations are comprehensive and strong, they may be able to constrain wage increases and thus allow the economy to be run at relatively full capacity. But firms have less control over their labour supply and over work organisation. Recruitment costs are likely to be higher as is staff turnover at times when the labour market is tight. Worker commitment to the firm is also likely to be harder to develop under externalised arrangements.

Strategies of internalisation have their disadvantages too. They entail high fixed administrative costs which come with a large workforce. It will obviously be harder to reduce the workforce when times are difficult. For the employees, too, there are downsides: as workers they are less mobile and much more dependent on the firm. And for the national economy, internalisation could mean a build-up of inflationary wage pressures when firms do not coordinate wage bargaining.

There is, however, recent evidence to suggest that some types of employment contracts can bring greater employee commitment and higher productivity: those which offer greater job security, internal promotion, and pay and benefit scales which reward workers according to their contribution rather than market forces. In the real world, what firms seek – or should seek – is a mixture of internal and external strategies which best meet their needs, those of their workers and, therefore, those of the national economic environment in which they operate.

Howard Gospel is Professor of Management at King's College London and a member of the CEP's Labour Markets Programme.

By Douglas McWilliams

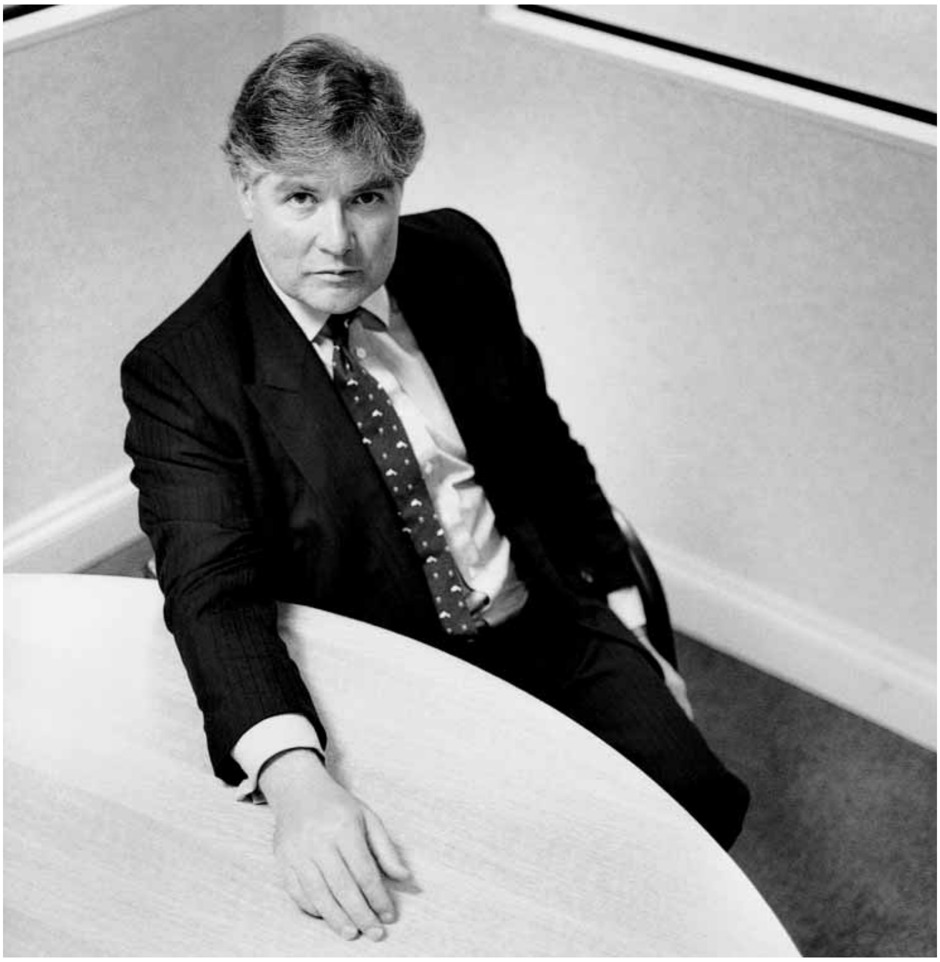
Thatcherism - twenty years on

May 1999 saw the twentieth anniversary of Margaret Thatcher's arrival in 10 Downing St. We asked Douglas McWilliams, chief executive of the Centre for Economics and Business Forecasting, for his assessment of the impact Thatcherism had on the UK economy.

In the two years after Margaret Thatcher took office in 1979, the UK's GDP fell by 3%, manufacturing production by 15%, unemployment rose by a million, while inflation had risen to 20% in 1980 before starting to fall back. Britain was one of the world leaders in strikes and had just suffered the so-called Winter of Discontent with a wide range of public sector workers (including, famously, grave-diggers) on strike, after two crippling miners' strikes and an electricity workers' strike had marred three of the previous nine winters.

