MARKETS IN A STATE?

The Social Market Foundation at 21

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John Kay is one of Britain's leading economists. His interests focus on the relationships between economics and business. His career has spanned academic work and think tanks, business schools, company directorships, consultancies and investment companies. John's main

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PETER LILLEY

Peter Lilley was Member of Parliament for St Albans from 1983-1997 and, following boundary changes in 1997, he became MP for Hitchin & Harpenden (which includes two thirds of his previous constituency). His first ministerial appointment was as Economic Secretary to the Treasury (June 1987), then Financial Secretary to the Treasury (July 1989). He joined Mrs Thatcher's Cabinet as Secretary of State for Trade and Industry 1990-1992. Mr Lilley was appointed Secretary of State for Social Security 1992-1997. Previously he was chairman of the Bow Group (1973-75) and a consultant Director of the Conservative Research Department (1979-83). He has written widely on public services and the economy.

DAVID LIPSEY

Lord David Lipsey was previously Chair of the Social Market Foundation. He is also Chair of the British Greyhound Racing Board, and of Make Votes Count and of the Shadow Racing Trust; and is a Non-Executive Director of the Advertising Standards Authority and London Weekend Television. Lord Lipsey has previously served as a member of the Davies Panel looking into the funding of the BBC, the Jenkins Commission on Electoral Reform and the Royal Commission on Long Term Care of the Elderly. Prior to becoming a Peer in 1999, Lord Lipsey was Political Editor at *The Economist* and was formerly a Special Adviser to the Rt Hon Anthony Crosland.

IAN MULHEIRN

Ian was appointed Director of the Social Market Foundation in October 2008. He joined the Social Market Foundation as the Chief Economist in February 2008, after three years as an economic advisor at HM Treasury. He has worked in a variety of policy areas including child poverty, savings & investment, welfare to work and higher education funding. He has also undertaken research into the drivers of worklessness in London and evaluation of the Working Tax Credit and the National Minimum Wage. Ian is currently specialist advisor to the House of Commons Work and Pensions Select Committee.

DAVID OWEN

David Owen was a Member of Parliament for 26 years from 1966-92. Under Labour Governments, he served as Navy Minister, Health Minister and Foreign Secretary. As one of the "Gang of Four", he was co-founder of the Social Democratic Party established in 1981 and its Leader from 1983-87 and 1988-90. He helped to create the Social Market Foundation and served on its initial Board with Tom Chandos, Alistair Kilmarnock, David Sainsbury and Robert Skidelsky. David Owen was created a Life Baron in 1992 and sits as an independent social democrat in the House of Lords. From 1992-95 Lord Owen served as EU peace negotiator in the former Yugoslavia and was co-author of the Vance-Owen Peace Plan.

MARY ANN SIEGHART

Mary Ann Sieghart writes a weekly column, every Monday, in *The Independent* and presents *Profile* on Radio 4. She is an equity partner in the new website, *The Browser*, featuring fine writing on politics, international affairs, business, science and the arts. She is Chair of the SMF and sits on the board of Henderson Smaller Companies Investment Trust and on the Council of Tate Modern.

Between 1988 and 2007, Mary Ann was Assistant Editor of *The Times*. She was a political and social affairs columnist both on the Comment page of the main paper and in the *Times 2* section.

From 1992 to 1999 she was the paper's chief political leader-writer, working closely with the Editor to devise *The Times'* political strategy and day-to-day stance.

ROBERT SKIDELSKY

Robert Skidelsky is Emeritus Professor of Political Economy at the University of Warwick. His three volume biography of the economist John Maynard Keynes (1983, 1992, 2000) received numerous prizes, including the Lionel Gelber Prize for International Relations and the Council on Foreign Relations Prize for International Relations. He was made a life peer in 1991, and was elected Fellow of the British Academy in 1994.

FOREWORD

MARY ANN SIEGHART

Two decades ago, the collapse of state socialism in Europe confirmed the ascendancy of the market economy and prompted commentators to call liberal capitalism 'the end of history'. In the aftermath of the fall of the Berlin Wall, the Social Market Foundation was founded. Its aim: policies that embed markets in public and private realms, while recognising that government needs to shape them. Its founding principle: that social justice would be created by a well governed capitalist society.

But the recent financial crisis is the greatest challenge to the market economy since the Iron Curtain was lifted. The global capitalist system would have broken down without government intervention. This has challenged people's faith in the market economy, dangerously undermining trust in markets and the important role they can have in creating a fair and just society.

So the SMF has come of age at a time when the economic and social assumptions of the past two decades are being questioned. Can unfettered financial markets price risk effectively? Can the state be an engine of social mobility? Can government deficits be reduced without creating mass unemployment?

In keeping with its role as the leading independent think tank committed to social justice and the use of markets, the SMF has asked leading economists, politicians and commentators to look at these vital questions and contribute to a volume that sets out the challenges for government over the next decade.

When I was approached to take over as Chair of the SMF in the summer of 2010, I was attracted by the SMF's free-thinking approach to policy: unafraid of market mechanisms, but determined to ensure

that outcomes are fair. I also liked the SMF's pragmatic and non-partisan attitude and its blend of open-mindedness, rigour and expertise. In a climate in which politicians of all parties continue to grapple with the fallout of the global recession, it is important to examine economic and social policies afresh, free from the constraints of party politics and tribal agendas.

Throughout its history, the SMF has sought to work constructively with the government of the day, regardless of party, to craft solutions to some of the most prevalent social problems. Originally born from David Owen's SDP movement in the 1980s, the SMF has been variously described as "John Major's favourite think tank", "Blairite", "centrist", "left of centre" and "right of centre". This is no coincidence. It does not reflect a lack of focus or a sense of political "flip-flopping" but rather demonstrates the reality that the social market approach is rich in ideas and solutions for governments of all affiliations.

A social marketeer can be left-wing or right-wing or of no political affiliation at all – as the makeup of both the SMF's board and Policy Advisory Board show. What unites us is our view that in pursuit of social justice, government should use market mechanisms, where appropriate, to achieve the best results.

This view has proved fruitful for almost every government over the past two decades. Many market-based reforms that were unthinkable 20 years ago have been incorporated into mainstream policy due in large part to the innovation and influence of the Social Market Foundation – from the market-based reforms to public services of the later Blair Government, to the current Coalition's focus on 'payment by results'.

So the Social Market Foundation's work is more relevant today than ever. This collection of essays from some of the most influential thinkers in the SMF's history is a clear manifesto for the

future direction of the foundation. The contributions offer both a profound analysis of the difficulties faced by markets in recent years, and of possible social-market solutions to some of the big issues facing government and society in the years ahead.

CONTRIBUTIONS IN THIS COLLECTION

In the course of 2010, the year of the SMF's 21st birthday, SMF commissioned contributions from leading politicians, academics, commentators and economists on the social market. This publication is divided into two principal sections: in Part One, readers hear a range of views from across the political spectrum, including Philip Collins, David Lipsey, David Owen and Peter Lilley, reflecting on how and where social market responses may emerge to confront the UK's post-crash problems. Part Two comprises contributions from the leading economists Robert Skidelsky, Dieter Helm and John Kay who give their take on the merits of a social market approach to the economy, learning lessons from the financial crisis and beyond.

SMF's Director Ian Mulheirn provides an introductory paper that considers how the financial collapse came about and what to do about it. Mulheirn sets out three principal lines of enquiry that social marketeers need to pursue in the aftermath of the crisis: first, reforming public services over a period of prolonged fiscal tightening; helping the economy grow again; and preventing a repeat of the financial crisis.

Philip Collins starts off Part One, arguing boldly that the social market is a radical proposal, not a compromise between Thatcherism and social democracy. Collins notes that in an ideal world there would be a social market party, but that, even though a significant party political realignment is unlikely, social market ideas can flourish through cooperation. Next, David Lipsey, who stood down as Chair of the SMF last year, offers parting thoughts on the continued importance of social market thinking in today's political debate. He highlights potential areas of focus for SMF in the coming years including the issue of excessive profits and remuneration in the financial sector, payment by results in driving public service reform, the nature of regulation, climate change and the challenge of longevity.

In his chapter, David Owen explores the origins of the social market approach, of which he was a notable proponent. He concludes with an analysis of the European context, the need for a rethink about European social policy and asks for a sensible debate on what aspects of the social market economy need to be European, and which national. Last in this section, Peter Lilley explains why, despite the pressures created by the crash, recession and deep public spending cuts, socialism will not be revived whatever the hopes of the left. Reflecting on the debate on the financial collapse, Lilley concludes with commentary on the false assumptions underpinning statist ideas of intervention in the economy, but elaborates a series of arenas where the social market should hold sway.

In Part Two, Robert Skidelsky and Dieter Helm both address the problems balancing consumption, savings and investment, and explore the role of the state in achieving that goal. Skidelsky argues that a series of responses could be taken to the financial crisis drawing on the insights of Keynes. These involve recognising a role for state investment in order to 'steady the economy' and redistributing incomes so as to raise the propensity to consume. As a rejoinder, Helm criticises the short-termism of the Keynesian approach and proposes that 'sustainability' should be the organising principle for the state. Intergenerational concerns – like debt, pensions and the environment – need to inform the emphasis we put on infrastructure and investment in both physical assets and human capital.

The edition concludes with John Kay's exploration of how markets create progress. In particular Kay argues that there has been insufficient emphasis on markets as a 'process of discovery and the importance of the diffusion of political and economic power'. The former underscores that a healthy market economy recognises that disruptive innovations most often come to market through new entrants. Meanwhile, where power is concentrated in

an economy it often becomes self-reinforcing with an increasing propensity to rent-seeking rather than wealth creation.

THE SOCIAL MARKET AFTER THE CRASH

IAN MULHEIRN

The SMF was founded in 1989 – a revolutionary year, not least for the global economy. The collapse of the planned economies gave stimulus to the attempt to marry social justice with market economics. The market system had been demonstrably better than planned economies at boosting living standards for several decades by the time the latter collapsed. The central questions for the UK after the end of state socialism were about the appropriate role of the market in the public realm; how to promote social mobility, limit income inequality and expand individual freedom concurrently; and the regulatory and monetary apparatus needed to stop macroeconomic failures leading to volatile swings between inflation and unemployment.

It was to help to answer these questions that the SMF was established. The social market approach to public policy starts from an appreciation of the basic superiority of the market mechanism in allocating resources, combined with caution about its limitations. As John Kay has put it "markets work: not perfectly, and not everywhere."[1]

By using price to balance supply and demand, markets ensure that resources are put to their most productive use. In healthy markets, competition between providers pushes prices towards the costs of production to the benefit of the consumer. But these 'static' benefits of competition are only one half of the story – and arguably the less important half. Over time, market competition leads to innovation to make new and better goods and services that improve our lives. And, perhaps more importantly, the genius of the market is not some abstract political idea but simply the

1 J. Kay, *The truth about markets: Their genius, their limits, their follies* (London: Allen Lane, 2003)., 337.

manifestation of individuals expressing their own preferences in what they choose to do and consume.

All of this has a bearing on the social market approach to public policy. First, it implies a presumption that markets are to be nurtured not only in the private sphere, but also in the delivery of public services and goods – provided they're well designed. This is a principle on which the more successful reforming administrations in the UK in recent years, from both left and right, would agree. Second, it entails a degree of caution about – although not outright opposition to – the use of taxation for the purposes of redistribution, which distorts the work and investment choices of both net contributors and net recipients. On this view, the market is emphatically not the goose that lays the golden eggs of tax revenue, which can then be redistributed to achieve some higher – and centrally-planned – purpose, as social democrats would have it. Instead it should be seen as an end in itself, representing the intrinsic good of individual freedom. The corollary of that observation is that the legitimacy of redistribution depends largely upon the ends to which it is put. Where it can increase choices and opportunity for everyone, such as through investment in opportunity-enhancing public services, the case is strongest.

The social marketeer is therefore not a free marketeer, but sees an important (although limited) range of roles for the state, and displays a healthy scepticism about the free market for three reasons. First, because market failures are pervasive. Problems such as the externality of carbon emissions causing to global warming, or the information failures that led to the collapse of the UK banking system, can be a serious threat not only to our prosperity but to life and limb. Government has a role in correcting such failures through policy action where the *costs* of doing so are outweighed by the *benefits*. While this argument is theoretically well-worn, many of those who claim to agree often dismiss the role for regulation even in the face of egregious market failures.

Second, while the market is itself a manifestation of individual freedom, it can result in outcomes so unequal as to restrict that freedom only to the better-off. The issue of higher education funding provides a good example here. It is right to charge students a proportion of the cost of their university tuition: both to avoid burdening non-graduate taxpayers with the costs, but also for efficiency reasons. Nevertheless, the state must retain a role in facilitating access for those from low-income backgrounds through subsidised loans and bursaries, to prevent unequal labour market outcomes in one generation unfairly distributing opportunity to privileged young people in the next.

The third reason for caution is that markets do not necessarily create the conditions needed to originate and sustain them. Social institutions such as the rule of law are essential ingredients of the trust that underpins a flourishing market. Meanwhile, beyond the barren and rational world of *homo economicus*, the political sustainability of the market economy depends crucially on its legitimacy: the outcomes of the market economy must be generally considered to be 'fair' if it is to be considered acceptable to citizens. Frustratingly vague as that concept may seem, it implies a clear rationale for government action to provide what Robert Skidelsky, in his founding paper for the SMF, described as 'social goods'.[2] The most important of these, he argued, was steadiness of employment, 'fair equality of opportunity', and wide dispersal of property. Hence a social marketeer, suspicious of government intervention, cannot stand idly by in the face of recession and mass unemployment, on the grounds that the market will self-correct in time.

Over the past 21 years we have seen policy that adheres to these principles and policy that does not. But no political party has had a monopoly on the social market approach – even though that is the

2 R. Skidelsky, *The social market economy* (London: Social Market Foundation, 1989).

thread that binds the most successful ones together. Nor has any administration taken full advantage of it as a way to look at the world.

The shifting debate

Between 1989 and 2007, the UK's political and economic debate moved away from the caricature debate of the 1980s. The Labour party elite accommodated itself to the market, abandoning its commitment to public ownership and limiting trade union influence. In government it used buoyant revenues from historically high rates of economic growth to spend on public services and redistributive transfers. In the realm of public services, Labour initially sought to achieve value through a system of rules, targets and plans. Only once the limitations of command and control became apparent did Blair begin to move in a more social market direction, on health, education and welfare-to-work, frustrated by a coalition of vested interests and opponents within the party.

In the private sphere Labour left largely untouched the economic model inherited from the Conservatives, with the exception of substantially increased wage subsidies and a minimum wage to 'make work pay'. Apparent macroeconomic stability, and the ascendancy of the Efficient Markets Hypothesis, gave the Government little reason to interfere further, despite the need for more scepticism about the sustainability of the status quo.

The Conservatives and Liberal Democrats have had internal battles over social market thinking and the Blair-Brown settlement. In their years in the wilderness from 1997, small-state Hayekian Conservatives clashed with Conservative social marketeers, who partly agreed with New Labour's analysis of the problem – under-investment in public services, and the failure to make work pay at the bottom end of the income distribution – if not its initial prescription. Under Brown's premiership, those modernising Conservatives were able to capture the reforming social market mantel, preferring to orientate the delivery of services towards

individual preference, championing choice and creating funding models that reward providers that give citizens what they want. This thinking is largely reflected in the current government's pronouncements, not to mention many of the specific reforms underway.

With the ascent of the Orange Book liberals from 2004, the Liberal Democrats – always natural decentralisers, albeit for reasons of political expediency as well as philosophical conviction – struggled over the right form of devolution. Should public service control be reformed through market devolution, with power passed to citizens as consumers; or through democratic devolution, with power lying at a local political level. Here, a split between the more social market leadership (who advocate the former) and the activist base (who argue for the latter) has been increasingly hard for the party to hide, especially in government.

If the terms of UK political debate, over the past 21 years, became more measured and mushily centrist, can we now say that 'we're all social marketeers now'? Far from it. While the stark divisions of the 1980s are gone, the internal battles within each of the parties show that the perspectives of social democrats and free-marketeers alike still dominate the major political parties.

Many on the left continue to see markets as, at best, a necessary evil, and in public service delivery a mistake. That is to misunderstand markets as a powerful tool to pursue the goal of social justice that the left prioritises.

Meanwhile on the right, the prevailing view is too often that unfettered markets maximise freedom. This viewpoint underestimates the pervasive imperfections of some markets or their tendency to generate delegitimising levels of inequality, as the recent crisis and its aftermath has shown. In this context, the social market approach has much to offer as a framework for both sides.

The financial and economic crisis

When the financial crisis struck in late 2008, the terms of the political debate were turned on their head. The state's evident exposure to a financial sector, with a balance sheet four times UK economic output, meant that both the role of the state and the regulation of the private economy had to be fundamentally reconsidered. The state's implicit guarantee of the sector was not properly understood until calamity struck. For this reason, and because of the prevailing intellectual climate, risk management and regulatory scrutiny were inadequate to the task at hand.

As an indirect consequence of the financial meltdown, the recession in the wider economy, starved of credit, led to the exposure of a structural deficit in the public finances of over 6% of GDP. The spending debate consequently shifted decisively from how to invest in public services to how to cut back spending on them. This was an abstract debate, involving meaninglessly large numbers, while the state absorbed the debts of the private sector through deficit spending. But now citizens are beginning to feel the real impact of the boom and bust in the form of higher taxes, poorer public services, and wages that are falling in real terms. In this context, broader questions about the appropriate role of the state are set to grow in prominence. But it is hard to pick our way through these debates without a clear assessment of how we came to be in this situation.

Unfortunately, the public discourse on this is highly polarised. Both statist and free-market advocates implausibly claimed that the crash proved that they were right all along, despite the glaring evidence of market and regulatory failure in equal measure. In the subsequent performance of the labour market, where unemployment rose by far less than feared given the scale of the drop in output, credit was due both to the advocates of discretionary fiscal stimulus and proponents of labour market flexibility, as large numbers of employees move to part-time employment.

Despite the mixed picture, the crisis is proving to be a powerful polarising force in British politics. Some social democrats called for Labour to reconsider its liberal economic model. The blame for the UK's current fiscal predicament is pinned firmly on greedy capitalists who wrecked the place and made off with taxpayers' money. On this reading it is possible to extrapolate from failures in financial markets to condemn markets more generally as mechanisms that benefit the rich and are prone to failure at the expense of the poor. Nowhere is this view more potent than when it comes to public services, despite the pressing need for greater efficiency, innovation and responsiveness if they are to weather deep spending cuts in such a way as to retain the support of increasingly demanding citizens.

Some Conservatives, meanwhile, see the crisis as an opportunity to permanently reduce the size of the state. Never mind the obvious market failures and injustices laid bare by the crisis. Never mind the fact that the millions whose jobs have been lost as a consequence of the actions of others might begin to question the fairness of a society where the losses of the financial elite are socialised. Blame for the crisis is aimed squarely at the perceived fiscal profligacy of the left. Meanwhile too much regulation was the cause of the crash among the fruitier brand of economists who appear to believe that the state should extricate itself from guaranteeing its citizens' savings. Even if one buys the argument that it should, it if fanciful to imagine that it ever could. These partial explanations for the UK's current predicament, from both statists and free-marketeers are unhelpful.

But in rejecting these caricatures, are we left only will an insipid mushy pragmatism to guide the policy response to the challenges posed by the crash? No. It calls for a more nuanced analysis. The remainder of this essay provides such an analysis, before going on to set out a social market policy agenda in response.

How we came to be where we are

So what does a more balanced reading of the crisis and its aftermath look like? The causes of the crisis remain the focus of huge debate. But it seems clear that the failures were multiple, and came in the form of a combination of unsustainable international monetary regime, domestic regulatory failures, fiscal imprudence, and a vulnerable economic structure.

While the domestic blame game has tended to revolve around the greed of bankers or the failure of the regulators, it is undeniable that the international monetary policy was an essential ingredient in the crisis. In the wake of the 1997 East Asian crisis many developing countries – not least China – learned that export-led growth combined with currency manipulation and the accumulation of a buffer of foreign exchange reserves would protect them from the devastating impact of volatile capital flows. This new approach, combined with rapid growth in these countries began to generate vast global imbalances by holding their currencies down to make exports more attractive, developing nation governments funnelled surpluses, in the form of cheap credit, into developed nations to finance the latter's unsustainable consumption. It is hard to believe that any financial regulation regime would have been sufficient to completely protect the UK and other developed nations from what Charles Morris has referred to as the "tsunami of Dollars".[3] But it is worth noting the conditions that led to unsustainable asset prices and the US sub-prime crisis was not the result of a market failure or regulatory inadequacy, but a policy decision. One made in China.

Chinese monetary policy notwithstanding, it is clear that domestic regulatory failure was also an important part of the story, leaving the UK economy more vulnerable to a financial bubble than it should have been. There were broadly three parts to the failure.

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3 C. R. Morris, *The trillion dollar meltdown* (New York: PublicAffairs, 2008).

First, was the failure of regulators to keep up with the explosion in complex financial engineering, which put informational distance between regulators and the regulated. Second, alongside lax scrutiny were weak and pro-cyclical capital adequacy requirements which helped to inflate the bubble to ever more precarious levels before exacerbating the problems when it burst.[4] Third there were substantial coordination failures between regulatory jurisdictions, with different financial centres encouraging regulatory arbitrage.

But none of these developments was seen as a cause for alarm because of the prevailing intellectual climate: strong versions of the Efficient Markets Hypothesis acted as an anaesthetic that allowed and encouraged those in authority to let these otherwise worrying developments run.[5] It is ironic as it is unfortunate that those in authority failed to understand the system sufficiently to see that complex securitisation meant that risk got passed not to those most willing to bear it – as proponents of the Efficient Markets Hypothesis would have us believe – but to those least able to understand it. Ultimately the risk – and the losses – were socialised because the political and regulatory system couldn't understand it.