Moreover, this was merely the culmination of a period of persistent UK underperformance compared with other countries. As I observed in 1988, "In the 1960s and early 1970s, the OECD statistics for growth show the UK growing about two thirds the rates of the other industrialised countries and in the mid-to late 1970s, despite the boost from rising North Sea Oil production, this had fallen to about half."

Flash forward 20 years and the UK still has problems but the performance of the economy is widely admired. Growth is currently temporarily subdued, but an early recovery with a trend rate above that of the rest of Europe is expected not only by Gordon Brown but by most other forecasters. The CEBR's current forecasts show that even on the official figures the UK economy is likely to overtake the French economy in size by 2003 and, after allowing for the probable understatement of the UK service sector in the official statistics, may have already done so. Inflation seems to have little difficulty in holding to the official target rate of 2.5%. Strikes in the UK are largely for history students to read about.



Even *The Guardian*, hardly a Thatcher-supporting newspaper in her heyday, has concluded that "she effected the change brutally, and with

The 1981 Budget had a major psychological effect. It convinced industrialists that they were in a new world where economic policy would not necessarily be adjusted simply because the economy had turned down.

great pain, but it was a change we had to make. Our partners in Europe are having to undergo that process now; thanks to Thatcher, we were ready for the global marketplace sooner than they were."

So there has been an undoubted economic improvement. But how much of the improvement can be attributed to Thatcherism? And was the collateral damage to society and the economy greater than necessary to achieve the desired results?

The problems were great

The UK ended the 1970s with three key economic problems. The first two were macroeconomic and inter-related. Government borrowing was excessive, running at over 5% of GDP, and inflation was in double digits and accelerating. The GDP deflator (a measure of inflation) rose by 11.6% in 1978, 14.6% in 1979 and 19.4% in 1980.

The third problem was more micro-economic - a structural supply-side failure that had led to slow productivity growth. Even this arguably had macroeconomic consequences – slow growth of productivity had led to slow growth of output that had probably exacerbated the tensions between expectations and reality that had resulted in excessive borrowing and inflation.

What Thatcher did

Thatcherism had three phases, roughly coincident with Mrs Thatcher's three Parliaments.

The first phase from 1979-83 focussed especially on the macroeconomic problems, bringing public finances under control and reducing inflation. But there were also measures targeted at the supply-side of the economy, such as trade union reforms, lower marginal income tax rates and the scrapping of wage, price, dividend and exchange controls. Some initial moves were made to scale back the public sector through privatisation.

The key decision during this phase was that not to reflate fiscally in 1981. Although based on Treasury forecasts of public finances that subsequently turned out wrong (as a result there was in fact a fiscal relaxation in Autumn 1981) and although monetary policy had already been relaxed, the 1981 Budget had a major psychological effect. It convinced industrialists that they were in a new world where economic policy would not necessarily be adjusted simply because the economy had turned down.

The first phase achieved its objectives, though with some luck and with policy errors (such as the Clegg awards that raised public sector pay by nearly a third, and the hike in VAT to 15%) that exacerbated the difficulties in achieving them. The heavy reliance on monetary policy to control inflation at a time of public expenditure growth meant that the internationally traded sector, in particular manufacturing, bore the brunt of the fight against inflation.

My mid-1980 assessment was that Thatcherism's only chance of success was for Mrs Thatcher to be reelected at least once, since her main economic policy measures were targeted at medium and long-term improvements and would only show negative effects within her first Parliament. Many political experts were not convinced that she would survive beyond one term of office and some suspected that she might not even get that far.

Luck played a part

But Mrs Thatcher was lucky in her opponents. General Galtieri attacked the Falkland Islands when her popularity was at its nadir – by the time the Argentinean troops had been repatriated to the mainland she had become the most popular Prime Minister for many years. As if this was not enough, the Labour Party chose Michael Foot as leader rather than the much more formidable Denis Healey, and the effects of this were enhanced by the breakaway of the 'Gang of Four' to found the SDP component of the Alliance. This meant that the opposition to the Conservatives was split into two almost equal parts. Because of the opposition split, Margaret Thatcher could have won the 1983 election with only 35% of the vote; because of the post-Falklands rise in her popularity she achieved 43.5% and an overwhelming majority. This left Thatcherism free to start to enjoy the gradual emergence of the fruits of the reforms that had taken place earlier.

The second phase of Thatcherism, from 1983-87, was the most productive. With the macroeconomy sorted out, the main focus was on the supply-side. Privatisation, sales of council houses, the 1984 Budget reform of Corporation Tax and further scaling back of the public sector took place against the background of accelerating growth. But, partly because the supply-side reforms boosted productivity, unemployment remained stubbornly high. Meanwhile, the 1983/84 miners' dispute was costly in both financial terms and social terms. But it symbolised the reforms in the industrial relations climate.

Mistakes were made

Again with the opposition split (though less evenly) the Conservatives easily won re-election again in 1987 and the third phase of Thatcherism started. This was the point where the wrong decisions started to outweigh the right ones. Supply-side changes like the 1988 Budget cut in the top rate of tax to 40% and privatisations, contracting out and the development of the private finance initiative emerged. But these were counter-balanced by an unnecessary recession which had its roots in a quasi-theological debate between Mrs Thatcher and her Chancellor Nigel Lawson about whether to operate a monetary policy

Thatcher started to realise the need to reform education to create the skills to take full advantage of the information age far too late.

or an exchange rate policy. The problems of the recession were compounded by the Poll Tax, which hit living standards (and boosted inflation) at a time when the recession was starting to bite. And Europe started to become an almost impossible problem for the UK.

Thatcherism coincided with the heyday of North Sea oil revenues and with the emergence of the information age. The first Apple personal computers were sold in 1979 and the personal computer came of age with the original IBM PC in 1981. These changes would have helped improve the position of the UK economy without Thatcherism. But it was the mix of Thatcherite rhetoric, aggressively pro-free markets, and Thatcherite policies, which were a much more cautious 'Third Way' mix between liberalising markets and preserving the welfare state, that helped the UK take advantage of these changes. Abolition of exchange controls and the deregulation of the City meant that businessmen were forced to be productive; Thatcherite rhetoric reminded them that they needed to stand on their own two feet. Meanwhile the technological changes of the era gave them some of the tools that they needed for success.

Not all good news

But, surprisingly for a former Secretary of State for Education, Mrs Thatcher started to realise the need to reform education to create the skills to take full advantage of the information age far too late. So although the UK economy has overtaken Italy and nearly caught up with France, we remain some distance behind West Germany in the productivity stakes. And the 1998 McKinsey report indicates that the UK is still insufficiently deregulated and uncompetitive to achieve US levels of productivity.

Armed with 20-20 hindsight, it is clear that the benefits of Thatcherism could have been bought more cheaply. The macroeconomic stabilisation at the beginning of the 1980s was achieved with only the traded goods sector in the front line. As a result, the pain suffered by this important part of the economy was excessive. Moreover, inflationary pressure in the rest of the economy continued and meant that a second counter-inflationary battle had to be fought at the beginning of the 1990s.

And the problems of the early 1990s were very much man-made. They started with a pragmatic decision, since Thatcher abhorred exchange rate targets and Lawson was sceptical of monetary targets, to compromise by having neither a monetary policy or an exchange rate policy. Then, when it was clear that inflation had got out of control, the introduction of the Poll Tax added fuel to the flames. Finally, the extent of the asset price deflation and the economic consequences of fixing sterling to the deutschemark at a time when reunification spending was likely to push German interest rates close to record levels were not at all understood. Sustainable recovery only emerged after George Soros and his fellow speculators pushed sterling out of the European Exchange Rate Mechanism.

But the cost of sorting out the UK's economic problems has been similar to the price paid by other major European economies. Indeed it is arguable that both Italy and France have paid a roughly equal price in unemployment and lost growth to the UK, despite more favourable starting positions and moving less far along the road to reform.

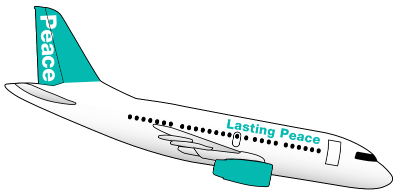
So the verdict on the Thatcher economic policies has to be largely favourable. But had the battle against inflation in 1980 been fought by the whole economy instead of the traded sector, and had the early nineties recession been largely avoided by pre-emptive monetary action and a clearer understanding of the impact of indirect tax rises, the powerful economic recovery of the mid- and late-1990s could have taken place at least five years earlier. If that had happened, the Conservatives might still be in office!

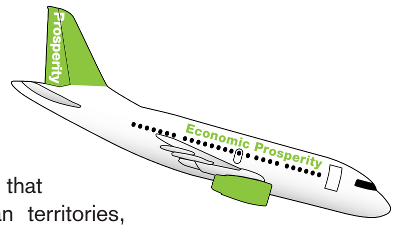
Douglas McWilliams is Visiting Professor of Economics at Kingston University and Chief Executive of the Centre for Economics and Business Research in London.

Hope and

Economic relations

Christopher Pissarides and Veronique Kessler look at what has gone wrong with attempts to strengthen the Palestinian economy: and offer some suggestions for the future.





Wars, suicide bombs, assassinations, peace treaties, the Middle East seems to have had them all. But behind these events, are economic factors that rarely attract the attention of headline writers. Lasting peace, though, depends on economic success. Make one side rich and the other poor and you have a perfect recipe for political disaster. In 1993 and 1994, when the peace agreements between Israel and the Palestinians were signed, many would have said that the economic foundations for lasting peace were laid.