Highly questionable though the behaviour of major financial institutions was, the UK would have been better able to weather the storm had it not been spending beyond its means at the height of the boom. Gordon Brown's fiscal rules dictated his prudence in the early years of the Labour government. But their backward-looking nature made them vulnerable to creative definitions of the economic cycle and allowed the Government to run a persistent structural deficit at what later emerged to be the height of the boom. Not only was spending excessive, but the revenue base was vulnerable too. In the aftermath of the crash it no longer seems wise

4 A. Turner, *The Turner review: A regulatory response to the global banking crisis* (London: Financial Services Authority, 2009), 22.

5 See, for example, International Monetary Fund (IMF), *Global financial stability report: Durable financial stability: getting there from here* (Washington DC: IMF, 2006).

to have relied so heavily for tax revenue on housing and business services growth – both sectors fed by the financial services bubble. This has implications for how taxes are levied, but also for whether policymakers should be concerned about industrial diversity.

The final major cause of the current predicament was unbalanced economic growth. Despite all of the problems above, the UK's vulnerability stemmed in part from its exposure to financial services in which it leads the world. Industrial diversification runs counter to principles of specialisation on which advanced economies are based, but the risks associated with being a monoline country are now apparent as never before. While being cautious about what policy should, and modest about what it can, do to engender industrial diversity, policymakers should take note that diversity – both sectoral and geographic – has its own insurance benefits.

Whatever the exact balance of these causes of the crisis, the impact will be most keenly felt in unemployment; lower real spending power through tax rises, inflation and wage stagnation; and public service cuts. Informed by this analysis, what would a social marketeer advocate in response to all of this? For the Social Market Foundation there are broadly three areas lines of enquiry that emerge from the crisis:

- how best to sustain and improve public services over a period of prolonged fiscal tightening;
- how to help the economy to grow again; and
- how to prevent a repeat of the financial crisis.

What to do about it: public services

In the face of cuts and demographic pressure, the challenge facing public services is likely to be a debate that shapes this decade. In practical policy terms, the Coalition is attempting speedy and wide-ranging reform of public services, introducing many market

mechanisms that the SMF has championed over the years – most recently in welfare to work and offender management – and some that it has not. The principles behind these reforms are to achieve more personalised, efficient and responsive services that deliver better outcomes for citizens at a lower cost.

In the debate on public services reform, the need to cut public spending rapidly has led to the conflation of two distinct issues: the appropriate level for public spending and the mechanisms by which services should be delivered. Those on the right want a lower level of spending, and see market-based reforms as a mechanism to sustain service quality in that context. For many on the left, the potential of market delivery mechanisms is tainted by its association with arguments about lower levels of spending. But questions about the level of spending and the mechanism for service delivery *given that level* should be distinct. Social marketeers may disagree much more over the appropriate *level* of spending than on the best *means* of delivery.

The practicalities of market-based reform are complex. There are many ways to skin the market reform cat. It can be done well or badly in much the same way as centrally planned policymaking. Public service markets need careful design and stewardship to get the right results for citizens. This much is clear, but much of the debate and disagreement about markets focuses not on questions of practicality but principle.

Detractors advance a range of often specious arguments against the principle of market-based reforms. First, concerns are often raised about the propensity for markets to exacerbate inequality. Will markets in, say, healthcare lead to the poor getting a lower quality of service? If this were true, it would be a major concern. But this fear is misplaced. Markets can exacerbate inequality where people come to them unequal. Through state funding, however, citizens come to a public services market on the

same terms. Indeed, government can rig the system in favour of the most disadvantaged – as in the Work Programme or the Pupil Premium (in both of these cases this has unfortunately happened to only a limited degree). As such the less well-off are more likely to receive equal (or better) treatment than in services where resources are allocated from the centre, as a large body of work has demonstrated.[6] There is, therefore, nothing contradictory between the market and the pursuit of social justice.

A second complaint is that it is unacceptable for private investors to profit from delivering public services. But apart from the fact that the definition of which services this principle should apply to seems arbitrary – is it unacceptable for grocers supplying school meals, or contractors building public roads to profit? – surely what matters to taxpayers is achieving the best possible services at the lowest cost. Why should it matter how this is done?

Another common objection is that markets lead to postcode lotteries. It's not clear why this problem should afflict a market system any more than it has tended to in a state-run one. Indeed, in a properly functioning market, the capacity for consumers to punish poor providers by taking their custom elsewhere should act to raise standards across the board, as numerous studies in healthcare have shown.[7] A market should *reduce* the lottery, not exacerbate it.

Fourth, many complain that markets can lead to lower quality provision, particularly when services are contracted-out. However, the contestability that bears down on costs need not entail private sector provision: public providers can compete too. And while there is a risk that government turns commissioning rounds into

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6 J. Le Grand, *The other invisible hand: delivering public services through choice and competition* (Princeton: Princeton University Press, 2007).

7 Z. Cooper, S. Jones, A. McGuire and J. Le Grand, "Equity, Waiting Times and the NHS Reforms," *British Medical Journal*, 339:32 (2009), 3264-3271.

price competition, what evidence there is on contracting out suggests that the deteriorating quality argument, as a general rule, is unfounded. In 2008, DeAnne Julius undertook a comprehensive trawl of the evidence on contracting-out for the Department of Business Enterprise and Regulatory Reform, and concluded that:

> *'The evidence shows that there are clear benefits, to both users and taxpayers, in subjecting incumbent service providers to competition. The academic literature typically found the cost savings from competitive tendering to be between 10% and 30% (including when the in-house team won the bid) with no adverse effect, and sometimes an improvement, in service quality.'*[8]

Finally, many claim that competition between providers will be the enemy of cooperation, resulting in fragmented services that help nobody. But competition and cooperation are not antithetical in a market. The success of large companies, operating in many of the most competitive goods markets, at coordinating complex supply chains of global reach is evidence of that. In the same way, to compete effectively in the final service offered to a patient, a healthcare provider needs to cooperate closely with other service providers to meet that patient's needs in a joined-up manner. The market will punish those who don't cooperate in the patient's interest, not those who do.

Despite the weak arguments against the principles of reform, practice is inevitably more problematic. And whether the pace and scale of the Coalition's agenda is wise or possible, coming in conjunction with departmental budget cuts of some 19% on average, is not yet clear. Poorly designed systems will deliver poor results, under a market or in the absence of one. Evidence suggests that introducing price competition in healthcare, for example, is

8 D. Julius, *Public services industry review* (London: Department for Business, Enterprise and Regulatory Reform, 2008).

liable to lead to increased mortality as harder-to-assess service quality suffers.[9] The principle of supply side liberalisation – as far as it goes – in education is unlikely to make much difference unless failing schools can be credibly threatened with closure. The Work Programme is a step in the right direction, but unless the Government's minimum performance requirements of contractors are allowed to respond to an unpredictable labour market outlook, the taxpayer is likely either to have to bail-out providers struggling with low labour demand, or hand them undeserved profits if employment grows quickly.[10]

Worryingly, a pattern is emerging of only partial reform across many of the public services that the Coalition is seeking to change. While arguments about the benefits of choice and competition have been behind reforms to Higher Education, the NHS and schools, whether meaningful choice will emerge is doubtful. Without citizens facing a variety of services to choose from, any purported benefits will be heavily circumscribed. In HE the Government's inability to remove the student quota makes it hard to see how good universities will be able to expand and bad ones close. The Government's fear of allowing privately-financed Free Schools will mean insignificant extra choice for parents, again cementing the position of poorly-performing institutions. Meanwhile in health, the Government has watered down earlier plans to close poor performing hospitals at a likely additional cost of £500m per year.[11]

Importantly nothing about the establishment of markets in public services necessitates private provision. A pro-market approach is not the same as a pro-business one. Pluralism in provision, not legal structure, is what matters. Nevertheless, in

9 C. Propper, S. Burgess and D. Gossage, "Competition and quality: evidence from the NHS internal market 1991-9", *The Economic Journal* 118: 525 (2008): 138-70.

10 House of Commons, *Work programme: providers and contracting arrangements: Government response to the Committee's fourth report of session* (London: HMSO, 2011), 9.

11 S. Gainsbury and N. Timmins, "Hospital failure proposals criticised", *Financial Times*, 15th July 2011.

many areas there are often benefits to non-state service provision and investment, and therefore service quality. Indeed, unless government is willing to invest in sufficient capacity in many service areas, private investment may be essential. One way or another, investment will be necessary for the public service reform agenda to work.

Weak productivity growth in public services in recent years has rightly been identified as a major challenge. But while efficiency improvements are necessary, they will not emerge if politicians are willing only to cherry-pick the politically attractive parts of the market reform agenda: choice without alternative providers and competition without a failure regime are all but meaningless. The SMF will continue to advocate for reform that acknowledges these realities.

What to do about it: growth

An equally pressing policy challenge in the wake of the crash is how to boost economic growth. Since the formal end of the recession performance has disappointed, showing the economy to have largely stagnated. Most worryingly, this started to happen largely before the impact of public spending cuts was felt. Public spending cuts are unavoidable and deep ones at that, given the sovereign debt crises sweeping the globe. With households rapidly paying down debt and government joining in, exports and investment are the two remaining routes to economic growth for the UK. Given the prognosis for growth in the UK's main export markets – the Eurozone and the US – it is clear that we're in for a sustained bout of weak demand and are therefore reliant on investment to provide much of the growth. In an environment of chronically weak demand, it seems like wishful thinking to imagine that private sector on its own is going to be the source of sufficient new investment.

The Treasury hopes that sustained low interest rates, and if necessary more Quantitative Easing by the Bank of England, will

sustain aggregate demand while the state retrenches. But this approach is likely to be either ineffective or dangerous depending on your view of what the problem with the UK economy is.

One argument is that growth is elusive because of persistently weak demand from consumers, government and foreigners. This being the case in spite of rock-bottom interest rates, it seems unlikely that any amount of cheap money will encourage businesses to invest: why would they do so if there is nobody to buy the resulting output?

The other argument is that the economy has flat-lined because the recession destroyed large quantities of productive capacity, and productivity growth is weak. On this view, attempts to boost aggregate demand through looser monetary or fiscal policy are liable to result in further inflation, which risks getting out of control.

While it seems unlikely, with unemployment running at almost 2½ million, that the economy is near full capacity, the challenge for policymakers must be to seek to boost demand in a way that expands the productive capacity of the economy. This can be achieved through state-led infrastructure investment – something made all the more attractive by the low cost of government borrowing.

Here the planned Green Investment Bank is a start, albeit on a very limited scale. As long as investments are made in respect of infrastructure that yields a direct and quantifiable return – such as transport, energy and information infrastructure – it would be possible to provide both a finite demand boost and expansion of productive capacity. The latter would, by cutting operating costs, in turn stimulate complementary investments by firms. Given the antiquated and congested state of the UK transport infrastructure, and the huge challenges the UK faces in the energy sector, it is difficult to argue that such opportunities for growth-enhancing productive investment are limited.

In the current context of chronically weak demand and possibly quite limited spare capacity in the economy, it seems unavoidable that the Government will, before long have to focus on the investment question. In doing so, the challenge will be to ensure the appropriate mix of cheap public finance and private investment to ensure efficient allocation of resources. Partnership between the sectors is essential if price signals are to guide resources to productive opportunities, but excessive reliance on increasingly costly private finance will no longer satisfy our infrastructure needs. Achieving the right public-private mix is something that the SMF is keen to focus on in the coming months.

What to do about it: stopping it from happening again

The third big policy challenge emerging from the financial crisis is how to stop it happening again. As indicated above, many of the answers lie in the international sphere, but the domestic financial regulation agenda is also important. Here, the over-riding aim must be to cut the mind-bogglingly huge implicit taxpayer subsidy that the banking sector currently enjoys. According to Andrew Haldane at the Bank of England, that subsidy amounted to around £100bn in 2009.[12] The subsidy allows banks to take riskier bets and make bigger profits than if they stood on their own two feet. It derives from two sources: that the Government is bound to come to the rescue if citizens' deposits are at risk; and that many of these institutions are too big to be allowed to fail by the taxpayer because of the economic shockwaves that would result. As John Kay has argued, this situation is neither compatible with democracy nor a market economy.[13] As well as contradicting the principles that underpin a market economy, this situation is at least partly to blame for recent economic volatility, the costs of which fall mainly on the poor.

12 A. Haldane, "On tackling the credit cycle and too big to fail" (speech to the University of Edinburgh Business School, 21 March 2011).

13 J. Kay, "Should we have 'Narrow banking'?" in *The Future of Finance: the LSE Report*, ed. The London School of Economics and Political Science (LSE) (London: LSE, 2010), 213.

Yet in many quarters there is reluctance to go as far as advocating the complete separation of the retail and wholesale functions at universal banks. Less drastic approaches, such as 'subsidiarisation' – the ring-fencing of retail deposits – would still allow some transfer of capital from the utility to the casino parts of such banks, leaving taxpayers still on the hook. For many, that caution stems from the fear that a radical separation of the two banking functions might cause the UK's prestigious universal banks to leave the UK for more welcoming regulatory shores. That would damage the pre-eminence of the City and cost the Treasury huge amounts in lost tax revenue from a sector that provided over 30% of corporation tax receipts in 2008 (albeit far less after the crash).

But would it matter if investment banking left the UK? The presumed trade-off between fiscal pragmatism and the regulatory probity is in fact a false choice, based on a partial view of how a globalised economy works.

The UK will not be reduced to subsistence farming and exporting fish and chips if the banks leave. During the long boom years for finance, the City exported its services all over the world. But its success came quite literally at the expense of other would-be exporters. As with a similar phenomenon experienced by Holland's exporting sectors – squeezed out after the country found gas reserves in the late 1950s – our non-finance exporters have become uncompetitive overseas in the face of the strong Sterling that resulted.

If appropriate regulation of our universal banks leads to bank flight, it would also remove our own 'Dutch disease'. Other export activities would become competitive overseas, allowing the sources of UK economic growth to diversify geographically and sectorally. Tax revenue from the new exports would replace those from the old. Indeed, it might even increase, given the skill with which financiers avoid corporation tax. For these reasons it is important

that policymakers make financial institutions self-sustaining, and eliminate the inefficient and inequitable taxpayer subsidy, if we are to prevent a re-run of the 2008 financial meltdown, which is largely responsible for our current broader economic malaise.

Conclusion

The financial crisis and ensuing recession have profound implications for public policy in the UK. Painful though it will be, public spending must adjust to the new fiscal reality. Government will have to think harder than it has for 30 years about how to promote sustainable economic growth. The challenge of preventing a re-run of the crash – and resolving the inequitable and inefficient state of affairs that led to it – is as important as it is complex.

In addressing these challenges the social market provides an important framework for policymakers. Markets are powerful tools for reform in the public realm, but those markets need careful design and stewardship if they are to work to create value rather than simply becoming a mechanism for distributing rents to private investors. In the private sphere the message is similar: public institutions, particularly regulators, can and should be the ally of competitive markets and the enemy of rent-seeking. It is simply incorrect to claim that unfettered markets are always competitive, sustainable and efficient value-creating systems.

The big policy challenges for this Parliament are: effective public service reform, the challenge of delivering investment-led growth, and the need to ensure that the financial sector never again threatens the stability of the market economy. In each of these areas it is the same social market principles that hold the keys to success.

PART ONE

THE SOCIAL MARKET: TWO DECADES ON

PHILIP COLLINS

What is the social market?

The social market is an idea from the European right imported into Britain by the dissident left that now has a contested political home. It originates with the German Christian Democrats and the works of Wilhelm Röpke – but we will not unearth its relevance for Britain there. The social market in Britain was, instead, the ill-defined legitimation of the Social Democratic Party. For quite some time it was a reasonable summary to say that the social market was what David Owen did.

As philosophical support for a party of the "radical centre" that was a refugee from the left, it is inevitable that the first term in the pairing came to be seen as a caveat on the second. There is something apologetic about the social market in its early years, as if its advocates understood they were obliged to accept market economics but wanted to prefix it with something more solidly familiar and appealing.

This account of the social market contrasts with that in which the apology runs the other way. There is a certain kind of conservative for whom the word "social" is a welcome back to civilized company which they fear, with their previous market advocacy, they may have abandoned.

All of this leaves too much unsaid. There is no need for the social market to sound like it would rather be something else or a failed solvent in which two incompatible liquids mix uneasily. The best account of the social market is still Robert Skidelsky's founding paper for the SMF. In this paper we no longer see the join and the social market emerges as an important compound term which has three main components.

The first is that all markets are inescapably social organisms. That is to say that they work within host societies and they are inseparable from the civic networks and institutions to be found there. To take only the most obvious example, a sophisticated market is inconceivable without an extensive array of laws of tort and contract and the means for effective enforcement. Such laws are a fatal desideratum in many nations and, even in developed countries, they take drastically different forms, lending a different variety to the form of capitalism that prevails.

It follows from this claim – that the line between politics and markets is thin to the point of invisibility – that markets have obvious social consequences. Market societies have a great deal in the credit ledger – in the battle with the command economies to generate prosperity they won a decisive victory. But a social market economy is one in which it is understood and proclaimed that there are other values besides prosperity and that the outcomes of market processes are neither necessarily fair nor just. Markets can have egregious results, results which might even throw into disrepute the very legitimacy of the social market order itself. The ludicrous remuneration of some bankers is a case in point. Of course there is always an argument about what counts as an egregious consequence but, for the moment, all that needs to be established is that the social market is not the product of laissez-faire economic thought.

This widening of the focus leads to the third argument for the superiority of the social market over alternate political guides. It is no small matter that market economies will, for good reason, defeat command economies, or extensively planned economies, in the fields of production and exchange. But imagine for a moment economic identity between two nations, one of which was governed by a comprehensive system of collective planning while the other was the upshot of the unstructured actions of players within a market.

The advocate of the social market would argue that there is good reason to prefer the latter society because it is a considerably more hospitable system for a plural and heterogeneous civil society. A nation in which individual difference can flourish according to desire is a good to be pursued for its own sake. Diversity is an intrinsic value of a social market and to the extent that some markets tend towards monopoly, public vigilance will be required. The social market is a plural doctrine, which begins and ends with the ugly term subsidiarity – that power should be at the lowest possible level.

The political journey of the social market

That is the nature of the idea and it is now, in its British incarnation, twenty years old. Not many political formulas wear well for twenty years. Certainly, most ideas associated with the political left in Britain have worn badly over that same period, notwithstanding the capacity of its adherents to carry on proclaiming them. It is a shame, in a way, that no political party has taken on the social market mantle and become its undisputed champion. Perhaps that is, at least in part due, to its original association with the brilliant explosion of David Owen. Although, as David Marquand has pointed out, Owen never really developed the idea beyond some rudimentary political slogans it was, without question, his property as an idea. To that extent the social market became damagingly associated with the vicissitudes of his more than usually volcanic political career.

With the deposition of Margaret Thatcher as Prime Minister in 1990 and her replacement by John Major, social market ideas came into government, not least because the SMF's second Director, Daniel Finkelstein became, in 1992, the Head of Research at Conservative Central Office. Though the Major Government was fatally blighted by the economic collapse of Black Wednesday, by the party's debilitating obsession with the European Union and by the curiously diffident character of the Prime Minister himself, social

market ideas can certainly be discerned in its education and health policies. Indeed, the reform programmes of the later Major years, which drew on SMF work, prefigure some of the later controversies of the Blair premiership.

The Conservative years as a whole contained elements of public policy that derive from the tradition of social market thought. This was true under Thatcher, too. The battles over trade union law reform, privatization and the Falklands war are the headlines of the Thatcher period. But Kenneth Baker's school reforms and Kenneth Clarke's usually fruitless battles with the professions at Health and the Home Office were guided, at least in spirit, by social market impulses. By the end of the Conservative period of office, independent status (grant maintained) was available for schools, funding followed the people, the principle of parental choice had been enshrined in legislation and GPs held the health budgets.

It is hard to detect much of an SMF tone to the early Blair years. Blair himself was a restless reformer but his attention in opposition had been, understandably enough, in ensuring that his party was electable and therefore, in his view, as close to invisible as possible. Such policy development as had occurred was either the legacy of John Smith (devolution) or an ill-starred reversal of good policy begun under Major (health and, to a lesser extent, education).

Indeed, the first Labour term, judged solely by social market criteria, was a regression. GP fund holding was replaced – later to be, in effect, reinstated. The schools reforms of the Baker period were reversed too, only to be echoed by Trust status and City Academies in the second Blair term.

In time, the Blair Government changed its character. The usual verdict on the Blair years – great start that all went wrong as time went on and foreign affairs came to dominate – seems, from a social market perspective, exactly wrong. The first term, with its

collection of small-scale central initiatives, was more or less wasted in undue caution. It is only in the second term, gathering pace in the third, that serious social market change began. The system of payment by results and patient choice in the health service and the Academy programme and tuition fees in education suddenly began to open up public services in a desirable way.

It has to be said that the enthusiasm for social market reform that was exhibited in the later Blair years was not carried through into the premiership of Gordon Brown. Indeed, the gradual disintegration of the Labour Government's fortunes have raised once again the question of which party (if any) is keen to wear the mantle of social market ideas.

The answer came in the form of an inevitable Labour defeat and the emergence of the new Coalition Government, combining the social market wings of both the Conservative and the Liberal Democrat parties.

Of course the dominant political fact of 2011 is the deficit and the consequent need to cut public spending. As Tony Blair argues in the postscript to his memoir *A Journey* these are economic conditions which make serious reform even more vital. The Lib-Con Coalition faces unfavourable circumstances in which to act – conducting an experiment in social market reform at the same time as cutting public spending is going to be very difficult. That said, the two main areas in which social market intentions to reform are visible are education and health.