But five years later hope has given way to disillusion. Growth in the Palestinian territories has been disappointingly slow. The trade deficit has widened. The Palestinian economy's dependence on Israel remains as high as ever, while border closures continue, putting further pressure on the small and struggling economy. The promised land of the economic take-off and lasting peace both look more fragile than ever, the need to halt the decline more urgent.

Unequal partners

Israel can boast a modern dynamic economy comparable to that of the richer European south. It has managed to absorb large numbers of immigrants; it has a well qualified workforce, low inflation and low unemployment; and a standard of living comparable to that of Spain. The Palestinians, too, at least when the oil rich states of the Gulf are excluded, are moderately well-off by the standards of other Arab countries: but the economy of their territories has had too much to cope with for its size. In 1997, the average income was about 1500 US dollars (in 1997 prices), about a tenth of that of Israel. The population is 2.5 million, compared with 6 million for Israel. The Palestinian economy is only between 3 and 4% of that of Israel. Economically, it is a very, very small brother.

In 1967, when Israel occupied the lands that now form the Palestinian territories, the Palestinians had virtually no economic relations with Israel. Indeed, even the two blocks of the Palestinian territories, the West Bank and Gaza, had almost no economic relations with each other, the former looking east to Jordan and the latter south to Egypt. Occupation severed all links with their respective Arab neighbours and brought integration with the Israeli economy. What happened next is a textbook example of growth through association with a more advanced economy. Israel needed labour, which the Palestinians had in abundance. Palestinians worked mainly in construction in Israel, needed to house new immigrants and to provide the infrastructure for the industrialising society, and in agriculture and low-skill service jobs. With the money they earned they bought goods produced in Israel. A flow of labour by Christopher Pissarides and Veronique Kessler

disillusions

between Israel and the Palestinians

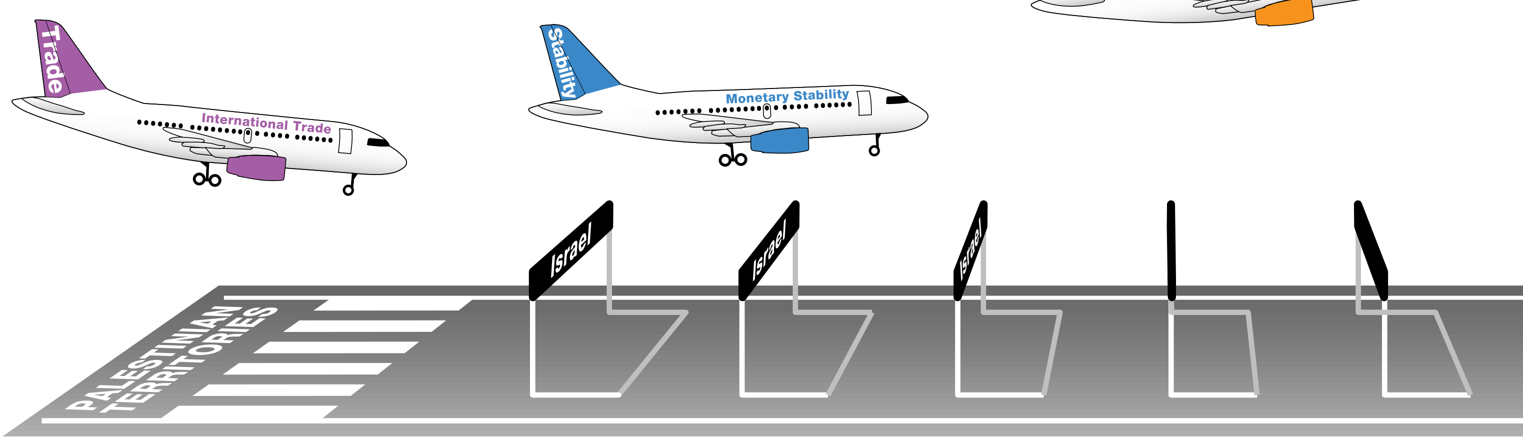
from the Palestinian territories to Israel was matched by a flow of goods from Israel to the territories and supported a fast expansion of Palestinian living standards.

In addition to the demands of the Israelis for unskilled labour, Palestinians were fortunate enough to have access to the oil rich economies of the Gulf. When the price of oil went up in 1973 and large scale economic expansion started in the Gulf states, skilled Palestinians emigrated there in their thousands. The income they earned was either deposited in banks outside Palestine (and much of it is still there), or it was sent back to provide more support for economic expansion. Between 1968 and 1980, national income in the Palestinian territories grew at an astonishing 12.5% per year. But at the onset of the 1980s, Israeli expansion slowed down, the initial gains from reconstruction after the occupation were exhausted, and oil revenues in the Gulf stagnated. Palestinian growth collapsed to 2.5% per year, hardly able to keep up with population growth.

Stagnation brought the *Intifada* in 1988 and further economic hardships followed political uncertainties, strikes and the repression of economic activity. Coupled with this, the outbreak of the Gulf War in 1991 found the Palestinians backing the wrong side and paying for it after the war with mass repatriations. Israel imposed its own restrictions on Palestinian labour, through the now famous (or infamous, depending on your point of view) border closures: Israeli security forces do not allow Palestinians to cross into Israel to go to their jobs because of fear of terrorism. So from a situation where Palestinians had access to two rich labour markets, the Israeli one to the north and west and the Gulf one to the east, they were left with neither: no source of outside funds and no domestic employment. Although statistics at this point become unreliable, there is no doubt that Palestinian output fluctuated painfully, on average either falling or rising only slightly. Unemployment and under-employment became common.

Peace and economic prosperity?

It is in this environment that the peace agreements of 1993 were signed. The economic framework for relations between Israel and the Palestinian territories was written in what is known as the Paris Protocol, signed in Paris in 1994. The Protocol created a customs union with some modifications. Goods were to be freely traded between Israel and the Palestinian territories, which were to have a common external tariff. Employment of Palestinians in Israel was to continue but at the discretion of the Israeli employment service (and the security forces). The same national insurance taxes were to apply to Palestinians as to Israelis, but, because Palestinians were not allowed to settle and claim benefits in Israel, most of the revenue collected from Palestinians



The ambitions behind the Paris Protocol were to improve productive activity by transforming the Palestinian economy from the forced and distorted integration with Israel to a self-supporting exporting economy.

was to be passed on to the Palestinian Authority. Some tax harmonization in VAT was to be observed and in practice VAT rates have been the same in the territories as in Israel. Finally, the new Israeli shekel (NIS) was to continue as the currency of the Palestinian territories, though the Jordanian dinar and the US dollar also continued to circulate. In practice, the NIS is used to finance most day to day transactions but most savings in banks are kept in Jordanian dinars or US dollars.

The challenges facing the Palestinian economy at the time of the signing of the Peace Agreements and the Paris Protocol were clear. Although the economy of the territories benefited from the association with Israel after the occupation, development was unbalanced and fragile. The combination of restrictions in the free flow of goods imposed by Israel, the weak and sometimes hostile regulatory environment and uncertainties surrounding the future political status of the territories prevented the growth of private investments in the Palestinian economy. The high investment rates in the territories, around 30% of GDP in the West Bank and 40% in Gaza by the mid-1980s, were predominantly in housing and were noticeably absent in the private productive sector. Rather than Palestinian or Israeli capital coming to the cheap labour populating the occupied territories, cheap Palestinian labour went to Israel (with skilled labour going to the Gulf): productive activity in the Palestinian territories stagnated.

High hopes, anyway

The ambitions behind the Paris Protocol were to improve productive activity by transforming the Palestinian economy from the forced and distorted integration with Israel to a self-supporting exporting economy. The Protocol was meant to create the necessary conditions to stimulate growth in labour-intensive sectors and to improve the trade position by promoting export industries, developing efficient import substitution, and encouraging diversification. Export growth was seen as a potentially important source of new job creation, although there was still hope that Israel would not close the door completely to the employment of Palestinian labour. The key idea behind the Protocol was to provide a framework for growth in the Palestinian economy supported by the free movement of goods instead of the free movement of labour.

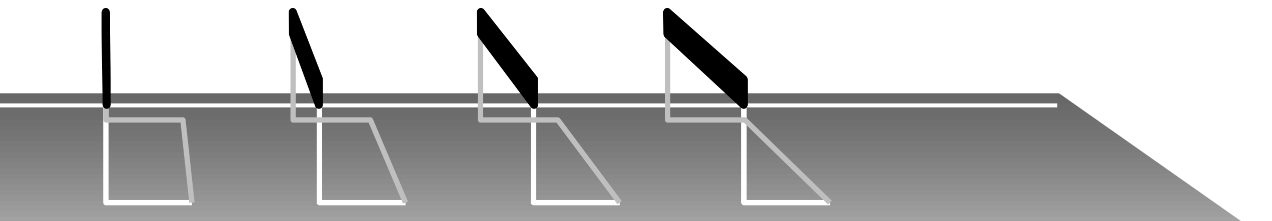
But there were also high hopes elsewhere. The new autonomy gradually given to the Palestinian Authority was expected to lead to policies geared to the needs of the Palestinian economy, not ones borrowed from Israel. Although flexibility in monetary policy was limited, the use of foreign currencies was beneficial in that it acted as a check on domestic inflation and interest rates and provided the monetary stability necessary for the repatriation of Palestinian capital that would eventually lead to the creation of a Palestinian employment base. There was euphoria as the busy reconstruction boom to house the new administration went under way.