The Education Secretary, Michael Gove, is an obvious convert to the social market philosophy. He wrote to every primary and secondary school in England inviting them to become an Academy. The City Academies were, until the policy was watered down by Ed Balls, one of the best reforms of the Labour period. His intention is that schools that are ranked as outstanding by the inspectorate –

about one in five – will be fast-tracked into academy status by the autumn. They will have the same freedoms and status as the City Academies and will not be subject to local control. The coalition Government also wants parents and charities to set up completely new schools like the Swedish free school model or American charter schools. Policies have many authors but both of these ideas were proposed by the SMF in a series of publications on choice in education in 2004. There is, though, one important difference. Labour's Academies were all established in deprived parts of the country. Mr Gove plans to begin with the more affluent areas.

The place of social justice in social market thinking is the subject of much dispute. There are those from the political right who see it as an encumbrance on the social market and there are those on the left, still within the social market fold, who see social justice as an intrinsic property of a social market. Perhaps the best resolution of this argument is to say that when the market throws up an obvious injustice that casts doubt on the social market model itself. Therefore, clear cases of injustice matter enormously to social market thinkers. It is not enough to say simply that the upshot of market encounters is, ipso facto, just.

The same trend can be seen in health policy, although to greatly more uncertain effect. The plan announced by the Health Secretary, Andrew Lansley, envisages the phasing out of strategic health authorities and many of the powers of Primary Care Trusts will be granted to new consortia, led by GPs. These new consortia will be given the power to commission although, at the time of writing, it is by no means obvious that it is a power they relish. This is another lesson about reform of a social market character, indeed any reform at all. If it designed poorly it will not only not work it will make subsequent reform of a similar kind all the more difficult to enact. Adversaries of reform, of which there are many, will not distinguish between good and bad variants of an idea.

The Social Market Party

The doubts that advocates of the social market approach must always entertain about social democrats and conservatives points to a bigger philosophical question. Social markets emerge naturally out of neither, but from political liberalism. The abiding shame of British politics is that the liberals are scattered amongst three parties rather than concentrated into one. Given that both of the two main parties seem to win the consent of the electorate only when their liberal wings are uppermost, it would, if it only had a social base, be a highly successful enterprise.

This is not to say it is at all likely. From the point of view of one who was concerned, most of all, with establishing a social market approach to politics, a thorough realignment is devoutly to be wished. But, for all the current attempts of the coalition, there are two reasons why the future of the social market idea in Britain is likely to remain alternate administrations of partially committed parties rather than the full-blooded endorsement of a liberal party.

The first reason is the most important. Even at the depths of its unpopularity in 1983 the Labour party retained the vote of 28% of the electorate. It lost in 2010 with 29% of the electorate. It has roots that clutch. Those roots are stirring: slowly the tree will begin to move. But it is sturdy enough for the foreseeable future. Not sturdy enough to win a majority of the electorate but strong and tenacious enough to survive as a viable independent force.

The last time there was a major change in the political parties in Britain – when the Labour party supplanted the Liberal party in the mid-1920s – there was one obvious and huge difference with today. The electorate had changed. A series of Reform Acts over a thirty-five year period had changed the nature of the voting public beyond recognition. The working class had been enfranchised and a party had emerged out of the trade union movement to ensure they were represented in parliament.

The second reason was that the incipient ability of the Liberal party to respond to the new electorate, and accommodate its needs within an expanded radical liberalism (a possibility which as acute an observer as David Marquand entertains) was squashed by the split in the Liberal party after 1916 between the followers of the deposed Asquith and the supporters of his conqueror, David Lloyd George. And, of course, there was an epochal issue standing behind that extraordinary split – the Great War.

There is no comparable change to the nature of the electorate today. It is true that the public is more politically volatile than it was. It is true too that the public is less likely to vote automatically for one of the two main parties. If we project these trends forward – always a dangerous assumption – then we arrive eventually at realignment. But, unless the Labour party undergoes a serious convulsion in response to defeat, occasioning a split and the creation of a new party, it is difficult to see this as the harbinger of a central Liberal party.

So whoever demands social market ideas is likely to have to make their peace with those agreeable elements in the existing parties. But, in that sense at least, the omens are good. The Labour party has rid itself of the ideological dirigisme that was an article of faith for even its most revisionist thinkers. The Conservative party has had a decade-long lesson in the fact of economics that markets are sophisticated social creations, neither free nor necessarily to be left alone. The coalition has given a chance for the liberals in both parties to practice social market policies – so even if the party arrangement doesn't last more than one term, the policy ideas could well leave a legacy of social market innovations which will be heard to pull up.

The answer now, as it has been for a long while now, is to civilise capitalism rather than to fantasise about replacing it. Both social democracy and conservatism have their tendencies in this

direction and so the future for the social market will be to civilise them rather than fantasise about their replacement.

To this limited extent, coalition government is good because social market thinking operates at the point of overlap between the parties. There are social market thinkers in all three parties and when two come together it is likely that they will find their common ground in a set of ideas which bear at least a family resemblance to the ideas ably promulgated, over twenty years now, by the Social Market Foundation.

THE FUTURE OF THE SOCIAL MARKET – AND ITS THINK TANK

DAVID LIPSEY

Free market conservatism and interventionist socialism are dead. We are all social marketeers nowadays. So is there any need for the Social Market Foundation – the think tank which has the propagation of the social market philosophy and practice as its objective?

To see why we do, we need to understand where we have been, and where we are. There follows a potted history.

In 1989, the Social Market Foundation was founded. Its birth came as the political party to which its progenitors belonged was dying. David Owen was one of the "Gang of Four" self-styled social democrats who defected from the Labour Party as it yawed to the left in the early 1980s. That act apparently fed Owen's appetite for fissure. When the bulk of their Social Democratic Party decided to amalgamate with the Liberals after the 1987 General Election, Owen dissented. He felt that there was an ideological gulf between what the Liberals believed and what he and his followers believed. He and his disciples were social marketeers and the Liberals were not. So he left his colleagues who formed one half of the Liberal Democrats. In 1988 he set up his own party, the Social Democratic Party Mark 2, to carry the banner of the social market into the electoral marketplace.

Unfortunately for him, voters proved less moved by the philosophical distinction between the Liberals and the Social Democrats than he was. His new party was wound up in 1990 after finishing an ignominious seventh in the Bootle by-election, behind even Screaming Lord Sutch's Monster Raving Loony Party.

However, it did have one lasting memorial: the Social Market Foundation. Set up by a mildly eccentric peer, Alastair Kilmarnock,

and gifted substantial core funding by another, Lord Sainsbury, the SMF has long outlived its progenitors.

A tendency to follow the intellect rather than bow to the conventions of partisan politics has been a characteristic of leading SMF figures. My predecessor as chair, the distinguished historian and economist Robert Skidelsky graduated from the Social Democrats to the Tories, then fell out with them and now sits in the Lords as a crossbencher. I meanwhile expect quite shortly to complete my half-century as a member of the Labour Party but my egalitarian, non-liberal, anti-regulatory and anti-choice views have little in common with whatever it is the Labour Party under Gordon Brown believed in. Fortunately for my psychic comfort, Ed Miliband is now tiptoeing cautiously towards a new Labour philosophy.

Two SMF directors, Danny Finkelstein and Rick Nye also went the SDP-to-Tory route, though Finkelstein, who did not get selected for a winnable Tory seat, is now a senior journalist on *The Times*. Philip Collins, a later director, is also at *The Times* via becoming an adviser and speechwriter to Tony Blair. Even by New Labour standards, he is hard to classify as a man of the left. The present and excellent director, Ian Mulheirn, has no public political allegiance.

As for our distinguished board, now chaired by Mary Ann Sieghart, it has members with allegiances to the three major parties, and members with no partisan allegiance at all. Party divides have no correlation with the position board members take on what issues SMF should be focussing on, where all display complete independence. It is to the SMF and the SMF alone that the Board owes its collective allegiance.

The focus of the organisation has changed over time too. Some indication of this can be gleaned by surveying a list of the 200 plus publications it has produced since its launch. In the early days, wide ranging philosophical pamphlets were commonplace: Robert

Skidelsky's *Social Market Economy* of March 1989, John Gray and David Willetts *Is Conservatism Dead?* In 1997, John Kay's *Community Values and the Market Economy* in 1997. More recently however there has been a concentration on specific policies, for example, Stephen Evans's *Disability, skills and work: raising our ambitions* in 2007 and Dr Henry Kippen's *Anglo-flexicurity II: insuring against unemployment in the UK* in 2009, with my own *The Social Market and its Enemies* of 2009 an exception.

Along the way Robert Skidelsky became fascinated with the liberalisation of Eastern Europe. The SMF spawned a satellite organisation, the Centre for Post-Collectivist Studies, which concentrated on this topic. Today's leadership of the SMF might look to other countries for examples of how Britain might do things better, but it would not regard pushing for reforms abroad as one of its core functions.

As Chair, I preferred a less hands-on approach to determining the priorities of the SMF than my predecessors. That is a job, I firmly believe, essentially for its director in consultation with the board. My first director, Phillip Collins flirted with turning it into an organisation whose principle focus was liberty. In his provocative moments he would illustrate by defending the liberty of smokers, and the feebleness of the evidence (as he saw it) linking passive smoking with ill health. But this was not an approach which ever attracted the board or the chairman, and it had relatively little impact on the SMF's essential mission.

For under Collins, and even more under his successor, Ann Rossiter, the SMF's focus was more and more on public service reform. This included the privatisation of delivery (in the early days a more controversial policy than it later became); the use of market and quasi-market mechanisms to promote efficiency; and the extension of choice and work incentives. Pamphlets poured from the presses on education, health and transport (particularly, and appropriately, road pricing).

There were four reasons for this shift from the broad philosophical to the narrower practical.

First, public service reform was the focus of the government and indeed most politicians, as they struggled with reconciling the services people demanded with the taxes they were willing to pay. Tony Blair in particular saw little fault in the private sector and glaring weaknesses in the public sector, the scars of which, he famously said, he bore on his back.

Second, politics in general was becoming less ideological and more practical. The SMF was founded at the end of a decade where a gulf had opened up between free-market Conservatism, statist Socialism and a Social Democratic/Liberal middle way. With Margaret Thatcher's replacement by John Major, and Labour's long march back to sanity under Neil Kinnock, ideology was in decline by the time the SMF was born, but back then it still mattered. Twenty years later, it is dead or all but dead.

Moreover, the advent of coalition politics – both in its current incarnation and in the previous Labour Government's broad coalition of modernising centrists and trades unions – has necessitated a move away from philosophical issues towards the practicalities of government.

Third, over the past decade this has been accompanied by a revolution in policymaking. Social scientific practices of rigorous data collection, analysis and a focus on what works have, rightly, superseded ideological rectitude.

Finally, the financial crisis and public sector deficit has forced policymakers to look at how to squeeze the most from the public purse whilst balancing fiscal and social responsibility. This has taken policy and political discourse into areas of work long associated with the Social Market Foundation – the use of market mechanisms

to ensure social justice, payment by results, accountability and more.

The gaps between the parties are narrower than they have been in recent recorded history. They are narrower even than in the days of Butskellism in the 1950s and 1960s. Today, politics involves extremely shrill argument about issues which are fundamentally technocratic. So a think tank like the SMF which does not wish to be shrill has to concentrate its efforts on the technocratic problems.

To define our future focue, we did produce a piece, signed off by the board, setting out what these days is called our mission statement:

> *"The social market philosophy seeks to marry markets and social justice. It neither sees the market as a necessary evil nor as an end in itself but as a means to improve people's lives. The social market has been the radical force at the centre of British politics since the 1980s.*
>
> *Two key principles underpin the social market approach: a positive preference for market mechanisms, while recognising that a truly pro-market approach is often not a free-market one; and a belief that a sustainable market economy rests on social and political foundations that are widely regarded as fair.*
>
> *Well-functioning markets distribute resources efficiently. But they are also a manifestation of personal freedom, with open exchange allowing people to express preferences, often more effectively than they can through politics. The state must therefore protect the competitive environment from the dangers of both free-market and statist approaches: public or private monopoly, and government and market failure.*
>
> *The state also has an essential role to play in promoting social justice, so that the market can work for everyone in society. A lack*

of social justice can lead to a sense of unfairness that erodes the legitimacy of the market economy and threatens its existence. In pursuit of social ends, government should use market mechanisms, where appropriate, to achieve the best outcomes."

So: what does this mean for the future work of the SMF? That will be for the current chairperson and the board to determine, but I might be permitted the legacy of a few thoughts. Generally, the work of the SMF should:

1. **Have a clear and recognisable relationship with the concept of the social market**, namely that markets are the key to the efficient production of private and often public goods but that they have to be rendered compatible with the imperatives of a "good society".
2. **Be relevant to current active debates** in the public policy sphere; and have the prospect of influencing policy both through visible media coverage and through various forms of networking and propagation.

What might feature on our agenda in the coming years? There are some broad philosophical issues that we ought to be looking at – many of them canvassed in the contributions to this book. The first of these is the future of financial markets.

The financial crisis of 2007-09 has meant that a number of assumptions that were widely accepted about financial markets are now unsustainable. For example, it is clearly not the case that financial markets behave entirely (or even largely) rationally. Banks cannot be relied on to behave prudently if they are subject to "light touch" regulation. (Whether they can if they are subject to stricter regulation is however a moot point). A free(ish) market in finance cannot be assumed to maximise growth and prosperity. It may matter after all if you have an economy which is reliant on financial products, and no longer farms or manufactures.

On the other hand, it would be disastrous if the malfunctioning of financial markets provides ammunition for a crusade against markets in general. A think tank like the SMF has to point out the contribution of an unbalanced global financial system (American deficits, Chinese surpluses) made to the problem. This is the fault less of markets than of governments interfering in them.

For example the mercantilist Chinese government has deliberately depressed its exchange rate, resulting in enormous surpluses. These surpluses have flooded into Western markets, becoming part of the credit bubble. Similarly, in the US, after the 2000 to 2001 recession, the US Federal Reserve acted quickly to push down interest rates in order to maintain employment, which also inflated it.

Any holistic analysis of the crisis has to examine the role of governments and of regulators as well as of poorly regulated markets. Had the Chinese allowed their currency to float – upwards as it would have – and had the Fed kept interest rates higher the crisis might not have occurred or, if it did occur, might have been less serious.

A balanced analysis, of which the SMF should be capable, will conclude that a complex crisis cannot be ascribed to a single cause. And it would probably conclude that, contrary to leftish opinion, this is not a time to be chucking babies out with bathwater – for example, by a return to Glass-Steagall Act in the US. Banking liberalisation turns out to have higher costs than had been realised; but it still has many benefits.

One particular area where the SMF could bring a unique perspective to bear is the fraught issue of bankers' bonuses. Is high pay merely the excess profits made on the back of a government bailout? How much can be done to curb top remuneration through better governance, for example by a greater empowerment of

shareholders, and a revision of the workings of remuneration committees? Is there scope for an ongoing High Pay Commission, as proposed by the think tank Progress? Should it have powers, or merely exercise moral suasion? What should be the role of the government as a major shareholder in the banks? In tackling these and other questions, the SMF's perspective as a believer not just in markets but also in social justice could have much to contribute. And that will be particularly so when it comes to getting beyond broad generalisations and into the nitty-gritty of effective policy.

A second broad area which will remain crucial for the SMF is the area of public service reform. This area has been covered in detail earlier on in the paper so I will only focus briefly on it here. During the past few years, when public money was spent as if it grew on trees, value-for-money – ministerial protestations to the contrary notwithstanding – was an optional extra. However we are now entering a period of an unparalleled squeeze on public spending.

We should beware the siren voices of politicians claiming that we can always get more for less. In particular, there is something stomach-turning about the way, every time government wants to spend more, it claims that it can be paid for by "efficiency savings" – such as the Labour government said local government should use to pay for its extravagant free personal care at home policy. Efficiency savings are easily mandated but in practice hard won.

Nevertheless, in the grim era ahead, it would be disastrous if efficiency in the use of public funds was not enhanced. If the public perceives that tax money is being used inefficiently, at a time when its pockets are under pressure from the recession anyway, it will turn against public services. As social marketeers we insist on an appropriate balance between public spending, to serve the "social" side of our agenda and market spending, to sustain a growing economy. That requires, as a matter of practical politics, that every penny of state spending is used to best effect.

In this context, the Social Market Foundation is ideally placed to provide expert comment and insight into how marketisation can reduce costs and improve public services. Specifically, the SMF can contribute to the debate by exploring the use of market mechanisms in public service delivery – in areas like childcare, higher education and welfare reform, and by examining and proposing models of accountability, such as payment by results.

The third area for future focus for the SMF must be sustained and fairly distributed economic growth. The role of public investment in leveraging growth in the private sector will be the subject of acute focus in upcoming years. Whether government can do much to 'rebalance' the economy is another question for careful analysis, as is the role in tax, wages and welfare policy in distributing the proceeds of growth fairly.

More speculatively, I seek to identify some topics which, were we able to fund more work, we might more directly press the buttons above.

Regulation

What has happened to regulation, not just of financial markets but more generally in Britain, is a bit of a puzzle. On the one hand, intellectually, the debate has made much progress. No longer is it thought of as a debate between more regulation (ascribed to Labour) and less regulation (the Tory stance). Instead there is an understanding that regulation has a role, as well as markets, in a modern society. Five principles of regulation have been widely accepted. They are to quote the excellent report "Risk, Responsibility and Regulation" of the government's Better Regulation committee:

- **Proportionality** – regulators should only intervene when necessary. Remedies should be appropriate to the risk posed and, costs identified and minimised.

- **Accountability** – regulators must be able to justify decisions and be subject to public scrutiny.
- **Consistency** – government rules and standards must be joined up and implemented fairly.
- **Transparency** – regulators should be open and keep regulations simple and user-friendly.
- **Targeting** – regulation should be focused on the problem and minimise side-effects.

Yet this does not accord with the day-to-day management of markets. For example, the Health and Safety Commission has succeeded in making "health and safety" a phrase that has entered the popular discourse, as shorthand for totally disproportionate regulation.

Someone needs to get behind the facts of excessive regulation and explain why it happens. There is no single cause. But causes include the tendency of the political system to panic: for example, a tiny number of admittedly horrific tales of child abuse has led to the horrendous new register for those who have contact with children. It includes the fact that, though in general regulators are criticised for doing too much, in each specific case they are criticised for doing too little.

An underestimated cause of excessive regulation is pressure from big business, which understands that the more regulation there is, the more difficulty it will be for new entrants to challenge established firms. Gordon Brown made a contribution uniquely his own. Being (as he is) admirably radical in his attitudes to regulation, but being (as he also is) cautious, he substituted a policy of amalgamating regulators for a policy of cutting back regulation. So the Healthcare Commission, the Mental Health Commission and the Commission for Social Care Inspection have been rammed into one Care Quality Commission. This behemoth, which has already lost an excellent chair, is predictably proving hopeless.

To summarise: here is a social market case for regulation as one means of rendering the market and social objectives consistent. Sometimes, regulation is about making market mechanisms work better, or is a means of mimicking the effects of competition in the market place in cases where natural monopoly limits the extent to which actual competition can be introduced. However the instinctive stance of a social marketer should be suspicious of regulation. We should take on board the insights of anti-regulators as to why it grows, willy-nilly, and seek to ensure that the five principles are also the practice.

Climate change

It is tempting for the Social Market Foundation to be equally suspicious of climate change. For an extreme environmentalism, which wants to preserve every species, abolish every fertiliser, and ditch aeroplanes for bikes is today's most fundamental threat to the social market economy. This philosophy is rooted in the anti-growth environmentalism of the early 1970s, which incidentally was also a movement that embraced an anti-democratic politics. The fears that movement posited – a rapid exhaustion of raw materials, slumps in food production, a population explosion – proved wrong and so, it is tempting for social marketeers to believe, will be today's Malthusians.

Unfortunately, however, social marketeers have to have regard for facts as well as to convenient opinion. A tiny minority of opinion, though more journalists than scientists, continues to hold that climate change is not occurring or, if it is occurring, it is not the fault of humankind. However, the science is now overwhelming – nearing that for the thesis that smoking cigarettes causes lung cancer – that global warming is occurring (virtually certain) and that it is in whole or in part caused by humans via emissions including CO_2 (highly probable).

Rather than continue to pea-shoot the charging elephant, social marketeers should concentrate on the next big question:

what should we do about it? For where genuine doubt comes in is whether this is a crisis to which the world would sensibly respond (as Britain shows signs of responding) by a huge policy shift to combating climate change.

In general, warmer periods for the world have been more prosperous than cooler periods. It is true that some developing countries might lose heavily from climate change – the flooding of Bangladesh is a popular example – but the gainers are frequently ignored in calculations of this kind. The losers could be compensated by the gainers; or problems dealt with by population and species migration.

Moreover, it must be understood how limited can be the effects even of quite far-reaching changes on the reality of climate change. Andrew Dessler and Edward Parson wrote one of the best-balanced assessments in *The Science and Politics of Global Climate Change*.[14] They are not climate change 'deniers'. But they point out that changes will take a long time to take effect due to the 'inertia' of the climate system. They quote an analysis of an aggressive emission-reduction scenario which found that a cut in emission of 40% by 2050 would lower global temperature by only 0.2%. Should we rather hang on, waiting for technical breakthroughs, such as non-carbon powered cars which would dramatically improve the outlook? In short, could such a huge amount of money not be better spent ameliorating the effects?

For as the "sceptical environmentalist" Bjørn Lomborg has pointed out, extremely expensive remedies may not be worth the cost. He argues, for example, that the most compelling problem for many developing countries and their peoples is the shortage of readily accessible drinking water. This is a problem which could be

14 Andrew Dessler and Edward Parson, *The science and politics of global climate change* (Cambridge: Cambridge University Press, 2006).

solved globally (given the will) at a fraction of the cost of dealing with climate change.

Here is a role for the Social Market Foundation in making sure that costs are looked at together with benefits when anti-global warming measures are considered. It needs also to be pointed out – as Nigel Lawson does in his sceptical book on the subject[15] – that the world's economy will grow over time. We have to beware of snuffing out that growth now so as to avoid costs for a later, richer generation.