Hopes not realised…

But difficulties soon emerged. Domestic output has only managed a disappointing average of 2.8% growth per year. After an initial surge, annual export growth has slackened to a mere 5.6%, a very poor performance when compared to the ambitions of the Paris Protocol. Although imports have not grown much since the initial boom of 1995, the trade deficit has widened. Diversification in external trade has not taken place, and the Palestinian economy's dependence on Israel remains as high as ever. Border closures continue and Israel has imported cheap foreign labour from Asia and East Europe to take its unskilled jobs, shutting off a steady source of Palestinian incomes. Despite very generous amounts of official transfers to the Palestinians (averaging 11.6% of GNP over the period 1993-98) from donors anxious to see peace in the Middle East, the current account deficit has grown to an astonishing 18 -19% of GNP over the last three years. Unless these trends are reversed, the Palestinian economy is threatened with a spiral of increasing external debt and economic stagnation.

…so who's to blame?

Given the realities of Middle East politics, the Paris Protocol itself can hardly be blamed for the disappointing outcome. To get Israel and the Palestinians to agree to it was a far bigger achievement than any design failures that close and uncharitable scrutiny might reveal. The key problems lie in politics, the deteriorating relations between the two sides and the poor adherence to the Protocol that followed: put starkly, Israeli security considerations, irrespective of whether they are justified or not, have hijacked economic objectives. The closures and work-permit policies pursued by Israel since 1993 have shut off



It would be unrealistic to quarrel with Israel's security concerns. Any attempt to deal with a potentially acceptable solution has to recognise them as a permanent feature of the landscape

Israeli employment to thousands of Palestinians. Perhaps worse for the longer term, they have also blocked the access of Palestinian producers to the outside world. Security considerations have also raised numerous indirect obstacles to Palestinian trade with Israel and the rest of the world. The Joint Economic Committee, set up after the Paris agreements to iron out any difficulties in the implementation of the protocol, has become paralysed by political considerations.

The consequences have damaged the prospects for the long term prosperity of the Palestinian economy. Border closures, and the uncertainty surrounding them, have led to the wrong kind of adjustment in the fledgling economy. Correcting these when the political climate improves will not be easy. Import monopolies have been created in a domain where competition is at the heart of the success. Private firms importing from the rest of the world resorted to traditional indirect Israeli routes and intermediaries rather than direct routes, which are fraught with obstacles. As a consequence, the Palestinian Authority is losing important customs revenues. The entire Palestinian economy is now caught in a vicious circle. Security-related obstacles are impeding trade; they are making Palestinian industry uncompetitive; and they are discouraging private investors from financing the promised export-oriented economy. Private investment in the export sector has stagnated, preventing job creation. This in turn feeds into the political process, killing the will to work for peace and breeding discontent and enmity.

Many criticisms have been raised against the Protocol itself. The milder ones have spotted ambiguities and defects in some of its provisions, while the more ferocious ones have challenged the heart of the compromise, the establishment of a customs union between Israel and the Palestinian territories. But political considerations have ultimately killed the initial optimism. The risks ahead are now greater.

Economic dependence on Israel is here to stay...

It would be unrealistic to quarrel with Israel's security concerns. Any attempt to deal with a potentially acceptable solution has to recognise them as a permanent feature of the landscape. But the economy of the Palestinian territories will depend on the Israeli economy for its well-being, at least for the foreseeable future. How can these conflicting interests be reconciled? Improving the design of security measures and procedures, making them more transparent to the Palestinians and outside bodies, such as the European Union and World Trade Organisation, could go a long way towards removing the Palestinians' suspicions that Israel is using security as a pretext to strangle their economy. The ability to move Palestinian goods across the borders with Israel is of paramount importance. Since Israel agreed to this, arbitration by the World Trade Organisation in cases of dispute and help in the resolution of ambiguities is an obvious route to the building up of mutual trust. With the same basic aim, administrative procedures and institutional infrastructure, related to customs clearance, the issue of import licenses, ensuring that standards are enforced and other similar factors, can all be improved.

The movement of labour and the employment of Palestinians in Israel is also a measure that can provide a source of income for the Palestinians and a source of revenue for the Palestinian Authority, through the tax collected and passed on by the Israeli authorities. It is also a bridge that can build more trust. The issuing of some *closure-immune* permits has already taken place but their number is still very small. Expansion of this measure can help both sides in a sensitive area.

but more self-sufficiency would help...

Direct access from the Palestinian territories to the outside world, without having to go through Israel, and also between the various fragmented parts of the Palestinian territories, is also important. Improving the infrastructure is the key to achieving this. The Gaza airport is now operational, as President Clinton showed the world during his recent visit, but it does not yet carry goods – or people – on a commercial basis. The Gaza Industrial Estate is also built, but no industries are yet established there. A commercial port is badly needed, as are roads, customs facilities and telecommunications systems.

...as would more outside involvement

The European Union is a major trading partner of Israel. It is also potentially a major trading partner of the Palestinian economy, and an important donor of aid. Its economic clout in the area makes it a strong candidate for the role of intermediary as well as an adviser on economic issues and on the implementation of the economic agreements. But such a role also calls for an active involvement in the design, the financing and the realisation of any project aiming to establish direct links between the Palestinian economy and the rest of the world. Many have criticised the European Union in the past for failing to respond fast enough to avert conflict on its doorstep. The hope is that with the lessons learned elsewhere, it will act more quickly this time, before it is too late.

Christopher Pissarides is Professor of Economics at the LSE and a member of the CEP's Technology and Growth Programme. **Veronique Kessler** is senior economist at the World bank, currently on leave. They are both consultants to the European Commission. The views expressed in this article are their own and do not necessarily reflect those of the Commission.

The weightless economy

Danny Quah's regular column: in which the riders on the Clapham Omnibus find themselves at a coming out party...

Technology, intellectual property, and social efficiency: any debate with that many syllables strung together makes the subject under discussion a distant thing, slightly outside the event horizon for most of us. Wonderful technical developments might, indeed, be unfolding in the weightless economy. Social observers might, indeed, be attempting to place perspective on and come to grips with the large-scale changes that they think important and profound. But why should a proverbial rider on the Clapham omnibus care?

I have previously argued in this column and elsewhere that the weightless economy is a technological development that matters because it slings the hapless consumer right up against the chalk-face of frontier technical change.

Sure, the economy has always been knowledge-based. But in the old days scientists, engineers, and inventors plied their trade in laboratories hidden from the consumer. And we preferred it that way. We walked into stores and bought the fruits of that intellectual labour. New products had

Danny Tyson Quah

technology and knowledge embedded in them, but we never needed to be hit over the head with this fact. Individuals plugged in, turned on, rode in, swallowed down, or shrugged off. The knowledge-based economy? We hardly knew ye. And to understand economic performance in such a world? Policymakers and observers could well relegate technology, knowledge, and science to mere footnotes.

Now, however, daily newspapers are not shy about putting on the nation's breakfast tables feature articles about open-source computer operating systems, about gene sequencing, and about encryption policy. New

Products had technology and knowledge embedded in them, but we never needed to be hit over the head with this fact.

releases of operating systems are rolled out in sparkling media events complete with rock stars, world tours, and theme music. What is an operating system anyway, and why does anyone care enough to spend millions of dollars to tell us there is a new one of those available? Answer: a string of 1s and 0s. The 0s have been put in a different part of the string this time, and, oh, a couple million new 1s have been sprinkled in the middle, not all together though. The millions of dollars spent on the coming out party? Because you're worth it.

This is stuff no longer arcane, intangible, and visionary. It is no longer about propeller heads getting their hands dirty on a keyboard, coding in a nifty new hack to squeeze ever more performance out of 2k RAM on a board with flashing lights. Nor about old men and women in white laboratory coats, tinkering. Nor about brainy social misfits, poring over tables of unintelligible markings, while beautiful debutantes carry translation chits back and forth in blacked-out Bletchley Park.

No, this is now everyone's bread and butter. When did we all become such techno-geeks? Who brought us centre stage and why? What do we need to know about these changes to understand economic performance?

You're part of it

In March 1999 IBM announced it would no longer advertise on websites failing to announce an explicit privacy policy on data collected from web browsing activity. Even if IBM intends to spend only $60m on online ads this year, peanuts compared to the billion-dollar exchanges now routine for Internet deals, IBM is still the number two Internet advertiser, and the money is not exactly funny money.

Apparently, collecting information about who does what is contentious, and those with economic resources that matter take it very seriously. And this is collecting data about you, the consumer, the user, the Web surfer. The one who rides that omnibus. You and information about you are what this discussion revolves around.

In the recent uproar over the Melissa computer virus, it emerged that Microsoft assigns unique identifiers to its Office suite of programs. Thus, when a user produced a new document on a machine using a particular copy of Word, that document was thereafter tagged and identified. On the one hand, this allowed tracking down the possible perpetrator of a heinous crime. On the other hand, we now realise there is a shining trail of indelible breadcrumbs marking out the uniqueness in the each of us, amidst the swarm of information ebb and flow that is modern economic activity.

Intel had achieved the same identification in hardware with its latest processor chips that sit hidden in our computers. Thus, the same goal is attained. There continues debate on whether this feature can be deactivated. But the fact of the matter is, one way or another, the electronic information that we produce is indelibly stamped with a version of our identity.

Software programs can be obtained freely on the Internet that would enable my computer to sniff the bytes traversing the LSE network. It would be a simple matter for me to log Web traffic. Not that I would ever do this, of course.