Again, the role of technology has to be considered. Is it really worth despoiling our landscape with expensive windfarms, which produce only intermittent electricity, and at great cost? Or should we be looking at the various technological supplements and alternatives to conventional fuels, of which nuclear power is only one?

In encouraging technological change of course pricing is important. The more expensive today's fuels are, the more there will be an incentive to discover tomorrow's less polluting energy. So for example, China's coal subsidies are undesirable. Nor should we in Britain be resisting adding increases in taxation to increases in fuel prices as the market operates. Increases in taxes are not burdens, for if (say) petrol taxes go up, then it should be possible to reduce other taxes pari passu to compensate. The politics may be difficult but be assured nothing like as difficult as the politics of restricting economic growth.

The SMF has recently suggested market-based remedies that are more effective than the existing EU ETS carbon trading scheme. The ETS fixes the amount of carbon that may be released, and allows prices to fluctuate for carbon 'credits' – permits to release

15 Nigel Lawson, *An appeal to reason* (London: Duckworth and Co., 2008).

a tonne of CO_2. This leads to highly volatile prices, as other factors like the recession and the oil price interact with the programme. This provides no consistent incentive for investment in viable green technology. Fixing the price instead, through a tax, would give investors certainty and therefore stimulate investment in new technology.[16]

The SMF should establish and propagate a social market approach to climate change in its next phase of work.

Longevity, population and the market

Here, it seems to me, thinking is at an early stage. A revolution in longevity is taking place, with the expectation of life rising quickly. This is a major change, and one to which we have responded only slowly. For example, postponing the retirement age is clearly something we need to do. But is a couple of years' increase really sufficient when we are looking at people in future who might be working for 40 years in the expectation of 30 years or more of retirement?

It is questionable whether the Turner pension solution can last.[17] In particular, we now face a period in which real returns on capital (as with index-linked gilts) have now fallen to barely above zero; in Japan they turned negative in the 1990s. That makes the economics of pension provision all the more challenging.

There is also the problem of long term care. We seem now to have a capacity to keep people alive for longer, even when they enter a period of morbidity towards the end of their lives. This imposes enormous social costs: for example, two-thirds of the total NHS money the average person consumes is spent on chronic

16 Ian Mulheirn, "A change in the weather", *Public Finance*, 9th October 2009.

17 Pensions Commission, *Final Report* (London: Government Pensions Commission, 2005).

conditions, typically towards the end of their lives.[18] It imposes enormous costs on the individual too, especially better-off people whom we insist – rightly – pay the bulk of the cost of their care. Yet all this expense is not generating much happiness. End-of-life periods for those who have serious problems are not pleasant however good the care provided. People at this stage in life have reduced or even no autonomy, and autonomy is the key to human happiness.

The Dilnot report into funding social care of (July 2011) gets the architecture of a solution right, but with an eye-watering financial tag attached. Can there be a cheaper solution that nevertheless attracts a social consensus? Are there new ways of improving care while at the same time avoiding a cost explosion? There are in these issues of enormous potential for the SMF, which understands the importance of social care but understands also that it comes with a price tag. We should not hesitate to think the unthinkable.

Conclusion

Social marketeers believe in markets; and so can hardly be resistant to getting into the marketplace of ideas. The successful project of the future will address a major issue of the day – or, better still, an issue of tomorrow. It will show imagination in the thesis it addresses. It will have a predisposition to market-based solutions, but not a dogmatic or extreme adherence to them. It will be thoroughly researched, and where possible make specific policy proposals rather than culminate in generalisation. And, of course, it will be beautifully written. I bequeath the chair to Mary Ann, confident that our excellent staff and our insightful trustees will make this vision real.

18 *The Times*, "The state of the nation's health", 25th May 2011.

BRITAIN AND THE EUROPEAN SOCIAL MARKET

DAVID OWEN

Introduction

As we celebrate the 21st anniversary of the Social Market Foundation, it needs to be recognised by all political parties in the UK that the term social market economy is now enshrined in the 1997 Treaty of Lisbon:

> *"The Union shall establish an internal market. It shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress, and a high level of protection and improvement of the quality of the environment. It shall promote scientific and technological advance. It shall combat social exclusion and discrimination, and shall promote social justice and protection, equality between women and men, solidarity between generations and protection of the rights of the child. It shall promote economic, social and territorial cohesion, and solidarity among Member States."*[19]

The issue is, and has always been, what that social market should look like. Despite Europe being largely 'parked' in the Coalition agreement, the Cameronite wing of the Conservative party and the liberal half of the Liberal Democrats show social market instincts, and there is evidence of convergence between continental social markets and UK public policy. The new Conservative-Liberal Democrat Coalition Government makes it far more likely that Conservatives will accommodate themselves, albeit slowly, to a social policy accompanying Europe's single market.

19 Treaty of the European Union, Article 2 (3).

Hitherto the polarized left-right language of British politics did not fit easily with European social policy. For example, a minimum wage was initially deeply controversial between Labour and Conservative politicians, but is thankfully widely supported and is now an EU-wide social policy. But fixing the level of the minimum wage must remain a member state responsibility, just as fixing the balance in tax levels and social security payments is.

Ironically, given Conservative hostility towards Europe, the Coalition is in a position to lead in creating a flexible European social market. The Coalition takes social policy more seriously than a Conservatives-only government would, and it is driving in a social market direction. Conservative scepticism about Europe, combined with liberal social market instincts may well lead to improved social policy, the re-nationalisation of social policy powers in Europe, and a more flexible, pragmatic and sustainable European social market economy – if the coalition makes it a priority.

The next British social market

The period between now and the next General Election, probably in 2015, promises to be a productive period for British politics. The Government's austerity budget and the changed general macroeconomic conditions give more urgency to debates on how to make economic growth sustainable and the state of the European social market.

Labour MPs are likely to become more openly continental social democrats under Ed Miliband's leadership. In arguments about the balance between efficiency, redistribution and regulation, it is likely they will sacrifice the former for the latter two. This is a welcome development; for the lack of any ideological underpinning became a central weakness in Labour's 13 years in government under Tony Blair and even, somewhat surprisingly, under Gordon Brown.

Nor is a redefinition towards a 21st Century social democracy that flows naturally from Attlee, Gaitskell, Wilson, Callaghan and John Smith's leadership something that Ed Miliband need be defensive about. All of these leaders had real and genuine friendships with trade union leaders.

Labour has a few years to rethink while the coalition wrestles with economic reality.

The next stage of debate about the social market will not repeat old arguments about the frontiers between the private and public sector. There can no longer be any doubt that Labour got the nationalisation issue wrong before the Second World War and in the postwar period. The Conservative Government under Margaret Thatcher radically shifted the economic framework away from a heavily state managed economy and towards private enterprise.

However, while Margaret Thatcher was prime minister there were few nods towards the social market, even though Sir Keith Joseph had given a boost to the use of the term in the mid-1970s, while re-thinking the mistakes of Edward Heath's government. While John Major was an underestimated and necessary transitional premiership, it needed thirteen years of New Labour Government to settle the new cross party orientation towards the market. Today Labour and Liberal Democrats accept virtually all the hated 'Thatcherite' changes, including the trade union reforms.

There is no point in the Conservatives rehashing old arguments; they should put policy flesh on the political bones of compassionate conservatism or the "Big Society". In the 1995 Hugh Gaitskell Memorial Lecture I tried to develop the underlying assumptions of John Rawls' *A Theory of Justice* for a society with the property of "close-knittedness" and his concept of "social

union".[20] There are some of the philosophical underpinnings, with Edmund Burke's writings, for the concept behind David Cameron's "Big Society", that will and should contribute to this debate. Social democrats may not agree with all its manifestations but there are no grounds for knee-jerk disparagement of Conservative Party initiatives in the 21st century. No political party has or should even aspire to a monopoly of wisdom about the society in which we all have to live together.

I am convinced that for all political parties the co-operative movement has much to contribute to UK society. One of the few beneficial effects of the recent world financial crisis is that it has exposed the raw greed and hubris of the market. To compensate, there needs to be a rediscovery of the benefits of co-operatives and mutual and friendly societies. Our secular society may experience waves of religious revival but the growth of not-for-profit companies is a more likely trend to challenge the belief that market efficiency can only stem from ever larger personal financial reward.

The ideas of the American economist Martin Weizman can help us to recast our views on the forms of partnership and participation in British industry. In *The Share Economy* Weizman argued for a shift from a wage-orientated economy to a share-income economy, so that a substantial part of the average person's take home pay would be expressed not as a regular wage but as a share of the profit earned or value added in the company to which he or she contributed.[21] Wider share ownership was part of the Thatcherite 'privatisation'. It did not seem to catch on as much as it might have done then but it is worth trying again.

After the justified public anger over taxpayer bailouts of banks, which continued to pay massive bonuses, there needs to

20 David Owen, "Politics and consensus in modern Britain", in John Morgan ed., *Lectures in Memory of Hugh Gaitskell* (London: *Macmillan*, 1988).

21 Martin Weizman, *The Share Economy* (Cambridge, Mass.: Harvard University Press, 1984).

be a renewed insistence that employees are rewarded through share options and restricted stock with longer limits on how soon they can be sold, rather than cash or short-term stock. Where bonuses are paid to retain key staff they should be rewarding actual audited performance on publicly announced targets made available to all shareholders. Alongside the pay issue, the principal-agent problems that dog corporate governance must be tackled. Institutional investors in public companies pay insufficient attention to shareholder interests. They too often develop cosy relationships with management. Independent non-executive directors in public companies have also got far too close to management, forgetting their responsibility to shareholders to see that financial incentives reward effort and enterprise, not just position.

I hope that amid all the Coalition's talk about fairness, we will see a return to the politics of fairer distribution of wealth. In the 1980s, the SDP championed integrating tax and benefits. For a time Gordon Brown's tax credit reforms looked as if they might lead in this direction but the momentum went, along with the loss of control of public expenditure from 2002, and an excellent opportunity for radical reform coinciding with economic growth was lost. The Coalition decided to eliminate child benefit for families with an earner paying the 40% income tax rate, without the technology to link fathers' taxes with mothers who receive the benefit in the revenue and benefit system. This highlights multiple governments' lack of social radicalism and appalling administrative mistakes, particularly over the computerisation of the Inland Revenue. Rushing to withdraw housing benefit has revealed harsh anomalies, reminiscent of the incompetence of many Number 10 initiatives under Tony Blair. The integration of tax and benefits will take time, but is a prerequisite for full scale benefits reform. In the meantime, rushed ad hoc changes will be damaging. Continuing universal benefits combined with fairer taxes fits better with a "Big Society", until the tax and benefits systems can be brought together.

The history of the social market in Britain

It is an old adage that there is not much new in politics. The Social Democratic Party and the Social Market Foundation have been championing public services markets for thirty years. The "tough and tender" formulation in the SDP version of the social market, seemed to ignite public interest at the time but it was merely the reformulation of an older concept developed by the American philosopher William James, "The tough think of the tender as sentimentalists and soft heads, the tender feel the tough to be unrefined, callous or brutal."[22] Yet when it came to drafting the 1987 SDP/Liberal Alliance manifesto, the 'social market' was so unacceptable to Roy Jenkins, then the SPD's economic spokesman, and other Liberals that the SDP did not press for its inclusion in our joint manifesto.

In the mid-1980s the SDP began to champion an "internal market" for the NHS. Our proposals were bitterly attacked by Margaret Thatcher before the 1987 election and only reluctantly accepted by our Liberal partners in the Alliance. After that Election I wrote a book, *Our NHS*, further elaborating the ideas. It was John Major who introduced GP fund holding which was then foolishly abandoned by Labour. The Coalition Government has now reverted to GP control and hopes for a universal application by 2013. That may be too fast but essentially this is an evolutionary reform and all the better for it now having cross-party support.

On the face of it, Tony Blair's New Labour in the late 1990s looked as if it was an extension of the SDP, and as such many of us who had been in the SDP welcomed it and wanted it to succeed. Largely because I found Blair so passionate about the euro and so ignorant about the possible damaging consequences of British entry, I decided to remain a crossbencher in the House of Lords and not rejoin Labour.

22 William James, *Pragmatism: A New Name for Some Old Ways of Thinking* (1907).

Labour never fully embraced social market thinking, to its detriment. The Blair/Brown 'presidency' made improvements in the governance of Northern Ireland and also in Scotland and Wales. They achieved significant increases in expenditure on the NHS and education and worthwhile initiatives on schemes like Sure Start, as well as the minimum wage. Yet their extraordinary dominance at the expense of Cabinet government was marked by an uncritical and at times breathlessly naïve endorsement of the free market, especially in finance. Sadly, despite inheriting growth Blair and Brown together left a massive fiscal deficit. If only their welcome decision to give the Bank of England independence had not been accompanied by the rash removal of the Bank's regulatory function then the UK might have avoided some of the harshest consequences of the global banking crisis from 2007. But their really damaging choice was to lose control of public expenditure from 2002. The UK economic model since then became unbalanced and very vulnerable when the global financial crisis hit the UK. In particular, the structural fiscal deficit was far too high and we had by 2010 to demonstrate a readiness to bring this under control for international confidence to be retained.

The Social Market Foundation's influence

The Social Market Foundation was established in 1989 as a charity devoted to promoting the concept of the social market economy. The first Director was the late Alistair Kilmarnock and its first chairman was Tom Chandos. After a while, Robert Skidelsky became the Chairman and Danny Finkelstein the Director followed by Rick Nye. David Sainsbury helped with the initial funding and it was perhaps inevitable that they had all been actively involved in the SDP. When the SDP was wrapping up, individuals began to choose different political homes. David Sainsbury and Tom Chandos went with New Labour. Robert Skidelsky became first a Conservative and later a Crossbencher; Danny Finkelstein and Rick Nye became Conservatives, along with a number of other young active social democrats. Many former SDP members are now playing significant roles in David Cameron's Conservative

Party such as Chris Grayling, Greg Clark, Andrew Lansley and David Mundell. Many in the SDP as Liberal Democrats are in the Coalition Government such as Vince Cable, Chris Huhne and Tom McNally. Many from the SDP contributed to Tony Blair's new Labour. David Sainsbury served throughout Blair's premiership as Minister for Science, others like Derek Scott, who advised me on economic policy in the SDP, was in No 10 for nine years advising Tony Blair on the economy, as was Roger Liddle who advised on the EU. Alistair Kilmarnock, myself and many others in the SDP never joined any other political party and I remain today a crossbench Peer, though when asked to define my status I call myself an independent social democrat.

The SMF has never been the monopoly or the preserve of a single party. Prominent Conservatives like David Willetts, a Conservative member of the Coalition cabinet, and never afraid of using the word social, have been involved from the early stages.

The SMF was established to focus its activity on whichever party formed the government of the day. John Major's government was influenced when Danny Finkelstein went to Number 10; likewise Tony Blair's when Phil Collins, a former Director of the SMF, went to Downing Street. When it became obvious that the new Labour government was likely to be in office for a decade or more it seemed wise to reflect this reality within the SMF. Robert Skidelsky, who had done so much as Chairman to establish the intellectual personality of the SMF, stepped down after ten years. David Lipsey, a Labour Peer, formerly political adviser to Anthony Crosland and a writer for *The Economist*, became chairman in 2001. After the 2010 General Election he stepped down to be succeeded by today's Chairwoman, Mary Ann Sieghart. I particularly welcome her appointment which I can say since I have had no involvement in it. She was active in New Europe, the pro-EU but anti-UK euro membership campaign, of which I was chairman. New Europe operated very successfully from 1999 to 2005 when it ceased to exist, safe in the knowledge that Tony Blair had never been able to attract sufficient public support to call a referendum on the euro. We concluded then that membership of the eurozone was off the agenda and that looks likely to remain the case until at least 2016, which in politics is about as far as it is possible to predict.

The social market philosophy embraces adaptation to changing events and evidence. All political actors must be prepared to learn afresh and keep open minds about the most effective way to combine social values and market realism. Wisely, the coalition has tried to maintain investment in infrastructure projects, to alleviate the impact of other spending cuts on aggregate unemployment in the medium term. They ring fenced health expenditure and protected investment in science and technology. These were welcome signs of a selective approach. Public opinion is, however, likely to harden against specific expenditure cutbacks.

In financial reform, the UK Government must argue its case in the EU if the innovative side of the City of London is not to be damagingly curtailed – while it should embrace reforms to the genuinely damaging practices in the sector. In a world of competing currencies and demands for national protection international cooperation has to achieve more. The G20 grouping of nations for international, not just European, reform is starting to prove itself.

Social science, and neurobiological ideas, when combined with economics help to explain the financial market breakdown. Technical reforms to financial markets, however, cannot ignore greed, hubris and deep rooted 'animal spirit' behaviour. Gillian Tett's analysis of the 'silo' mentality, in her book *Fool's Gold*, drew on her training as a social anthropologist.[23] In writing about 'Hubris Syndrome', in financial, not just political, decision makers, I have drawn on my own background in neurobiology.[24] Larry McDonald, a trader with Lehman Brothers, explains how the repeal of the 1933 Glass-Steagall Act in late 1999 unleashed a devastating new period of wild behaviour on Wall Street.[25]

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23 Gillian Tett, *Fool's gold: how unrestrained greed corrupted a dream, shattered global markets and unleashed a catastrophe*, (London: Little Brown, 2009).

24 David Owen, *Time to declare: second innings*, (London: Politico's, 2009), Ch. 10. David Owen and Jonathan Davidson, "Hubris Syndrome: An acquired personality disorder? A Study of US Presidents and UK Prime Ministers over the last 100 years," BRAIN (2009).

25 Larry McDonald, *A colossal failure of common sense: the collapse of Lehman Brothers* (London: Ebury Press, 2009).

Old and new lessons being brought to bear to create a behavioural approach to financial regulation, fencing off the animal spirits of derivatives, futures and currency traders from utility banking. The wisdom of Paul Volker, the best Chairman of the US Federal Bank for many decades, had some influence over this issue on President Obama. US legislation does make some provisions for a clearer demarcation between trading and utility banking. Canada, which maintained traditional banking, noticeably, came through the banking crisis unscathed. It was a mistake in the UK to remove the Governor of the Bank of England's authority in this area in 1997 and right to try to restore some powers in 2010.

The European social market at a crossroads

The most pressing debate underway in Europe is how to save the euro. A related question is how to make the social market more globally competitive and as part of that debate to what extent social and employment policies are better exercised by member states or at the European level. A more fundamental question, frequently aired in the UK and some other member states, is whether the EU can define limits to integration, spelling out which powers should be exercised by member states, and which are really needed in Brussels for an effective EU. The current eurozone crisis is an opportunity for the UK to establish the parameters of the EU social market, and to improve its constitutional relationship with Brussels.

There are few, if any, organisations in the UK better placed to contribute constructively to these debates than the SMF, which can help build a cross-party consensus. There are some Labour and Liberal Democrat MPs who are still somewhat dismissive about any changes in the EU, either because they think it is impossible to negotiate changes to treaties, or because they think that it is wrong because they want more EU integration not less. There are also MPs who fear any treaty amendment knowing that it will now involve a referendum under the UK coalition government. They fear that

they will not be able to win support for treaty changes to make the eurozone work more effectively, even though the UK is unaffected. The eurozone undoubtedly needs new procedures and powers to avoid a collapse or an ongoing crisis of confidence. It is in the UK's interest to avoid consequential damage to us, even though we are not members.

As for social market reforms, there are some Conservatives who disparage the very word social and see the EU as a single market, pure and simple. Even Kenneth Clarke MP, a committed European, has disputed that any attempts to repatriate powers could leave the UK isolated in Europe. In November 2010, he said, "I do think we will not be alone. We will have allies. So long as you don't overdramatise it, done properly, there's a serious negotiation to be had".[26]

The trials of the eurozone do offer an opportunity for a rethink about European social policy.

One country, Germany, will determine much of the debate about the eurozone and the social market over the next few years. "Rhineland capitalism" and its associated social market economy which prevails in Germany, Austria, the Netherlands and part of Belgium was well described by Will Hutton in his book *The world we're in*, and by Horst Siebert, in *The German economy: Beyond the social market*.[27] Attitudes have continuously shifted in Germany, and the social democrat Chancellor, Gerhard Schroeder, tilted opinion towards the market and the need for competitiveness through labour market discipline to maximise export-led growth. For a while his fellow social democrats appeared ready to move in some areas closer to the Anglo-Saxon model. Now, no longer in government they are rethinking aspects of the German viewpoint on the social market.

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26 *Daily Telegraph*, "Kenneth Clarke: Tory pledges on Europe are just 'reassurance'", 10th November 2010.

27 Will Hutton, *The world we're in* (London: Little Brown, 2002), 259-264, and Horst Siebert, *The German economy: beyond the social market* (Princeton: Princeton University Press, 2005).

Across Europe many social democrats are challenging the virtues of open and free markets. They are also questioning flexible labour markets. Any enthusiasm for the Anglo-Saxon economic model, never strong in Europe, is tempered by its perceived failures in the financial crisis.

A specifically European social market model has yet to emerge – if it will at all – and its contours are hard to discern. The first step in any emergence is for the eurozone to demonstrate far greater economic convergence, discipline and political cohesion. The Germans understand that a European social market economy needs to increase productivity at a far faster pace than before. Yet France resists significant reforms to European agriculture and manufacturing.

Labour was not too keen on the EU in the early 1980s. After its crushing defeat in 1983 it changed tack. In the process, it began accepting uncritically many EU policies with the zealousness of the convert. In 1988 when Jacques Delors, the former French Socialist Minister of Finance and then President of the Commission, gave a fraternal address to the TUC Conference his reception had been so warm and his exposition about the Social Charter so well received that Labour leaders began to see advantage in all European solutions. In that process they began to distance themselves from voter unease about European integration.

It was not just the Conservatives, but also Labour and Liberal Democrats who had egg on their face, when the UK was forced to leave the ERM in 1992. When the 1997 election came all three parties agreed that they would not enter the eurozone without a referendum. But this was a purely tactical and defensive reaction by Tony Blair and Paddy Ashdown. In truth, they were already determined to enter the eurozone and would have done so early if Tony Blair had been confident that he could win a referendum on euro entry. On the other hand, the Conservatives became evermore

hostile to the EU under, William Hague, Iain Duncan Smith and then in the 2005 Election Michael Howard. So, the British debate on the EU became partisan, to the detriment of our capacity to challenge the pretensions of the Commission and the European Parliament. There is a unique opportunity now for the coalition to develop a voice on Europe that better reflects public opinion, not just within the UK but in a growing number of member states.

It would be a great mistake for Liberal Democrats within the Coalition to believe that changes in EU social policy concern only the closet anti-EU faction within the Conservative party. The repatriation of powers is possible, and in other countries calls are growing for clear limits to EU power. On June 30th 2009, the German Constitutional Court made an important ruling on the Lisbon Treaty. It laid down general guidance as to how it might be possible to establish a narrow interpretation, setting limits and parameters, (either in a new Protocol or by amendment of the Treaties), for the future development of social and employment policies within the framework of the Lisbon Treaty. Here detail is unavoidable to understand a complex ruling. The court said:

> *"European unification on the basis of a union of sovereign states under the Treaties may, however, not be realised in such a way that the Member States do not retain sufficient room for the political formation of the economic, cultural and social circumstances of life. This applies in particular to areas which shape the citizens' circumstances of life, in particular the private space of their own responsibility and of political and social security, which is protected by the fundamental rights, and to political decisions that particularly depend on previous understanding as regards culture, history and language and which unfold in discourses in the space of a political public that is organised by party politics and Parliament. To the extent that in these areas, which are of particular importance for democracy, a transfer of sovereign powers is permitted at*

> *all,* a narrow interpretation *[my emphasis] is required. This concerns in particular the administration of criminal law, the police monopoly, and that of the military, on the use of force, fundamental fiscal decisions on revenue and expenditure, the shaping of the circumstances of life by social policy and important decisions on cultural issues such as the school and education system, the provisions governing the media, and dealing with religious communities."*[28]

The UK has always argued for such a narrow interpretation. The problem is that Labour in government conceded much of their own initial negotiating position when it came to the final Treaty wording. David Cameron has therefore some scope to seek an adjustment of these powers that have passed to the EU. But as Cameron recognizes this has to be done by negotiation and it means finding allies in other member states. In this respect the Liberal Democrats could help to win them over.

The next EU Treaty looks likely to cover enlargement to Croatia and possibly, Iceland. The exact timing is uncertain – Croatia hopes for entry in 2012 but it looks likely to slip to 2013. The Treaty in the UK will not require a referendum if it is strictly confined to accession and creates no new powers beyond this. Yet in October 2010 the Germans and the French agreed bilaterally to amend the Treaty to create new governance for the eurozone. If treaty amendment is opened up it should be possible to negotiate other important matters, perhaps as part of the horse trading over the Budget, due in 2013. If Iceland were to become a member it would likely involve large reforms to the CFP. The Irish government will also want to put into any wider treaty all the verbal assurances they received on taxation, workers' rights and neutrality before voting in a second ballot to accept the Lisbon Treaty. If the treaty covered more than

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28 German Constitutional Court ruling, 30th June 2009, http://www.bundesverfassungsgericht.de/entscheidungen/es20090630_2bve000208en.html

enlargement, it would not be unreasonable for the UK to try to negotiate some amendments to social and employment policies. Undoubtedly, success would increase the chances of winning a referendum in the UK. It would also help to win such a referendum if the Treaty reflected the reality that the UK and other member states not in the eurozone should have their status recognized outside the eurozone as likely to be permanent. There should be changes to the assumption that euro entry is inevitable.

It is possible that the Coalition may be to help heal some of the divisions that still remain. A sensible dialogue on EU social legislation would dissect and determine what aspects of the social market economy need to be European, and which national. Many sensible Europeans accept that decisions on matters such as maternity leave, the working week, and the rights of part-time workers should be made at national level. There may be good arguments for general injunctions to member states to ensure such provisions are made but few valid arguments for detailed EU legislation. Variations between member states would not affect the single market and only a very few states argue that there must be exact equivalence. The same applies to the Working Time Directive already hampering the provision of public services as it affects medical practitioners and other health and fire workers. Variations at a national level would make the EU more flexible and less prescriptive and would accord with EU-wide public opinion surveys. While David Cameron has made it clear that for Conservatives EU social policy is not of immediate concern and that the first priority for the coalition government is to deal with the UK fiscal crisis, they will become of pressing concern if there are to be any treaty amendments, let alone a referendum.

The new UK Supreme Court could start to exercise some of the powers of the German Constitutional Court over EU legislation,[29]

29 David Owen, *Time to declare*, Chapters 8 and 10.

particularly if Brussels continues to creatively interpret the wording of the Treaties well beyond any reasonable construction at the time when they were passed by national parliaments. The Commission proceeds, knowing that the European Court of Justice will back them up if a member state challenges. This is what lies behind European 'legislative creep', where the treaty wording in a member state language is re-interpreted at the European level. This creep has to stop, and the point at which it may be checked is over the interpretation being put on the existing "bail out" clause of the eurozone in the Treaty.

The UK Supreme Court has already decided some important constitutional cases about the powers of the European Union. If it continues it may raise fears that the UK is developing a written constitution. But there is a growing recognition inside the UK that the combination of legislative devolution to its respective nations, the EU treaty obligations, and rendering the European Convention on Human Rights justiciable in the UK courts, has created a written constitution in practice if not in name. The Supreme Court should be a necessary safeguard and, as in Germany, we will develop our own form of constitutional court. In particular MPs will welcome the Supreme Court's involvement where there develops a flagrant mismatch between the interpretation that MPs have put on the wording of European Treaties only to find the ECJ interprets differently.

Conclusion

To sum up – the Coalition government in the UK is expected to last for a five year fixed term. Political debate in the UK is going to focus initially on how to reduce our fiscal deficit, maintain economic growth and ensure that public expenditure reductions and tax increases are applied fairly. Much also depends on whether the EU achieves a vibrant and internationally competitive social market economy. During this debate it is a safe bet that the social market will outlast the 'Third Way'; indeed it probably already has. The

Social Market Foundation can influence and shape the arguments within the coalition and the Labour party even more than it has done over the last 25 years.

THE SOCIAL MARKET, THE FINANCIAL CRISIS AND THE ROLE OF THE STATE

PETER LILLEY MP

Introduction

The banking crisis and subsequent recession has given a new lease of life to critics of the social market. They had been impotently licking their wounds since the retreat of socialism in the West in the 1980s and the collapse of communism in the East in the 1990s. But the near implosion of the banking system has been seized upon with relish by those who want to extend the power of the state and fetter the role of markets and individual initiative. They argue that the financial collapse was the result of deregulation and unbridled greed. And since the response has involved state intervention, much tighter regulation and even public ownership this demonstrates the need for much more comprehensive state control not just in financial markets but over economic activity more generally.

It is important to rebut this thesis in order to defend the social market against an expansion of the state into all areas of the economy. More important still, unless we establish the true cause of the current economic crisis, we will not be able to find a cure for the current recession nor prevent similar problems in future. Unfortunately, so far analysis – even by those who are not determined to discredit the market economy – has focused not on establishing the ultimate cause, but largely on allocating blame among greedy bankers, impotent regulators and incompetent Americans.

This case rests on three faulty premises. The first is that the failure of financial markets justifies state intervention elsewhere. The second is that deregulation caused the credit crisis. The third is that greed (a constant) was a decisive factor in the crisis (a change).

Each is rebutted in turn below. Loose monetary policy and global macroeconomic imbalances better explain the financial collapse and should be addressed with specific policy changes. This leads on to a robust analysis the role of the state, which must be founded on the failures of markets, and which is provided in conclusion.

Does financial market failure justify state intervention elsewhere?

Banks are not typical capitalist enterprises so even if they need tight state control that does not justify similar control over all other businesses. The argument that, because banks need tight state regulation and control the same is true of the rest of the economy, is a non sequitur. Economists have always recognised that banks are sui generis: they differ from ordinary enterprises in two respects: first, they are inherently unstable, and second, if they collapse they destroy the deposit money they have created and on which the whole economy depends.

Banks are inherently unstable – because they borrow short and lend long. Some commentators have criticised them for doing so as if this were a recent innovation which led to the current crisis. But it is the very essence of banking. If banks did not borrow short and lend long they would not be banks. Or, to be precise, they would not be fractional reserve banks.

Banks rely on the fact that although depositors have the right to withdraw their money immediately or on very short notice, withdrawals normally roughly match payments into deposits. So the banks only keep a fraction of the money deposited with them in the form of cash or near cash to meet fluctuations in net withdrawals. The rest they invest in longer term assets and loans. But if concerns (however unjustified) about the profitability of a bank's investments lead large numbers of depositors to try to withdraw their money simultaneously the bank will not be able to meet their demands from its own liquid assets. If it cannot borrow

sufficient liquidity to meet those withdrawals it will have to sell illiquid assets which will usually fetch less than their long term value. Fear of similar failure may then infect depositors of other banks especially as the failure of one bank may depress economic activity, the viability of loans made by other banks and the value of their collateral. So a banking panic could lead to collapse of the whole system.

This is very different from any normal economic activity. For example, if car buyers had lost confidence in Toyota as a result of recent safety issues, that would have weakened Toyota but it would not have brought down the whole car industry. Indeed, car buyers would probably have transferred their demand to other producers which would have been strengthened.

That is why economists have always recognised the need for special regulation and supervision of banks: rules on their reserves, restrictions on the nature of the assets in which they can invest and the need for a lender of last resort – the central bank.

Far from banks being the epitome of capitalism, the most extreme capitalist theorists, like Murray Rothbard, have long claimed that these problems arise because “fractional reserve banking is fraud” which is incompatible with capitalism so fractional reserve banking should be outlawed. Rothbard argues that if a granary owner issued more warehouse receipts than the amount of grain stored in his granary he would go to jail. So why are bankers allowed to issue more promises to repay money deposited with them than the amount of money they hold in their coffers?

In practice there are social advantages in allowing banks to borrow short and lend long. They thereby increase the proportion of people’s savings which can be lent on more profitable long term ventures. But, because the result is inherently unstable, it is essential to have a lender of last resort to the banking system

which can provide additional unlimited amounts of cash in the event of a run on the banks. That role is provided by the central bank which alone can create unlimited quantities of additional money as required. It can also withdraw that additional money once the panic subsides.

When banks collapse they destroy the deposit money they have created thereby depressing economic activity. Why shouldn't banks be allowed to collapse? After all, most economists advocate allowing other enterprises whose investments go wrong to collapse. Again, banks are different from other enterprises. The collapse of any normal enterprise is painful while its assets are redeployed. But those assets do not automatically disappear.

If Hertz, which lends out cars, were to go bust the number of vehicles in existence would not alter. Its car fleet could be sold off, most probably to other companies hiring out cars. But if banks collapse, the deposit money they have created is destroyed. And a sudden reduction in the supply of money will cause the level of economic activity to contract equally sharply. There is general recognition that it was the collapse of thousands of banks in the thirties in the USA which led to a sharp contraction of the money supply and turned a severe recession into a prolonged slump.

So economists have long recognised that banks need to be regulated differently from ordinary enterprises and ultimately backed up by a lender of last resort – the central bank.

Even if banks were badly or insufficiently regulated in the period leading up to the recent financial crisis that would be an argument for better or tighter regulation of banks in future. It would not justify extending state control over normal economic activities which do not have the inherent instability of banks nor their pivotal role in supplying the means of exchange to the whole economic system.

Did deregulation cause the credit crisis?

The second leg of the statist case is that the collapse of the banks was the result of deregulation of the financial system. This allegedly left regulators unable to prevent the bad lending in flaky assets which ultimately brought the system down.

Sometimes it is suggested that the regulatory regime was stripped of its powers under Mrs Thatcher. In fact, the regime which has been in force over the last decade was introduced by Gordon Brown in one of his first acts as Chancellor in 1997. Responsibility was shifted from the Bank of England to the Financial Services Authority which replaced the previous self-regulatory system. But the new FSA was given every bit as much power as its predecessors. It actually has more powers, more comprehensive coverage of the whole financial sector (including mortgage lenders), employs more people and spends a bigger budget than ever before.

Although the new regime certainly did not involve deregulation it did divide responsibilities creating regulatory confusion which aggravated the problems that emerged with the collapse of Northern Rock. Those problems were foreseeable and foreseen. As shadow Chancellor when the Bill that became the Bank of England Act 1998 was introduced I was not alone in doing so. In the debate on that Bill, I warned:

> *"With the removal of banking control to the Financial Services Authority...it is difficult to see how...the Bank remains, as it surely must, responsible for ensuring the liquidity of the banking system and preventing systemic collapse."*

I went on to say:

> *"The coverage of the FSA will be huge; its objectives will be many, and potentially in conflict with one another. The range of its activities will be so diverse that no one person in it will understand them all."*

And so it turned out. I added that I feared that

> *"the Government may, almost casually, have bitten off more than they can chew. The process of setting up the FSA may cause regulators to take their eye off the ball, while spivs and crooks have a field day."*

The problem with the regulators worldwide was not lack of power, but lack of foresight and insight. Until the eleventh hour, they were as convinced as the bankers that everything was going swimmingly. In its Global Financial Stability Report a year before the crisis erupted, the International Monetary Fund said in reference to securitisation and other complex derivatives:

"There is growing recognition that the dispersion of credit risk by banks to a broader and more diverse group of investors, rather than warehousing such risk on their balance sheets, has helped make the banking and overall financial system more resilient … The improved resilience may be seen in fewer bank failures and more consistent credit provision. Consequently the commercial banks … may be less vulnerable today to credit or economic shocks."

That is what the pinnacle of the regulatory system worldwide was saying a year before the crash. Regulators are just as likely as those they regulate to get carried away by fashion and mood swings.

Can bankers' greed explain recent events?

The renewed assault on the social market system is as much moral as economic. Statists have always claimed that free markets foster greed and are driven by it, so they have blamed the current crisis on "greedy bankers".

I am sure that bankers have been greedy. But bankers have always been greedy. I cannot remember a time when they were not

accused of being so. Yet it is a fundamental axiom of logic that you cannot explain a change by a constant. If bankers have constantly been greedy, why has that only now resulted in this change in our economic fortunes?

The interesting thing is that, in the past, bankers were accused of being greedy because they would lend only to the rich, who had ample collateral, and on low-risk projects at high interest rates. This time they are accused of greed because they have lent to poor people at low interest rates with inadequate and inflated collateral and a risky repayment profile. Bankers' greed has been a constant feature; it is the form that it has taken that has changed and needs explaining.

That brings us to more fundamental explanations of recent events than those proposed by critics who simply want to discredit capitalism or bash bankers.

The truth is that the behaviour of bankers and regulators was not so much the fundamental cause of the crash as a symptom of a long period of easy money and irrational exuberance fuelled by excessive credit. The monetary authorities allowed lending and borrowing to outstrip personal incomes for years on end. They ignored bubbles in dotcoms and house prices, and promised to limit the downside risk should bubbles burst by what became known as the "Greenspan put" – the promise to cut interest rates and pump in money if ever the economy faltered. However, it was not just down to Alan Greenspan in America – the monetary authorities on both sides of the Atlantic pursued almost identical policies. Indeed, the British authorities slavishly copied Greenspan's policies, appointed him as adviser to the Chancellor and awarded him a knighthood for, let it not be forgotten, 'services to financial stability'! (It is worth remembering, too, that knighthoods for 'services to banking' were also awarded to several of the bankers who were subsequently most vilified for their greed and recklessness.)

Underlying that 'easy money' policy was the determination of half the world to run savings and balance of payments surpluses, tempting the other half – the Anglo-Saxon and 'Club Med' countries – to run deficits fuelled by borrowing. It was lovely while it lasted, but it could not go on for ever. Our banks had to find people to lend the surplus savings to, and as they ran out of rich people with good collateral and low risk of default, they started lending increasingly to poor people with inadequate and inflated collateral and a high risk of default. The ultimate cause of our problems, which we must recognise if we are to come up with the correct solution, is that we took advantage of the cheap savings from the surplus countries until households were so over-borrowed and inflated that the system was ripe for collapse.

The resultant dilemma

We now face a huge dilemma. The cure for too much borrowing cannot be yet higher borrowing – least of all for the UK which, as well as having incurred unprecedented private debts, was in danger of running a public sector deficit of almost Greek proportions.

The other half of the dilemma is that if the whole world tries to spend less than it is producing, then output and/or prices will fall in a deflationary spiral.

We have to resolve two apparently contradictory truths – that we cannot solve problems caused by too much borrowing by ever more borrowing, and that we cannot simultaneously, across the world, all try to spend less than is being produced. The only way to reconcile those two truths is to recognise that the countries that have borrowed too much must, sooner or later, start saving, and those that have been running prudent surpluses should start spending more.

The trouble is that political leaders invariably want to universalise their own policies in order to justify them. So Angela

Merkel has tended to argue that every country should be as prudent as Germany. In fact, we should each take the other side's medicine. The Anglo-Saxons and Club Med countries need a period of fiscal retrenchment. The Germans, Chinese and other chronic surplus countries need to expand domestic demand to offset the inevitable slowdown in their exports to the retrenching countries. What the world does not need is a one size fits all policy which international gatherings inevitably strive for.

Failures of economic understanding

All policy failures are failures of will or failures of understanding. The most common economic error is 'partial equilibrium analysis'. This involves focussing on what happens because people did one thing without bothering to think through what they would have done if they had been prevented from doing that. The classic example of that is the 'broken window fallacy': I break your window, you employ a glazier to mend it, he orders glass and other materials, the glass factory has to increase its output and pay its employees to work a little longer – result: employment and activity increase. Nonsense. It fails to take into account that if I had not broken your window you would have spent the money on something else. So the employment required to produce the goods and services you would otherwise have consumed will be lower.

That sort of error is excusable in a layman. It is inexcusable for a trained economist. Astonishingly, most of the analysis of the banking crisis makes an analogous error. Almost all those who blame the credit crunch on failures of regulation or greed simply fail to ask what would have happened if regulators had prevented banks from lending on/investing in complex derivatives based on sub-prime mortgages. Would banks instead have invested in safer or more rewarding assets? Or would they have simply lent less? The implicit assumption of those who blame the crisis on the quality of lending is that there were higher quality lending opportunities available. But it is scarcely credible that banks ignored safe, high yielding assets in order to invest in junk.

Bankers would have preferred to invest in derivatives based on mortgages to sound borrowers with ample collateral at low valuations. They just were not available in sufficient quantity to meet the banks' demand. So, if regulators had prevented banks from investing in sub-prime assets, banks would either have had to invest in even more dubious assets – or they would have lent less. If they had lent less the economy would have experienced a slow down – since it is net bank lending which creates the money fuelling growth. If Greenspan had stuck to his policy of relaxing monetary policy whenever the economy flagged he would, in effect, have been further inflating property prices and prompting banks to restart lending on assets, inevitably based largely on property collateral at inflated prices, however junky they might be. Alternatively the world would have experienced rather earlier (albeit maybe more gently) the slowdown that it is now likely to face over the next decade.

Quite apart from this egregious error the recent economic crisis revealed major holes in economic understanding which still need to be filled. Above all the role of cumulative indebtedness (when debt grows faster than income) is scarcely addressed by monetarists, Keynesians or economic modellers.

Monetarists rightly focus on the supply of money but assume the sole relevance of credit expansion is that it is the mechanism by which money is created. They place the blame for the credit crunch on the period of excessive monetary growth which preceded it. But that growth, though excessive, was not unprecedented and had never before provoked a recession on the current scale. By contrast, few if any monetarists devote much attention to analysing how expansion of credit can: a) progressively exhaust the supply of low risk, high reward lending opportunities, b) artificially inflate the value of the collateral against which credit is extended, and c) result in a more brittle economy as heavily borrowed individuals will be likely to curtail spending if their confidence is shaken.

On the other hand, Keynesians ignore (as Keynes himself certainly would not have done) the danger of a lenders strike. They assume that the UK could get out of today's problem if only we applied the policies the master prescribed for the rather different circumstances of the 1930s – notably running a government deficit. They ignore the fact that some countries had begun to run large deficits in the boom. Nor do they make any allowance for the likelihood that, beyond a certain point, lenders will calculate that, just to pay the extra interest on this year's borrowing, a country running a large deficit will either have to borrow even more next year or make substantial cuts just to stand still. So lenders may only continue lending if interest rates are raised which will exacerbate the problem. Greece has demonstrated that this can happen.

Economic models incorporate all these failings and more. As Charles Goodhart has pointed out, the assumptions on which most models are based (perfect foresight etc.) would mean that money would be unnecessary. As a result models rarely give money, and still less credit expansion and cumulative indebtedness, any role in influencing economic activity.

The only economist who did analyse some of these issues in advance was Herman Minsky. But because his analysis was not amenable to expression in mathematical form it was largely ignored by modellers and academics of all persuasions.

Unless and until economics can advance enough to address these features of the recent crisis we will not be able to reduce the risk of similar problems recurring in the future. And unless we can achieve that it will be all the harder to sustain the social market system against revived statist criticism.

The fundamental case for the social market

Although critics of the social market have seized on the economic crisis unleashed by the credit crunch to launch a new offensive to

extend state power over the market, their faith in statism is not caused by capitalism's current travails. Nor will that faith fade away if their specific criticisms based on the credit crunch are rebutted. Their faith in the desirability of state control springs from a deeper and more fundamental source. It is important to examine and respond to their more general case.