Apparently, collecting information about who does what is contentious, and those with economic resources that matter take it very seriously.

Why does anyone bother?

I don't do it, but plenty of others do, evidently. DejaNews, a net search engine and early provider of easy Web access, was recently publicised to be – inadvertently or otherwise – keeping records on who was sending e-mail to whom.

On a level further up, the 1998 European Union Directive on Data Protection recognized the importance of consistent transnational statutory stances on record-keeping and information-use. Without this harmonisation, European consumers might be averse to allowing their information into commercial circulation in the first place. By default, the lowest common denominator – the tightest security – would emerge as the focal point and defacto standard. This can only restrict the further development of useful information systems. But in attempting to harmonise statutes across European member states, the EU directive became inconsistent with free information flow outside the European Union, and in particular, towards the United States. For companies in the business of slinging information back and forth across the Atlantic – banks, financial houses, insurance companies, even academic establishments – this is a serious barrier to cross-country operation.

OK, enough examples. What are the general lessons to draw? First, what passes for wealth-creating activity in the weightless economy is easily monitored. The technology itself facilitates that. We don't know everything about that which is payoff-relevant, but we know a lot, enough to worry lawyers and policy-makers. When advertisers want to know where to direct their spending dollars, they seek measurements to find out how effective their Web ads have been. Despite all the insidious technological capabilities I described above, the principal complaint is that not enough precise information is being collected. Companies like Media Metrix – a market leader in monitoring Web traffic – undersample relevant populations, and are unable to detect

People are different, and acknowledging those differences in the provision of goods and services removes the social efficiency losses associated with monopoly profit-maximisation.

when advertising has been truly effective. It seems to me that these complaints are no worse than for traditional advertising, but the technology promises more, and so dissatisfaction is easier to generate.

Second, more controversy appears to arise when information is collected online than when it is otherwise obtained. All legal economic transactions in countries where VAT operates are already tagged and the information used. For most of us, cash exchanges are an ever-smaller part of economic life. Exchange done otherwise – through checks, credit cards, or other methods of accounting – can be easily cross-referenced to obtain very precise pictures on our spending patterns.

In national surveys that all social scientists use, people actually volunteer to keep diaries on what they do, what they eat, how they spend their time. Sure, in one case, online activities are recorded without the individual's explicit consent, while in the other, the surrender of information is voluntary. But this can make a difference only if, in the second case, the volunteer lies or otherwise alters his behaviour. No one wants to contemplate that possibility.

What then is special about this participation of the masses in activities in a weightless economy?

Economically valuable mass information

Information about consumers now can not only be sliced and diced to yield statistical trends and generalisations. They can also be exploited to provide customized products in a way that is economically profitable now but not so before. The customer becomes part of the value chain through his or her characteristics. Thus, everyone helps engineer progress in the weightless economy through their simply being a consumer of these products.

Knowledge-products in the weightless economy are not just infinitely expansible, they are similarly malleable and adjustable. Sure, the auto industry will sell you a car with add-ons that then distinguish this car from the next, but there is only a fixed set of templates from which customization can draw. Indeed, the logic of mass production in such industries is that customization is necessarily limited. By contrast, computer software, biotech pharmaceuticals, and video entertainment can be tailored to fit each customer's characteristics, and without much more in extra cost. This product differentiation represents non-price competition and is, in fact, a move in the direction of social efficiency. People are different, and acknowledging those differences in the provision of goods and services removes the social efficiency losses associated with monopoly profit-maximisation.

At the same time, if the customization is then frozen in the product, the problem of market price tending towards zero marginal cost under perfectly competitive markets is alleviated. No one else finds useful the cheap knock-off copy of the string of 1s and 0s that has been specially developed for just me. The developer of weightless economy products does not find her ex-ante incentives at odds with the subsequent market outcome.

When advertisers want to know where to direct their spending dollars, they seek measurements to find out how effective their Web ads have been.

In this view, increased precision of information capture – whether through Internet audit trails, medical records, or brandname loyalty cards – is a natural and healthy market-driven solution that has emerged to deal with the allocation and competition problems otherwise inherent in a newly-developing weightless economy.

Many observers, of course, take a less positive view on this information proliferation through the consumer's inadvertent actions. That debate on privacy and information in a weightless economy then sometimes garners rhetoric such as the need to protect the "fundamental rights and freedoms of natural persons". Now I don't know what an unnatural person is, but there might well be an economic question surrounding ownership of the intellectual property rights on my shopping patterns. Or on the genetic information in my spleen cells. Or that in the population of Iceland.

There is certainly an opposing economic argument to the sanguine one above that can be developed. The next column will seek to investigate exactly that.

Danny Tyson Quah is Director of the CEP's Technology and Growth Programme and Professor of Economics at the London School of Economics.