Both advocates of state control and social marketeers, presumably want a society from which poverty has been eliminated and in which everyone has the opportunity to fulfil their God-given potential. The difference is the assumptions of each side about the best means to achieve these ends.

The statist assumes that if the state is led by the most intelligent and the best intentioned people it will be able to allocate resources most efficiently and most fairly. The economy will be more productive, problems will be tackled in the most rational possible way and everyone's needs met to the maximum possible extent. Good intentions and a comprehensive vision will replace greed and the wastefully competing narrow perspectives of market participants.

This view is so axiomatic that it is rarely spelt out explicitly by those who hold it. But it is the implicit paradigm underlying the liberal intelligentsia's knee jerk response to any problem that 'the government must do something'.

Because it is rarely made explicit it largely escapes critical analysis. By contrast, the assumptions on which the case for the free market is supposedly based are subject to rigorous criticism. Nothing has done more damage to the case for the social market than the model of the 'perfect market'. It has been presented to generations of economics students as if it was the basis of case for relying on a free market. They are told that if there were a 'perfect market', resources would be allocated as to maximise the sum of

human satisfaction. They are then shown that the assumptions required for a 'perfect market' to exist are ludicrously unrealistic and in any case the likely distribution of outputs from such a market would be unfairly distributed. It is then taken for granted that state intervention is the default option either to replace the free market entirely or at least to remedy its ubiquitous 'market failures'.

It is time we subjected the assumptions behind the implicit belief in the perfect state to a similarly rigorous analysis.

First, there is no guarantee – even in a democracy – that those who win control of the levers of state power will be the brightest and best. Historically, the more extensive the power of the state, the more brutal the sort of people who have won control of it. Even in a partially socialised economy those who almost automatically gain enhanced power are public sector trade union leaders, who can enhance their members' well-being at the expense of the rest of society.

But there is a more fundamental critique that applies even if we could guarantee that those who would win control of the levers of state power would be the most enlightened, clever and good. That is that however intelligent and however well intentioned the enlightened elite, presumably a few hundreds or thousands at the most, whom the statists envisage controlling the levers of state power, they will never have a fraction of the brain power, knowledge and energy of the population as a whole. If we can harness the intelligence, knowledge and enterprise of millions of citizens to their mutual benefit through co-operation and exchange they will always outstrip the efforts of the limited number of talented bureaucrats and ministers who set government policy.

Moreover, it is hard to see how to meet the second and higher objective of allowing every one to attain their God-given potential unless everyone is allowed to pursue their own aims and make

their own choices rather than being required passively to follow the government's enlightened guidance as to what those aims and choices should be. People's aims and preferences, are subjective and, by definition, each individual knows their own preferences the trade-offs they would make, not to mention their own circumstances better than any official can surmise them to be. The state cannot hope to find this information by asking people however elaborate their surveys since people are invariably better at acting upon their personal preferences than they are at articulating them.

A lot of what we need to know can only be found by trial and error. The market is a discovery process. It rewards those whose hunches prove successful and forces those who make mistakes to desist. The argument for state control is that it can impose a single coherent view. It is a contradiction in terms to expect the state to pursue multiple and conflicting options. It is also particularly difficult for governments to admit they have made a mistake. They are likely to persist in pursing failures whereas the entrepreneur has no option but to stop when he runs out of money.

So, the superiority of the social market over state controlled activity is that the market harnesses the many not the few; that it co-ordinates the knowledge of individual consumers and producers and transmits that information through the price mechanism; that it releases individual's energy rather than requiring conformity to the dictates of the state and that it unleashes creativity and encourages discovery in a way the state is intrinsically unsuited to do.

As far as the private sector is concerned those arguments were largely won in the 1980s and implemented in the 1990s. That still left a major role for the state in the social market economy – hence the word 'social' – not least in ensuring the provision of public services. The challenge of the future is to see how the knowledge and creativity of the market can be harnessed to improve the public services. Where possible we should encourage multiple providers

rather than a state monopoly, freedom of entry for new providers, and taxpayers' money to follow individual choice. However, the fact that we accept that the state must be involved implies that we cannot simply leave the provision of these services to the market. Each service is in the public sector for a specific reason and those reasons may restrict the scope for social market methods. Education is compulsory because there may be a minority of parents who would not send their children to school. Once the state makes education compulsory it must define at least the content of a basic acceptable education.

Health is a state responsibility since sickness – at least anything serious – prevents a person earning enough to pay for it. So health care cannot be rationed by price. Even if health insurance were made compulsory that would not involve rationing by price, contrary to what some economists assume. The state would have to specify what conditions and treatments must be covered by the compulsory scheme. It would also have to set a maximum premium towards which it would contribute for those on low incomes, the chronically sick and the retired. Like the NHS, insurers have to pay for care (apart from prescription charges and any minimum charge) when it is needed – they do not ration it by price. In practice compulsory private insurance would involve means tested premiums, premiums unrelated to medical history, and rationing of provision by quantity not price – so it would be little different from our present tax payer funded system. That does not mean there is no scope for market mechanisms – but it will be limited to allowing diversity of providers, making taxpayers' money follow patient choice and providing maximum information to enable patients (and their GPs) to make informed choices.

Social security is also a taxpayer funded insurance scheme. Most of the risks it covers are inversely related to income which effectively rules out any private insurance. The principle exception is retirement. Life expectancy is strongly positively correlated with

income. So the working poor contribute according to their income during their working life then receive a pension, also related to their lifetime earnings yet typically receive it for fewer years than the better off. So they do rather worse out of the state system than they would out of a private actuarially based system. There may be scope for a more genuinely contribution based pension scheme on grounds of fairness as well as efficiency.

In short, there is still plenty of scope for creative thinking if the benefits of the social market are to be extended within the public services in the years ahead.

PART TWO

THE SOCIAL MARKET ECONOMY REVISITED

LORD ROBERT SKIDELSKY

Keynesianism and the dilemma of unemployment

In my essay, *The Social Market Economy*, which launched the Social Market Foundation in 1989, I identified the inability to maintain continuous full employment as one of the failures of the market system, justifying government intervention. I pointed out, though, that there was no agreement among economists as to why heavy unemployment should develop and persist. Classical economics taught that efficient markets 'always clear'. However, for markets to be efficient very strong conditions had to be satisfied, the chief of which were perfect competition and perfect information. Mass unemployment could develop if one or other of these conditions were not satisfied.

The Thatcher revolution tried to banish the spectre of mass unemployment by moving the market economy closer towards the competitive ideal. This is what was meant by 'supply side policy'. Unemployment was blamed on monopoly pricing by trade unions, unemployment benefits set at too high levels and given under too easy conditions, minimum wage legislation, and so on. If unions were sufficiently weakened, unemployment and other benefits reduced in amount and scope, and minimum wages abolished, unemployment would recede to its 'natural rate' – that rate consistent with stable prices. To make labour and product markets more competitive was thus the object of Thatcher's supply-side reforms. If supply-side reforms could deliver a tolerably satisfactory average rate of unemployment, the long-standing commitment by government to maintain full employment by expansionary fiscal and monetary policy could be safely abandoned. Macro-policy could be reduced to one single aim: to maintain stable prices.

This reorientation of economic policy was justified by a double failure of the hitherto dominant Keynesian school. The first was

the failure of Keynesian policy to predict, and hence to control, the simultaneous rise of both unemployment and inflation in the 1970s. Milton Friedman had provided a plausible explanation of this. Powerful unions, he said, were pushing up wage costs and hence the 'natural rate' of unemployment. In their attempts to push unemployment below its natural rate by increasing the quantity of money governments were simply pushing up the rate of inflation. Workers realising that their real wages had gone down demanded compensating increases in their money wages which rendered the unemployment reducing policies abortive.

The theoretical failure of Keynesianism was, if anything, seen as more profound. The Keynesians were unable to provide a theoretical explanation for the widespread phenomenon of 'sticky' wages and prices. Why, when the economy suffered a shock – like the OPEC price shock of 1973-4 – did not producers adjust their wages and prices immediately to the new situation? The answer seemed to lie with external interferences with market adjustment by powerful trade unions, government subsidies for overmanned industries, and so on. So the way to get unemployment down was not to expand aggregate demand, which only pushed inflation higher, but to make labour markets more competitive.

The new doctrine was proclaimed by Nigel Lawson in his Mais lecture of 1984:

'It is the conquest of inflation, and not the pursuit of growth and employment, which is or should be the objective of macroeconomic policy. And it is the creation of conditions conducive to growth and employment … which is or should be the objective of microeconomic policy'.[30]

30 Nigel Lawson, *The View from No.11* (London: Bantam Press, 1992), 415.

However, economists were shocked by the huge unemployment cost of getting the inflation rate down in the 1980s. Despite sweeping supply-side reforms, unemployment in the UK went on rising for seven years, peaking at three million in 1986. It was in the light of this experience that a 'New Keynesian' school grew up. This concentrated attention on the second condition for efficient markets: perfect information. New Keynesians started to explain heavy and persistent unemployment in terms of 'information failures'. Whereas the rational expectations theory of Chicago University assumed that market participants made efficient use of all relevant information, the new Keynesians identified blockages to the information flow sufficient to account for various forms of 'market failure'. A favourite example was 'asymmetric information', which was used to explain failures in the market for private insurance. But as Paul Krugman later admitted, such information failures as identified by the New Keynesians were not up to the job of explaining the systemic crisis which hit the global economy in 2008. For this we need to turn to Keynes himself.

Keynes and the market's treatment of uncertainty

At the heart of Keynes's economics is the distinction between risk and uncertainty. Risk is when probabilities can be measured; uncertainty exists when no such measure is possible. The financial system, which crashed so spectacularly in 2008, used mathematical models which assumed that it was possible to measure risk and therefore insures or hedge against loss. Individuals could miscalculate the odds but, given the assumption of rationality, their mistakes would be randomised.

In his *Treatise on Probability* (1921), Keynes set out an alternative: the landscape of chance. First, there is cardinal or measurable probability, e.g. 'There is a one in six chance of your house catching fire in the next year'. This frequency view of probability partly derives from games of chance, partly from invariable connections found in the natural, and some parts of the human, world. 'In actual reasoning … exact measures [of this kind] will occur comparatively

seldom', Keynes wrote.[31] Second, is ordinal probability, in which we have some evidential basis for believing that something is more or less likely to occur without being able to attach numbers to 'more' or 'less'. Most risk assessments used by non-financial firms are based on this informal procedure. However, there is a residual category of 'unknown probabilities', in which our evidence is too scanty even to say that something is 'more likely than not, or less likely than not, or as likely as not'.[32] For Keynes, probability is the hypothesis on which it is reasonable for us to act in conditions of limited knowledge.[33] There is no presumption that our knowledge will be sufficient to give us calculable probabilities.

Here is Keynes's canonical statement, from a 1937 essay:

By 'uncertain' knowledge, let me explain, I do not mean merely to distinguish what is known for certain from what is only probable. The game of dice is not subject, in this sense to uncertainty; nor is the prospect of a Victory bond being drawn. Or again, the expectation of life is only slightly uncertain. Even the weather is only moderately uncertain. The sense in which I am using the term is that in which the prospect of a European war is uncertain, or the price of copper and the rate of interest twenty years hence, or the obsolescence of a new invention or the position of private wealth owners in the social system in 1970. About these matters there is no scientific basis on which to form any calculable probability whatever.[34]

Keynes thought this category of 'uncertain knowledge' particularly relevant for the investment process which is driven by the expectation of profit over time. The further we peer into the future, the less we see.

31 JM Keynes, *Treatise on Probability* (1921).

32 Ibid. viii, 32.

33 Ibid, 339.

34 CW, xiv, 113-4.

To illustrate why he thought the future will necessarily be opaque to us, Keynes gave the example of an apple endowed with 'human' characteristics. 'It is as though the fall of the apple to the ground depended on the apple's motives, on whether it is worthwhile falling to the ground, and whether the ground wanted the apple to fall, and on mistaken calculations on the part of the apple on how far it was from the centre of the earth'.[35]

Some part of the uncertainty attaching to the velocity of the apple's flight can be put down to the apple's miscalculation. However, the main 'human' characteristic with which Keynes equips his apple is 'motives' and 'intentions'. It is these which break the link between past and future, between economics and physics. Keynes's point is that economics 'deals with introspection and values … with motives, expectations, psychological uncertainties'. The future can't be predicted, because it is what we choose to make it. This view implies a large restriction on the applicability of econometrics. Basically Keynes believed it could be applied only to those fields in which risk is measurable. This excluded nearly all the risks incurred in investment markets.

Human beings, though, can stand only a limited amount of uncertainty. Keynes's economics is about the behavioural strategies we use to rob uncertainty of its sting. The main one is to transform uncertainty into calculable risk by giving it numbers. The best known technique for this purpose is Bayes' theorem. Bayes divided probability into prior and posterior probabilities. This division enables subjective beliefs to be construed as bets. The rationality of the bets is satisfied if they are such that no clever gambler can make a profit against the better whatever happens – that is, when no bookie can run a Dutch book on the better. As the number of observations grows, the starting odds come to reflect the objective merit of the horses.

35 Ibid. xiv, 300.

Keynes would have agreed that we do form our expectations by some such process. What he denied was that in investment and other future-oriented markets there exists an objective reality with which our subjective bets are aligned by a learning process. While repeated betting on horses allows you to update your 'priors' to match the 'true' merits of the horses, no amount of data on past financial crises or armed conflicts brings you any closer to their true probabilities in the future because they are by their nature *singular* events. Analysis of the 2008 crisis will not give you a probability of a crisis occurring in say 2013. What we do is to use mathematics to *invent* a world of calculable probabilities which we take to be an accurate reflection of the real world.

Keynes put uncertainty to work to explain two leading features of modern economic life: the frequent breakdowns in the investment machine, and the persistence of heavy unemployment following a collapse in investment.

Why, in Keynes's view, does investment break down? His answer is that the technique for transforming uncertainty into calculable risk is based on nothing more than a convention, the convention being that 'the existing state of affairs will continue indefinitely, except in so far as we have specific reasons to expect a change we are assuming, in effect that the existing market valuation, however arrived at, is uniquely correct in relation to our existing knowledge, and that it will only change in proportion to changes in this knowledge'.[36] This convention is philosophically flawed, 'since our existing knowledge does not provide a sufficient basis for a calculated mathematical expectation'. Nevertheless, it is compatible with 'a considerable measure of continuity and stability … *so long as we can rely on the maintenance of the convention'* [italics in original]. For by using the convention the investor can 'legitimately encourage himself with the idea that the only risk he

36 Ibid. vii, 152.

runs is that of a genuine change in the news over the near future', which is unlikely to be very large. 'Thus investment becomes reasonably 'safe' for the individual investor over short periods, and hence over a succession of short periods … if he can fairly rely on there being no breakdown in the convention'.[37]

But expectations so precariously based are liable to be swept away, because, as Keynes says, 'there is no firm basis of conviction to hold them steady' – that is, to be able to distinguish between new relevant information and 'noise'. Suddenly every one starts revising their bets. The existence of liquid markets for securities enables investors to do this. Everyone tries to become liquid. But, as Keynes notes, 'there is no liquidity for the community as a whole'.

'The practice of calmness and immobility, of certainty and security, suddenly breaks down. New fears and hopes will, without warning take charge of human conduct. The forces of disillusion may suddenly impose a new conventional basis of valuation. All these pretty, polite techniques, made for a well-panelled boardroom and a nicely regulated market, are liable to collapse'.[38]

This is as good a theoretical explanation for what happened last autumn as I have come across. There was no 'under-pricing of risk world-wide' as Alan Greenspan claimed. There was a break down of the convention that risks were being correctly priced.

Money plays a key part in the narrative of investment breakdown. Holding money is an alternative to buying investments. The collapse of investment is simultaneously a flight into money. The function of money as a store of value can only be explained, Keynes felt, by the existence of uncertainty. Since the crisis struck last year there has been a big increase in hoarding money – as the phrase is,

37 Ibid. vii, 152.

38 Ibid. xiv,114-5.

we are suffering from a liquidity crisis. Banks are reluctant to lend, and investors reluctant to borrow. They both sit on enlarged cash balances.

Uncertainty also lies at the heart of Keynes's theory of persisting unemployment. The classical theory, like its new classical successor, assumed optimally self regulating markets. It assumed, that is, the rapid adjustment of relative wages and prices to shocks – monetary shocks, technology shocks, and so on. What most normal people call unemployment is for Chicago economics a voluntary choice for leisure.

Keynes offers an explanation of why wages and prices remain 'sticky'. A shock to investment creates a new situation in which the old vector of wages and prices becomes unviable. But market participants have no knowledge of what the new viable vector is. They are forced to trade at disequilibrium prices. In the graphic phrase of Axel Leijonhufvud there is no auctioneer to call out prices before the new round of trading starts. So market participants hold off investing or offering labour services long enough for output losses to develop. Once output starts falling its fall is cumulative, as aggregate spending falls in a multiplied way until an under-employment equilibrium emerges. Wage costs, that is, are adjusted to the 'shock' mainly through a fall in output and employment which automatically reduces the wage bill.[39]

The chief 'sticky price' in Keynes's system, however, is not wages, but the rate of interest. Contemporary monetary theory – as in Keynes's day – suggests that a fall in investment relative to saving would bring about an automatic fall in the rate of interest. But Keynes, as we have seen, thought that a great deal of saving was done not to invest but to hoard money, and that this 'liquidity preference' rose during a financial crisis. So the rate of interest in his

39 Axel Leijonhufvud, *Keynes and the Classics* (London: Institute of Economic Affairs, 1969).

scheme was the price of 'not hoarding'; as he put it 'the price which adjusts at the margin the demand for hoards to the supply of hoards'. This price might easily stay too high to bring about a recovery of investment. I quote: 'When a more pessimistic view is taken about future [yields] of investment there is no reason why there should be a diminished propensity to hoard. Indeed, the conditions which aggravate the one factor tend, as a rule, to aggravate the other. For the same circumstances which lead to pessimistic views about future yields are apt to increase the propensity to hoard'.[40]

Uncertainty may cause the long term rate of interest to remain for years above the rate needed to restore a full employment volume of investment. This removes the main 'self-adjusting' element in the economic system. The listing ship does not automatically right itself. This is Keynes's main argument for a 'stimulus'. In a situation of rapid economic decline, it is the government's duty to provide an external source of spending to replace the shortfall in private spending. This usually means running a budget deficit. The extra spending created by government will reverse the initial fall in aggregate demand. As aggregate spending increases, the budget deficit will automatically shrink, since government revenues rise faster than national income. If the economy starts growing again at its old rate, then provided budgets return to balance, the national debt will also start coming down automatically.

The theory of the stimulus is not rocket science. How large it should be and what its effects will be are subject to uncertainty. A large part of the effect will depend on confidence in the government's policy and in the sustainability of its finances. In the UK the political parties have been arguing about the size of the government's 'structural' (that is, pre-recession) deficit, and therefore about how much public spending will have to come down or taxes go up to rebalance the budget, and how soon this

40 Ibid. xiv, 118.

should happen. In present conditions, Keynes would, I think, have been in favour of putting extra money directly in the pockets of the poorest section of the population, those with the lowest propensity to save.

Toward a social market economics

Although I identified persisting unemployment as one of the main issues a social market economy needed to address, I did not in fact address it in my SMF pamphlet of 1989. Had I done so I would have discovered a more extensive field for government intervention than I, or other social market theorists of the time, would have allowed.

The most notable omission in my pamphlet was any discussion of the financial system. Its capacity for self-regulation was simply taken for granted. This assumption has been blown sky high. Everyone now accepts that it needs to be reformed, but there is considerable debate about the kind of reform needed. If, as most people now agree, banking services need to be made less risky for most of their users, how can this be done without chilling the spirit of financial innovation? The short answer is that financial innovation is not always a benefit. It was Warren Buffet who described derivatives as potential financial weapons of mass destruction. I would limit the scope of financial innovation to those areas where people can be left free to gamble without endangering the system as a whole. This points to restoring the fire walls between different types of banks swept away in the de-regulation movement of the 1980s and 1990s. The basic cause of the financial crisis was not that retail banks over-lent mortgages, it was that the investment departments of retail banks used depositors' money to gamble in derivatives. If it is true, as John Kay contends, that retail banks had become 'utilities with casinos attached to them', the logical solution is to separate the utility from the casino, i.e., a return to Glass-Steagalism.

A banking reform along these lines would automatically reduce the scope for securitization. In Keynes's terms it would protect the

main part of the banking system from the quants who claim to turn uncertainty into calculable probability.

Secondly, Keynes suggested two measures to counter the inherent instability of the private investment machine. The first was to have a larger share of investment done by the state: 'I expect to see the State, which is in a position to calculate the marginal efficiency of capital-goods on long views and on the basis of the general social advantage, taking an ever greater responsibility for directly organising investment'. The reason he gave was that fluctuations in private investment demand were likely to be too great to be offset by any practicable changes in the rate of interest.[41]

The idea of a greater role for public investment to 'steady the economy' will raise howls of execration from all those who regard the state as the problem, not the solution. But what we always have to do is to balance the waste inherent in state activity against the waste of prolonged bouts of heavy unemployment. A crucial task for any updated version of the social market economy is to rehabilitate the state as a potentially beneficial economic actor.

Keynes's second proposal was to redistribute incomes so as to raise the propensity to consume, since an 'increase in the habitual propensity to consume will in general [i.e. except in conditions of full employment] serve to increase the inducement to invest'.[42]

The following passage from Marriner Eccles, chairman of the US Federal Reserve Board from 1934-1948, spells out the logic of this position in terms completely applicable today:

> *A mass production has to be accompanied by mass consumption. Mass consumption in turn implies a distribution of*

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41 JM Keynes, *The General Theory of Employment, Interest and Money* (1936), 164.

42 Ibid. vii, 373.

> *wealth to provide men with buying power. Instead of achieving that kind of distribution, a giant suction pump had by 1929 drawn into a few hands an increasing proportion of currently produced wealth. This served them as capital accumulations. But by taking purchasing power out of the hands of mass consumers, the savers denied to themselves the kind of effective demand for their products that would justify a reinvestment of their capital accumulations in new plants. In consequence, as in a poker game where the chips were concentrated in fewer and fewer hands, the other fellows could stay in the game only by borrowing. When their credit ran out, the game stopped.*[43]

Finally, it would be worth the SMF giving serious thought to the question of what kind of economics could best support the idea of a modernised social market economy. What would an economics look like which allowed for the possibility of unpredictable events with large consequences? Its basic axiom, I suggest, cannot be rational expectations as defined by the still dominant Chicago school. It would need to recognize the role of conventions in shaping the behaviour and expectations of individuals in an environment which lacks the clairvoyant signals about future events assumed by orthodox economics. It would need to understand why conventions thus formed are liable to periodic breakdowns, and would seek to create institutions which limited the ravages of unpredictable events. It would seek to rebalance our prevailing views about the role of state and markets. The great achievement of the Institute of Economic Affairs in its heyday was that by asking fundamental questions about economics it prepared the ground for new thinking about policy. This is something the SMF should try to do today.

43 Eccles Q, *Reforming the City*, ed. Sam Whimster (2010), 98.

RETHINKING THE ECONOMIC BORDERS OF THE STATE

DIETER HELM

Introduction

The economic borders of the state have expanded in fits and starts since the First World War. Gradually the state has taken on more and more functions, from the provision of social security to health, and education. It has expanded into production through nationalisation and industrial policy and developed wide-ranging regulatory powers. These extensions have taken place within a framework of macroeconomic management with fiscal and monetary intervention designed to control the business cycle. Now this reach into almost every aspect of the economy has been ratcheted up another notch in response to the current economic crisis. It is an expansion which has raised deep questions about the scope and limits of state involvement and a renewed interest in redefining and perhaps rolling back its domain.

Revisiting the economic borders of the state requires first an understanding of the debates of the past. That past, both intellectually and practically, conditions the current debates. Between the First and Second World Wars, the intellectual challenge was to define the role of the state in the economy, and out of this intensive debate emerged a post-Second World War consensus on what became known as the *social market economy*.

The First World War had broken the back of hierarchical societies across Europe: the millions involved and the scale of the destruction broke the back of the upper classes and the aristocracy, to the extent it remained in command. The Russian revolution and the collapse of the German monarchy were events on a par with the collapse of the Soviet Union and communism at the end of the twentieth century.

The initial post-First World War boom gave way to the great crisis in capitalism. It happened early in Germany with hyperinflation and, after the crash of 1929, elsewhere. By 1930 the old certainties – a stable monarchy, a hierarchical and deferential society, the Gold Standard and, behind it all, a self-correcting capitalism with flexible wages – had vanished. Now a new model was needed to correct the obvious and massive macroeconomic market failures, and gradual democratisation meant that the distribution of income could no longer be left to inheritance and the market.

The intellectual debate was vigorous and revolutionary. In one corner stood Hayek, with continental ideas derived from the supremacy of the law and the European (German) concept of order. Hayek advanced the case for a capitalism which relied on competition, but within the straightjacket of a monetary constitution and a promotion of the virtues of competition.[44] In the other corner, Lange argued that socialism and planning were the rational responses to market failures.[45] In the middle was Keynes, arguing for an activist macroeconomic policy within which a predominantly private and competitive market would function.[46]

Each of these positions was complex, and there was much debate about the details. There were many variants, and each changed their minds from time to time. Their disciples and allies extended and expanded the positions. In the political domain, ideas were moulded to electoral ends. Socialists built on the economic theories of planning. Liberals – notably in Germany – built on the constitutional and rules-based Hayekian model to create the social market economy, whilst in Britain, the Keynesians combined with the planners to create a social democratic blend

44 Friedrich Hayek, "The Meaning of Competition", in *Individualism and Economic Order* (London: Routledge & K. Paul, 1948).

45 Oscar Lange, "The Foundations of Welfare Economics", *Econometrica* 10 (1942); Oscar Lange and Frederick Taylor, On the Economic Theory of Socialism. (Minneapolis: The University of Minnesota Press, 1938).

46 John Maynard Keynes, *The General Theory of Employment, Interest and Money.* (London: Macmillan, 1936).

of macroeconomic activism, nationalisation of the commanding heights of the economy, and the welfare state.

The arguments from the 1930s steered the role of the state through much of the rest of the century. The inflationary shocks of the 1970s revived monetary constitutionalism to yield monetarism, and eventually a rules-based monetary policy framework. France's flirtation with Keynesianism in the early 1980s under Mitterrand revealed the limits to fiscal policy. Rules-based competition policy emerged, as did a preference for private over public ownership from the 1980s onwards. The process of European integration followed more the continental philosophy over that of the Anglo Saxons, and unsurprisingly, the European Commission pushed forward a model based on uniform rules (directives), whilst at the same time liberalising trade within the Union. Even European competition policy fitted rather neatly into the Hayekian framework: opening up markets, using rules-based competition law, and breaking up core utilities, were all policies which Hayek would probably have approved of.

By the beginning of the twenty-first century, the Keynesian vision of the role of the state might have looked to be in retreat. Yet in reality, the concept of an activist fiscal policy to manage the business cycle was very much alive: indeed, so ingrained was it that some thought the business cycle itself had been mastered – and thereby abolished. The reality was very different: in the hands of Keynesians, the neat idea of a long term balanced budget, with short term deficits and surpluses to even out the cycles, gave way to structural deficits in the good times and cyclical deficits in the bad times. The growth of the state in its share of national income was a natural consequence of putting the beguiling Keynesian ideas in the hands of practical politicians. The state grew from a share in national income of around 20% in the early 1960s to over 40% by the end of the century. Now it stands at over 50% in many European economies, supported by national debt levels close to 100% of GDP in several countries.

The bust from 2006 onwards presents a massive intellectual challenge which has many parallels with that of the 1930s. Economies are very different now, and the role for the state is of a different order of magnitude. Technologies have radically altered the way firms, consumers and governments behave – and their possibilities. The threat of European war – a persistent and overshadowing fear in the 1930s – has gone away. There are some new problems too: most notably from population aging and the environment. In the 1930s, people did not tend to retire for long, and the provision of pensions was not the challenge it is now. There was no climate change to worry about and little yet of the destruction to biodiversity that agrichemical industries would bring. Inter-generational concerns mattered little.

The debates of the 1930s give much guidance to the debates now. But a simplistic grasp of the Hayekian or Keynesian answer will not provide much more than a partial guide. The social market economy concept needs to move on to meet the issues of today rather than those of the 1930s. This paper starts with the lessons from the past – and in particular from Keynes and Hayek and particularly how they both shape and limit the current debate (section two). The next step is to add in what is left out of this debate – notably the intergenerational concerns which are raised by debt, pensions and the environment (section three). With the intergenerational issues brought to the fore, the next step is to work out what the role of the state is in providing a stable economic framework through time. This is in large part about infrastructure considered in the widest sense (section four), and intergenerational equity (section five). Taken together, a sketch of a new twenty-first century model for the role of the state can be glimpsed, and the paper ends with this outline (section six).

Keynes, Hayek and the economic crisis

Both Keynes and Hayek were towering figures in the debates of the 1930s because their contributions were much more than

mere economic theories. Both were political economists in the sense that they viewed their contributions in the wider political economy setting. They were concerned with the big questions of economic policy in a way that few academic economists would now understand. And in their approach they both wrote on the wider political economy agenda, and neither had much truck with empiricism. Indeed whilst the role of the state in the economy might be shaped by "facts", they shared with many of their contemporaries the view that economics was not a science subject to empirical testing.

Much has been written on the wider political economy of both. For Keynes, the short run was what mattered – the future would take care of itself, and the economic consequences for our grandchildren would be bright provided the immediate problems were fixed. He took an optimistic view of human potential. For all Keynes wrote about animal spirits and especially investment, his worry became underconsumption, and his General Theory was a direct descendant of those on the liberal left who wanted to use the state to solve what classical economists had regarded as the inevitable "stationary state" as appetites for consumption were satiated. Appeals to longer run concerns met the contemptuous often-quoted remark that "in the long run we are all dead". The economy would not self equilibrate at full employment and could get stuck (and in the 1930s was) with unemployment. The market failure was one of co-ordination and expectations. Savings and investment, and therefore aggregate demand and aggregate supply might not be brought effectively together at a desirable level by unaided market forces (such as by real wage reductions). There was a paradox of thrift, and an economy could stagnate in a psychology of pessimism with a deficiency of effective demand. The source of demand of last resort was the state, and it could borrow to plug the gap. Just who it would borrow from, and what the consequences of that borrowing would be, was as contentious in the 1930s as it is now.

Hayek's time horizon was very different. Hayek was very much concerned with the longer term, with less regard for the short term. For him the state needed to be set into a rules-based constitution, and it is therefore not surprising that many US constitutionalists saw more in Hayek than did their British counterparts with the British tradition of avoiding constitutions and scrutiny of the state by the courts. Hayek was ultimately a legal theorist who saw economics as a dimension of the law.

This was not, however, a simplistic diagnosis, for Hayek thought deeply about competition and its meaning. For him competition combined two great virtues: it gathered, used and distributed information far better than governments; and it embedded the idea of individual liberty. The former was very much an economic claim – and a claim which undermined the socialistic planners like Lange.[47] Socialism simply would not work – and the eventual collapse of that great planning experiment, the Soviet Union, could be explained in this way. In a competitive market, individuals and firms needed to know only their own circumstances and the prices; in a planned system, the state needed to know everyone's preferences and every firm's production costs. Trying to tinker with the market was doomed by an informational impossibility that not even modern computers could solve. Hayek therefore opposed the sorts of tinkering in markets that British social democrats came to expound.

The latter individual liberty comes directly from John Stuart Mill and his essay *On Liberty*. Hayek thought it fell to every generation to restate the case for individual liberty, and given his European context, this is hardly surprising.[48] This was a timeless truth for him. It was also the foundation of his political economy. Competitive markets – free from state interference – were the natural places for the flourishing of individuals.

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47 Hayek, "The Meaning of Competition".

48 *Friedrich Hayek, The Constitution of Liberty* (Chicago: University of Chicago Press, 1960).

It is no accident that in Britain the left was drawn to Keynes and the right to Hayek. Keynes appealed to the social democratic wings of the Labour party. For Wilson, Callaghan, Jenkins and Healey in the 1960s and early 1970s, the Keynesian framework was a natural way to think about fiscal policy. It provided intellectual cover for the expansion of government spending. It was only in the late 1970s under Callaghan and Healey that the activist fiscal approach was ditched (and Healey discovered monetary targets and privatisation). In the 1980s, Thatcher naturally gravitated to Hayek (and Friedman) as did the Reaganites in the US.

After 1997, and particularly after 2001, the Labour government of Blair and then Brown tried to combine the two political economies. Labour embraced an independent monetary policy with a "golden rule" only to borrow to invest over the cycle. A Hayekian constitutional approach was thereby set out, within which counter-cyclical policy was permitted, but as events unfolded it was observed more in the breach than in conformity. Fiscal policy was anything but constrained, and from 2001, a structural budget deficit of several percent of GDP was run. On the monetary front, interest rates were set well below their long run real rate after the stock market crash in 2000, and as the credit and then the economic crisis broke, any pretence at inflation targeting only was quietly abandoned.

As the full magnitude of the "bust" that followed the great boom of the late twentieth century become apparent, Keynes was resurrected and proclaimed as the saviour. We are all Keynesians now, the politicians proclaimed. Budget deficits exploded, the stability pact was effectively abandoned in Europe, in the name of maintaining demand and "going for growth". In the process, an enormous mortgage was written on the future, and the borrowing was supported by "quantitative easing" – directly buying up bonds by the central banks.

In Europe, deficits did also rise very sharply, but on average by considerably less than in the UK and the US. The monetary

constitution provided by the euro limited the scope to go down the Keynesian route. Instead, economies had to adjust, and standards of living had to fall to levels consistent with the realisation that the future was not as rosy as the prophets of the great boom had claimed. Across Europe real wages fell, pensions were cut, and the public sector was cut back through austerity measures. Devaluation – the option for the UK for decades since coming off the Gold Standard – was not available as a soft option for reducing living standards.

To the Keynesians, Europe was doomed to low growth by the monetary straightjacket. Without the stimulus of government spending, it was argued that it would struggle to recover, and indeed default was widely predicted for the weaker members, like Greece. The jury is still out on whether they are right. It is a debate which will rumble on for years amongst academics and politicians – in part because the extent of Keynesian stimulus in the UK was less than Labour had claimed (because the structural deficit plus the cyclical effects of the recession explained most of the deficit) and because there was more Keynesian stimulus in Europe than politicians wanted to admit to their sceptical publics.

Whatever the outcome of this debate, the "facts" about the consequences remain to be dealt with. The result is a significant reduction in standards of living, a recasting of expectations of what the state can deliver in spending terms, and an enormous mortgage on future generations who will inherit both the debts and the pension liabilities. Few argue that the deficits are sustainable: it is a question more of the timing of cuts in spending and the balance between tax increases and spending reductions. This fiscal legacy will be set in a context in which the environment has also been mortgaged: current generations have debased the atmosphere with greenhouse gas and despoiled the biosphere. Put another way, current generations have been living at a higher standard by borrowing the environment and consumption from

the future – the opposite of sustainable consumption. Hayek would have understood – and criticised – this: he was concerned with the longer term. Keynes thought the future was bright and could take care of the deficits and the debt as long as the effective demand was kept up.

Responsibilities to the future

A central idea from the Enlightenment was that the future would be an ever expanding world of new opportunities made possible by the developments of science and human endeavour. The future was a better place. Now that assumption is not quite so robust: whilst science continues to push out the technological frontiers, the growth of global population spreads these increased possibilities over ever greater numbers, and as population and consumption continue to expand, the environmental degradation may yet provide hard constraints.

The numbers are indeed daunting. The world's population is on course to increase from about six billion to nine billion by 2050 – more extra people than the entire world population in 1950. Economic growth on current trends may quadruple the Chinese and Indian economies by 2050, bringing their (by then) combined population of around 4 billion towards current European standards of living. In the meantime the economies of Europe and the US may double if growth returns to around 2-3% per annum. The implied wall of consumption is awesome.

The environmental consequences are correspondingly awesome too: global warming is predicted as emissions rise towards 550 parts per million, up from 275 parts per million before the industrial revolution. Current trends indicate a rising coal burn and fossil fuels show little sign of ceding ground in absolute or even relative terms to low carbon alternatives. The carbon intensity of global GDP continues upwards. Kyoto has made little difference to these adverse trends.

On biodiversity, the destruction of the rain forests – the repository of much biodiversity – is proceeding apace. Some scientists suggest by the end of the century perhaps half the species on the planet may be extinct.

These environmental problems are big market failures: they will not self-correct, and therefore the role of the state is pivotal in whether and how they are addressed. Nothing in the debate about Keynes and Hayek addresses these enormous challenges.

Environmental problems are complex: and they tend to be global, not national. The climate is not something most countries can do much about on their own (the exceptions are the US and China which together emit nearly half the world's emissions). The destruction of rainforests is an international problem too, as is the state of the oceans.

Environmental problems do, however, share one feature with a number of other pressing problems – like debt and pensions. They are *intergenerational*, and involve significant time spans. The debts run up by government deficits and the Keynesian stimuli will have to be paid by the next generation. The unfunded pensions promised to public sector workers will have to be paid by tomorrow's taxpayers. The next generation will inherit the depleted atmosphere and biosphere.

The organising concept here is *sustainability* – the idea that the state should arrange matters so that future generations are no worse off than current ones. In the past, the assumption of economic growth meant that future generations would indeed be better off. They would inherit a bigger economy. Therefore current generations did not need to worry much about them: economic growth would take care of their needs, and the emphasis, especially for the Keynesians, was very much with the present.

This turns out to be complacent, and for three reasons. The first is the obvious one: future generations may not be better off

because the environmental consequences of current consumption may reduce future consumption. The second is that the mortgage from current debt and future pension liabilities may be too large. They may not be able to pay the interest and the current generation's pensions. The third is related, and has profound implications for the role of the state: GDP measures of growth – and the consumption assumptions based upon them – are very poor indicators of the welfare of future generations. The reason is simple: GDP has no assets, no balance sheet and no depreciation. GDP can go on up whilst the environment is despoiled. Existing natural resources can be used up which will not be available to future consumers. An example is North Sea oil and gas: there was no depreciation offset in GDP to account for its depletion to the benefit of the current generation. More generally, there is no asset balance sheet to account for the rundown of physical infrastructure, and the environment.

Translated into the current context, not only has Britain been running up a structural deficit (not following the "golden rule") but it has also been eating up its assets. Now the infrastructure needs refurbishment and modernising, the carbon externalities need to be reduced and biodiversity addressed. The public sector pensions liabilities need to be funded, and the depreciation in the social fabric needs to be rectified. Obesity builds up future health costs and educational failures last for decades. In other words, when the concept of "rebuilding the economy and the society" is advanced, *what it means is getting back to a sustainable growth path, in which standards of living adjust to take account of the depreciation of natural and human capital.* This very radical idea requires a recasting of the economic borders of the state. The organising concept is "infrastructure".

Infrastructure and public goods

Infrastructure is what lies between companies and markets, and between consumers and essential services. It incorporates the core

network utilities – like transport, energy, water and communications. But it also extends further – into social infrastructure – the educational networks, the health services, broader social supports and law and order.

What all these have in common is that they are best considered as *systems*: we have an electricity *system*, a health *system* and a *system* of social support. Another way of putting this is that these are public goods, which lie between the state and the market. Decisions about such systems are not marginal ones: we either have these systems or we don't, and they have embedded characteristics of technology and the way they are integrated.

Much of the literature on the economic borders of the state focuses on the macro and the micro dimensions – leaving out the bit in the middle. Yet infrastructure in this wider context is what makes an economy and a society function. It can be privately provided but its framework is a matter for government decision making. At the system level, almost all are natural monopolies or at least contain monopoly elements, and for most the marginal cost is close to zero. Thus, how they are financed – how the sunk and fixed costs are recovered – is a matter of policy, and therefore for governments to decide. In practice, finance is mixed: health and education are largely financed through taxation, but energy is paid for by customer charges. Broadcasting is partially paid for by the licence fee, whereas the railways are part subsidised by taxpayers.

The fact that the marginal cost is close to zero in most of these examples, and that the average costs have to be recovered, has profound effects on the design of the state and the economic borders with the private sector. Investors in infrastructure face the problem of how to get their money back – how to avoid being expropriated through marginal cost pricing. In many cases, there is no credible solution and the state does the providing directly. This is part of the explanation for the nationalisation of much of the

infrastructure in the twentieth century and why the private sector under-invested.

Privatisation represented a profound change in the economic borders of the state, and it posed a central question: how could the state credibly commit to the new private owners such that if they sunk investments into the infrastructure they would get their money back?

The answer is some form of contract which binds future customers and taxpayers to honour the sunk costs – and it is therefore one example of the intergenerational equity issue raised above. Future generations want infrastructure to be built for them: but they must commit to pay.

How then is this to be effected? In the utilities a novel and impressive approach has been taken. The sunk investments go into a regulated asset base (RAB) and an independent body – the regulator – has a statutory duty to ensure that the functions of the utility are financed, including remunerating the RAB.[49] In some cases (water and the rail network), the assets are treated as infinitely-lived – it is assumed that the services will always be needed. Here the assets are valued in current cost terms, and there is no depreciation, but instead an asset maintenance charge which ensures that the services will continue to be provided.

In this somewhat technical concept lies the germ of a new way of thinking about the role of the state. It is the guarantor of the provision of the core public goods through time, and these are provided largely by the private sector under long term contracts which honour the investments, provided they are efficiently made. The "contract" is not only that investments get paid by future

49 Dieter Helm, "Infrastructure investment, the cost of capital, and regulation: an assessment", *Oxford Review of Economic Policy* 25 (2009).

taxpayers and customers, but also that current generations behave in a way which is sustainable – that we guarantee that we will invest to pass on infrastructures at least as good as those we inherited. It is an *intergenerational bargain*.

It follows that the current generation must set aside sufficient to do the investment to maintain the assets intact. Setting aside monies for investment means foregoing consumption now: in other words, a responsible fiscal policy focused on the balance between savings and investment, and current consumption would be the residual. This is beyond the Keynesian concern about aggregate demand: investment and consumption are both components of demand, and so less consumption does not decrease demand if it is compensated for by more investment. Provided saving is translated into investment (Keynes's core concern) then demand is unaffected. Conversely, continuing to keep consumption above the sustainable rate requires dis-savings to take place. In the past decade this has been achieved by equity withdrawal and gearing of personal balance sheets – borrowing from the future – and by running down the infrastructure – and hence also, in an important sense, borrowing from the future.

To sort out the intergenerational issues it is immediately apparent that we need accounts – and preferably current cost accounts – for the infrastructure in the broader sense. We now have some of these – for the regulated privatised utilities. However, such asset-based accounts are missing for health, education, social and environmental infrastructure and for defence and law and order. Arcane as it may seem, without the numbers, we have little idea of whether we are consuming at a sustainable rate – and, more importantly, what this might entail.

Poverty Vs inequality

The modern state has obligations in respect of future generations. But it also has obligations in respect of the current generation,

notably for those who are poorest. A core political debate of the twentieth century has been how far the state should focus on inequality – should it aim to equalise the distribution of income?

A related but separate question is whether the state should try to reduce poverty. Poverty and inequality are not the same thing, unless poverty is measured relative to income distribution, and then it is just inequality in respect of a particular part of the distribution.

The addressing of these distributional questions has been responsible for the growth of the share of government in the economy by a factor of around two: before the 1960s, the share was around one-fifth except in times of war. After the 1960s, it pushed up to around 40%, with most of the difference, in effect, being made up of transfers.

Different levels of transfers reflect different welfare judgements: the moral case for equality and the treatment of the worst off in society is a matter for political debate. However, a subsidiary issue of great importance given the share of the economy involved is whether the stated objectives are actually achieved. Furthermore, even if the goal is equality, few would contest the idea that it is the worst off in society who should have priority in any steps toward the broader equality goal.

What constitutes poverty is contested: there are two broad schools – absolute poverty and relative poverty. Absolute poverty was what worried Beveridge, and in his optimism about post World War Two recovery, he envisaged that it would get "solved" by the early 1960s.[50] Relative poverty is more stubborn, since the goal posts keep moving as society gets richer. At one level, access to television is now necessary to participate in society, whereas once

50 William Beveridge, "Social Insurance and Allied Services" (London: HM Stationery Office, 1942).

it obviously was not. At another, increased access to sugars and fats has led to obesity and health problems which are highly prevalent among the poor. We can be absolutely poor, in a relative way, as Sen famously pointed out.[51]

It is beyond the scope of this short paper to analyse the detailed design of the policy to address poverty or the precise economic borders of the state that would result for each of the possible welfare judgements. But what can be elucidated within the broader context of infrastructure, public goods and proper accounting is that the claims of the poor now and the poor in the future ought to be incorporated into the intergenerational bargain. For a key component of poverty is the failure to consider human capital. The poor tend to have less education, less good health, less access to broadband, and suffer from fuel, water and transport "poverty" (in that these basic services take up a large proportion of their household budgets). In other words, the poor are poor in access to infrastructure services in the wider sense.

As with the physical infrastructure, the asset-based side of poverty is not accounted for. We have no accounts for the (sometimes declining) value of human capital. When people live off benefits and are, in effect, excluded from the labour market, their skills decline. Human capital depreciates. When they are not given proper health care and education, the human capital is sub-optimal.

Treating people as assets rather than liabilities, and focusing on how these assets can be protected and enhanced, and therefore how the human capital values can be sustained across the generations, is a very different way of thinking about the distributional issues. Indeed, it is ultimately an efficiency argument and independent of considerations of inequality.

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51 Amartya Sen, "Poor, Relatively Speaking", *Oxford Economic Papers* 35 (1983).

How might these assets be enhanced? The answer is again partly about infrastructure. Concepts like "the Big Society" are in part about social infrastructure within which people in poverty can be invested in through their communities – a basic infrastructure building block for not only a civilised society but also an efficient one. These form parts of the overall infrastructure – in health, education and protections through law and order (given that crime is concentrated in its effects on the poor).

None of this militates against redistribution. But before pure redistribution, poverty has a prior claim, and the role of the state in providing and encouraging social infrastructure needs to be considered alongside the more obvious physical infrastructures.

Conclusion

The twentieth century has left us with states which have grown so much that they now account for around half the total economies of Europe. This growth has been in response to a combination of democratic preferences for ever greater transfers, and to the irresponsibility of Keynesians in respect of fiscal policy. Over time a greater and greater mortgage has been written on the future – on the mistaken Keynesian assumption that the long run would take care of itself, because economic growth – measured by GDP – would make future generations much better off than current ones. Borrowing from the future to boost current consumption is only desirable if *sustainable* growth is assumed to be high enough – after accounting for the state of the assets being transferred to the future.

The growth of the state has, since the beginning of the twentieth century, indirectly added significantly to that mortgage. The structural deficits in Britain since 2000, the cyclical deficits since the credit crunch in 2007, the unfunded public sector pensions, the depreciation of the infrastructure (physical and social), climate change and the destruction of biodiversity have tipped that

balance. Current consumption is not sustainable – or put another way – savings and investments are too low.

The task in reconsidering the economic borders of the state is to design the intergenerational bargain in a way which maintains sustainable consumption through time. A significant part of this bargain is to ensure that the physical and social infrastructure inherited by the next generation is at least as good as the one the current generation inherited.

Patently this is unlikely to be the case – and therefore there needs to be a significant redressing of the balance. Consumption has to fall, savings have to rise and the depreciation of the social and physical infrastructure needs to be rectified. And institutions need to be designed to maintain that bargain through time – to pass on assets (including regulated assets) intact in current cost terms. In turn, this needs a revolution in accounting – and in the way we measure the national product through time.

This is not a framework which sits easily with Keynes and his followers. Keynes tended to favour the present over the future (when we are all "dead"), and his followers have tended to prioritise consumption over investment. They emphasise "the paradox of thrift" – that private virtues of saving for the future undermine demand and hence current economic output, employment and growth prospects. They like "stimuli", and do not mind borrowing to maintain consumption.

Keynes famously remarked that practical men are the slaves of defunct economists. It is a remark which is particularly apt now. The task is not to hold up consumption. Rather it is to ensure that (higher) savings are translated into investment, to boost investment relative to consumption, and in the process drive up the savings rate. That investment needs to be concentrated on infrastructure in the widest sense, since it is the set of public goods which enables

companies and consumers to function. It drives competitiveness as a result.

High levels of saving and low levels of consumption are not barriers to growth. On the contrary, they can be argued to be necessary conditions for growth. The great expansions of Japan, and now China, are based on very high levels of savings. China is translating these surpluses into investment: Japan has arguably ceased to do so. In Britain, the last time our infrastructure was in very poor shape – in 1945, after the Second World War – the Attlee government did not set about expanding consumption. On the contrary, the state channelled savings into investment. The challenge now is to repeat this reconstruction, howbeit primarily through private rather than public infrastructures. To do this, we first need an assessment of the damage. In 1945 it was fairly obvious. The bomb damage could be seen. Now it is less transparent – the damage caused by lax (Keynesian) fiscal policy and the failure to maintain the infrastructures is not in national accounts. Indeed a focus on GDP positively encourages its depreciation.

Bringing these themes together, a very different view of the economic borders of the state emerges than that favoured by Keynes. It is grounded on rules in respect of intergenerational equity, and it is set within a long term framework. In this sense it owes much more to Hayek. But it goes beyond both of their concerns – it includes an asset-based approach, with the public goods of the climate, biodiversity, social and physical infrastructure at the core.

THE MARKET ECONOMY: TWO DECADES AFTER THE FALL OF THE BERLIN WALL

JOHN KAY

Introduction

The triumph of the market system over the planned economy was probably the defining economic event of our lifetime, its symbol the collapse of the Berlin Wall in 1989. In the advanced economies of the West, increased government intervention, more or less unchecked through the twentieth century, was halted in 1980 by the ideologically conservative governments of Reagan and Thatcher. Their policy innovations were widely if often reluctantly imitated elsewhere. In Asia, China and India followed some of their smaller neighbours into the market economy and the global trading system.

These developments provoked the hubris famously framed as the end of history by Francis Fukuyama. Fukuyama argued that a combination of liberal democracy and lightly regulated capitalism was now an inevitable form of political and economic organisation. If one country was the standard bearer for that new vision of the twenty-first century, it was the United States: if one industry was the standard bearer for that new view of business, it was the financial services industry.

Today, Fukuyama's assertion lacks conviction. If there were defining events in that revisionism, analogous to the breaching of the Berlin Wall, this would be – for politics – the collapse of the Twin Towers and its bungled consequences, and for economics the bankruptcy of Lehman seven years later. There is, evidently, no end of history – as, indeed, Fukuyama today readily acknowledges.

It is time for a more nuanced view of the nature of markets and the merits of the market economy. The critique of the market

economy today is, as it has been since the end of socialism, largely incoherent – an incoherence nicely captured in the demonstrator's slogan 'capitalism should be replaced by something nicer'.

But the defence of the market economy is often little more coherent. Supporters often do no more than point at the wealth of countries that have adopted the market economy – and to their own personal wealth. That isn't necessarily a bad argument. But it looks tarnished today. When those people who are the largest beneficiaries in terms of their own personal wealth have done substantial damage to the wealth of other people, that argument becomes more difficult to sustain.

I am going to argue that there are three elements to the triumph of the market economy. The first I will describe under the heading of 'prices as signals', the price mechanism is generally a better guide to resource allocation than central planning. The second element is 'markets as a process of discovery' – the chaotic process of experimentation through which a market economy adapts to change. The third heading is 'diffusion of political and economic power'. The economic point here is that prosperity and growth require that entrepreneurial energy should be focussed on the creation of wealth, rather than the appropriation of the wealth of other people.

In what we teach, in what we say, in our economic research and most importantly in the policies we adopt – we put too much emphasis on the first of these elements – prices as signals to guide resource allocation – at the expense of the, possibly more important, second and third elements – markets as process of discovery, markets as mechanism for the diffusion of political and economic power.

The result is that both supporters and critics of the market economy have often confused policies that are pro-business with

policies that are pro-market. That confusion has both undermined the social and political legitimacy of the market economy, and led to serious policy errors that follow from a mistaken, or at least incomplete, understanding of how a market economy works.

Disciplined pluralism

One central theme runs through all three strands of argument, the theme of disciplined pluralism. When prices act as signals decentralised enterprises and decentralised information are brought together to create a coherent result. Markets as a process of discovery are based on freedom to experiment, combined with discipline: unsuccessful experiments acknowledged and terminated. The use of markets as a means of decentralising power determines the shape of the areas where politics and economics meet.

If the essence of markets is their pluralist character, then there is an inevitable association between the successful market economy and other components of an open society – freedom of expression, and democratic institutions. While it is evident that authoritarian regimes have operated market economies, at least for a bit, the combination is probably not sustainable in the long run. There is an important corollary: political freedom is jeopardised by excessive concentrations of economic power. Even if Fukuyama was wrong in his assertion of inevitability, the identification of an elective affinity between liberal democracy and lightly regulated capitalism was entirely appropriate.

'The Model' as economic theory

The model of 'prices as signals' describes how self-interested agents – individuals or firms – might, through independent decisions, make consistent and efficient choices about how to organise production and distribution and the allocation of capital, labour and other resources. In a loose formulation, this idea has been around since the beginnings of economics. Many people interpret in this way

Adam Smith's famous remark about 'the invisible hand', and his observation that it was not the benevolence of the baker, but his self-love, that furnished our table. In an astonishing demonstration of the power of spontaneous order, decentralised markets manage the process of coordinating complex production systems better than centralised direction.

Although it appears to be an empirical fact that markets achieve such coordination, economists did not offer a comprehensive explanation of why until the 1950s. The explanation they gave then proved both that a competitive equilibrium might exist, and that, if it did exist, it could be efficient. That general equilibrium model (concisely 'the model') proved largely influential, both in shaping the research agenda of the economic profession and in providing an intellectual basis for economic policy among people who may know nothing of the underlying arguments.

The implication is that profitable transactions are socially beneficial: indeed that their social benefit is demonstrated by their profitability. A corollary is of the 'market failure doctrine', which is central today in economic policy in Britain and Brussels: intervention in markets is justifiable only in the light of a narrowly defined list of market failures, which is generated by deviations between the world and the assumptions of the model.

The model also provides a rationale for a certain kind of market fundamentalism. Not only is interference with market forces usually inappropriate, but market outcomes are efficient, even morally justifiable, simply by virtue of being market outcomes. Not only are markets good, but more markets are better than fewer markets. The emergence of new markets for financial products, for example, is presumptively beneficial.

Among economists, the popularity of this approach is in large part the result of physics envy: the general equilibrium

model provides a universal explanation of economic affairs which resembles in many ways the equilibrium models that have proved so powerful in the natural sciences. Rigour has become the measure of the quality of a theoretical economic argument, where rigour means the logical consistency which readily finds mathematical expression.

The omission of society

Among practical people, the simple message that government should go away and leave business alone has wide appeal to business: and the simple message that greed can serve a constructive social role also has wide appeal to greedy people. The claim that profitability demonstrates, is even the measure of, public benefit relieves people of any worries they might have harboured about the utility of their profitable activities. These worries are not common, but one does occasionally encounter them.

These messages, however, were angrily resisted by the broader intellectual community, which finds both the assumed motivation and the conclusions unappealing. These messages are also resistible to the population at large, which does not run business, benefits only indirectly from the activities of business, and is not necessarily enamoured of greed. The political world today is one in which both parties and voters acknowledge the empirical success of the market, but dislike almost every aspect of it. 'The market' and 'market forces' are the source of our prosperity, but are also terms of abuse. We have succeeded in providing a description of how markets work that is at once repulsive and substantially false.

The model probably contributes something to our understanding of how markets work. But that contribution is largely misunderstood and grossly over-emphasised. One problem is that there is no real acknowledgement of uncertainty in the model, or, to be more precise, uncertainty is acknowledged only in essentially formal ways. This omission is of fundamental

importance when the model is used to describe financial markets, in which trading in risk is the essence of the transaction. In these markets, the means of incorporating uncertainty into the model requires, in effect, that there is some true underlying value of an asset, which is independent of beliefs about that value, and that market transactions involve a process of convergence towards the true value. Experience has demonstrated clearly that this claim is a hopelessly inadequate account of market behaviour.

A larger problem is that the model fails to recognise the extent to which a functioning market economy is embedded in the society of which it forms part. Property rights are not a fact, but a social construction: and there are many alternative ways in which these rights could be constructed. In a modern economy characterised by complex products, sellers generally know more about what they are selling than buyers about what they are buying. Trust relationships and supplier reputation are the market's mechanisms for handling this problem.

These are not theoretical quibbles: they are problems at the centre of recent events. There were always two broad accounts of the reasons for the explosion of trade in complex structured products in the financial sector over the last decade. In one, these developments represented a more sophisticated form of risk sharing and risk transfer, an exemplification of the benefit of the creation of new markets. In another, the trade was mainly driven by information asymmetry: the products were bought by people who overestimated their value.

The consequences of these two explanations are very different. When complex products bring about more efficient risk allocation, the private profitability is mirrored by public benefits in the form of lower costs of risk. When such products are bought by people who do not understand them, private profitability overall is illusory and disappears when asset prices ultimately revert to the underlying value of the asset.

In retrospect, it is evident that this latter explanation is closer to the truth. Trade was driven by differences of information and interpretation and the profits from it evaporated when these errors were revealed. That is why Adair Turner is right when he invites us to query the social value of current trading values, and when he suggests that its extent goes far beyond what is needed to serve its economic function.

Markets explore, they don't predict

There is a good deal more to the power of markets than the description of prices as signals contains. The world is uncertain: not just risky, but uncertain, in the sense used by Keynes and Knight. Not only do we not know which future outcomes will happen: we are unable to specify at all fully what these possible outcomes will be. If we could predict or anticipate the invention of the wheel, we would have already invented it. Market economies do not predict the future, they explore it. That is a fundamental – perhaps the fundamental – difference between a planned and a market economy.

Hayek continues to be the most eloquent expositor of the concept of the market as a process of discovery. His argument was *a priori*, but vindicated by the failures of the eastern bloc in the post-war era. These planned economies failed in the development, not just of consumer products, but of business methods. Their technological development was disappointing in almost all not related to military hardware. Centralised systems experiment too little. They find reasons why new proposals will fail – and mostly they are right in finding reasons why they will fail. Most experiments do fail. Market economies thrive on a continued supply of unreasonable optimism. And when, occasionally, the experiments of entrepreneurs succeed, they are quickly imitated. It is a sad fact of the market economy that even for innovations that are commercially successful, few are commercially successful for the innovator.

If market economies are better than planned societies at the origination and diffusion of new ideas, they are also better at disposing of failed ideas. Honest feedback is not welcome in large bureaucracies. In authoritarian regimes, such feedback can be fatal to the person who delivers it. In less draconian contexts, unwanted messages can be fatal to careers. And when I describe large bureaucracies here, I refer just as much about large private bureaucracies as large public ones. Disruptive innovations most often come to market through new entrants – from Google, EasyJet, Amazon. Incumbents have good reasons to be suspicious of novelty and protective of their established markets and activities.

The health of the market economy depends, therefore, on constant replenishment of the business sector by new entry. If, as planner or sponsoring department, you had been planning the future of the computer industry in the 1970s, would you have asked Bill Gates and Paul Allen? If, as planner or sponsoring department, you had been planning the future of aviation in the 1980s, would you have asked Stelios Haji-Ioannou? If, as planner or sponsoring department, you had been planning the future of retailing in the 1990s would you have asked Jeff Bezos? Of course not: whether you were the politburo or permanent secretary you would have asked men in suits like yourself.

Watching the impact of electronics and the internet on children and grandchildren, makers of business and public policy have at least understood these issues. Committees of the middle-aged tweet about technology like embarrassing adults trying to have fun at the teenagers' disco. But, like those adults at the party, we are not really serious. Whether planners or governments of a market economy, we see industries through the eyes of established firms in the industry. And in doing so miss the pluralism that is the market economy's central dynamic.

Markets restrain concentrations of power

That leads directly to the third group of reasons for the superior performance of market economies. If I were to offer a one sentence description of why some countries are poor and others rich, it would be that the politics and economics of poor countries are dominated by rent-seeking and the politics and economics of rich countries are not. Rent seeking is the process by which the ambitious find it more rewarding to batten on the wealth created by other people than to create it themselves.

Rent seeking takes, and has taken, many forms – castles on the Rhine, the Wars of the Roses; ten per cent on arms sales, or seven per cent on new issues: awarding yourself control over former state assets, stealing the revenues from your country's resources deposits, seeking protection from foreign competition, blocking market access by new entrants; winning sinecures or overpaid positions by ingratiating oneself with public servants or corporate employees. The mechanisms of rent-seeking range from the application of armed force to victory in democratic election; the methods pursued range from lobbying on Capitol Hill and in the restaurants of Brussels, through access to the King or the Chief Executive.

But while rent seeking is ineradicable, we can have more of it, or less. Politics everywhere used to be dominated by rent seeking; factions would battle for control of the state and when they won such control would use it to steal as much as they could get their hands on. In much of the world, it is like that still. 'It's Our Turn to Eat' is the stomach churning title of one fascinating recent book about the corrupt – and moderately – democratic politics of modern Kenya. We have come to recognise the resource curse – wealth from national resources does more harm than good in many countries because of the rent-seeking it attracts – and foreign aid may have some of the same characteristics. But in Western Europe, at least, corrupt politics has ceased to be an avenue for rent-seeking.

The ability of a political/economic system to resist rent seeking depends on the degree of economic decentralisation. Individuals will try to get their hands on the rents which concentrations of power attract whether they are found in the public sector, in private businesses, or in groups of private business. The wider the extent of the opportunities this created, the greater the tendency for individuals to gain wealth and influence for themselves by attaching themselves to power rather than exploiting their own individual talents and by developing distinctive capabilities in their own economic activities.

There is a strong tendency for private concentration of economic power to be self-reinforcing. This problem was widely recognised in America's 'gilded age' at the end of the nineteenth century. The well-founded fear was that the new mega-rich – the Rockefellers, the Carnegies, the Vanderbilts – would use their wealth to enhance their political influence and hence enhance their economic power still further, subverting both the market economy and the democratic process. These concerns were the origin of anti-trust legislation, a point today often forgotten. The process that concerned Americans then is the problem we see in Russia – and elsewhere in the world – today.

The ability of a market economy to channel the desire for acquisition into channels that create wealth rather than extract it, depends on measures both to prevent the concentration of economic power and to limit the terms of access to such concentration. These are constraints on the economic power of the state: constraint on the concentration of economic power in large businesses: constant vigilance at the boundaries between the state and business: and a mixture of external supervision and internal restraint which prevents individuals who pull levers of economic power from using these levers to direct renting to themselves.

The current politics of the marketplace

Because the last decades have confused a pro-business stance with a pro-market stance, we have emphasised some of these conditions at the expense of others. Western – and especially Anglo-Saxon societies have constrained the economic role of the state. These measures have reduced the scope of one focus of rent-seeking, that by organised groups of public employees. A substantial element of such rent-seeking remains in areas that remain inescapably within the public sector.

But the larger issue is the concentration of power of large business, or groups of large businesses, and the use of the leverage that power gives to strengthen established positions and enhance that economic and political power still further. The topical – and most important example is the financial services industry.

The problems of that industry are too familiar to require much elaboration. The governments of the world have pumped unbelievably large amounts of money into the system. Directly through recapitalisation and purchase or underwriting of so-called toxic assets: more substantially if indirectly through wide-ranging implicit and explicit guarantees of liabilities. Even if these explicit guarantees expire, a 'too big to fail' doctrine has been established which means that implicit guarantees persist indefinitely. The criteria needed to qualify for these guarantees are, essentially, that the firm is large, well established, and unsuccessful commercially. It is difficult to think of a policy more directly contradictory to the dynamic of the market economy.

Behind that lies the central fact of modern political life – that the financial services industry, and particularly its investment banking arm, has become the most powerful political force in Britain and the United States. The reasons are clear enough: the rents available in the financial sector have attracted much of the ablest talent in the two countries and created a generation of financiers who are both smart and wealthy.

Our policies err focussing on the first pillar – prices as signals. They underestimate the strength of markets as a process of discovery, and the vital political and economic role of markets in restraining concentrations of economic power. Markets are not a well-oiled physical machine: they are a constantly changing, adaptive biological system. Pluralism is their motive force, their essence chaotic, and their development inherently uncertain. If we could predict the evolution of markets, we would not need markets in the first place.

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The Social Market Foundation was founded in late 1989, as state socialism collapsed in Europe. Today, a global economic crisis has brought us to another fork in the road. We face economic stagnation and a heavy burden of government debt. The consequences of the crash will reverberate for years to come and the relationship between the state and the market will inevitably be redefined. But how?

Social market thinking can guide us on the uncertain road ahead. To mark its 21st year, the Social Market Foundation commissioned essays by leading politicians, academics and journalists on social market policy in a period of sustained economic crisis. In this wide-ranging collection, Mary Ann Sieghart, Ian Mulheirn, Philip Collins, David Lipsey, David Owen, Peter Lilley, Robert Skidelsky, Dieter Helm and John Kay suggest how the boundaries between the state and the market should be redrawn.

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