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LESSONS FROM OUR ELDERS

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"Like a caged bird that learns that pecking on a lever gets it food", Niamh Brady picks through independent Ireland's economic history, with informative consequences.

Those of us born in the eighties find ourselves for the most part immersed in the generation of the 'why'. We take little for granted, especially the word of our elders. Economic history is a subject which many of this generation believe has little to do with our preferred area of knowledge; thus, we naturally turn to investigate the validity of such a study. In order to do this, I have decided to examine the economic policies and success of my parents' and grandparents' time – in other words, Irish economic history from the formation of the Irish Free State in 1921. The objectives of research in economic history, both recent and dated, are obvious. Why repeat the now infamous mistakes of our predecessors, when history has already tested many theories and therefore provides us with a clear manual of instructions from which to develop our present policies? History may also discredit once popular policies, by providing a vast perspective and discouraging popular myths emerging from the different interpretations on economic history. Finally, economic history satisfies the curiosity of all those who wonder where our economic and indeed social, historical and cultural roots lie– a fascination that spans across many generations.

With each successive government, since the inception of the Free State in 1921, have come new economic theories and policies on how best to achieve primary objectives such as economic growth and low unemployment. The problem remains that a theory of economic growth does not guarantee fulfilment of the ultimate aims. History is our reference map by which to test theories. Ireland, as a relatively young independent nation-state, has tested many opposing theories with varying success. In 1932, for example, the Fianna Fáil Government headed by Eamon de Valera reversed the Cumann na nGaedhael government's policies of free trade, minimal state intervention and parity with sterling. In its place, a programme of protectionism was instigated, with the aim of establishing Ireland as a self-sufficient entity. Behind these actions was the idea that high tariffs, which averaged at 9% between 1931 and 1932 and went on to peak at 45% in 1936, would prevent the post-Wall Street Crash United States from ‘dumping’ stock on the Irish economy. It was thus hoped that indigenous industry could be promoted through protection from international competition. It must also be acknowledged that there were ideological considerations behind the protectionist stance, as the nationalist community sought to prove that Ireland could be a prosperous economic power without being dependent on Britain. Although the formation of the Irish Credit Corporation resulted in a 40% increase in industrial output between 1931 and 1936, unemployment soared. The policies implemented in the 1930s not only failed to provide the concrete foundations for trade and sustained industrial growth in that decade, but have often been labelled as the cause of industrial stagnation through to the 1950s.

On a more positive note, in 1958, T.K. Whittaker proposed that trade might be bolstered by reduced tariffs and by partially redistributing social investment funding. This prompted a change in policy and a change in fortune for the Irish economy. His report signalled the start of the so-called “Golden Age” of the sixties by producing an unprecedented rise in GDP of 4% per annum, rather than the expected 2%. By the seventies and eighties, however, one negative consequence had became obvious; the increase in social investment resulted in little housing for the poor – a situation that later generations would inherit.[1]

Taken as a whole, then, such examples illustrate that economic history can prevent current governments from introducing policies which have already been attempted and failed. It provides examples of specific approaches which have yielded either the desired results or have had a detrimental effect on the economy. For a small, open economy such as Ireland, achieving the correct policy mix is essential, rendering economic history an especially relevant tool.

If the sixties are nostalgically remembered as the “Golden Age” of the Irish economy, history allows us to test this perception against a broader time span. Between 1960 and 1973, Irish real output increased by 4.4% per annum – truly a ‘golden’ merit in comparison with past records. However, this figure seems less substantial given the favourable results in other economies at the time. Furthermore, Ireland was simply playing catch-up with these countries, and so these rates of growth were not so outstanding. Radiating from the solid trade foundations laid in 1958 came the tariff reductions through the Anglo-Irish Trade Agreement in 1965 and the formation of GATT in 1967. Together with the introduction of tax breaks and subsidies, this caused foreign direct investment to increase. Thus, new industry accounted for 60% of industrial output by 1974.

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[1] Editor’s aside: see Nick Hodsman and David Comerford’s paper on housing policy, *Accomodating a Crisis*

If a broader perspective is taken on this, it is obvious that the dramatic boom in Europe was influencing the Irish economy. Increases in trade spread growth across many economies. During the thirties, protectionism may have been instrumental in protecting an infant economy, but on a wider time-frame, it slowed later economic growth. Perhaps this proves that perspective alters initial views on policies; if this is the case, then surely the study of economic history is a vital component of policy formation.

Like a child who burns their finger on a hot cooker or a caged bird that learns that pecking on a lever gets it food, so too do economists, and the human population in general, learn from negative and positive reactions to our actions. In psychology we call this conditioning; in economics, it is the study of history. When de Valera came to power in 1932, he taught future Irish governments about the negative and long-lasting consequences of being 'too big for one's boots'. The overly-protectionist policies of import-substitution and dramatic tariff hikes of the thirties may have prevented a U.S. dump on the fragile Irish economy after the "Crash" of 1929, but the unemployment rate soared, and the U.S. economy offered no incentives for immigrants. The short-term positive effects on industrial output ended in 1936, when Ireland realised that the economy was not large or diverse enough for import-substitution to be fully feasible. Even the agricultural sector had stagnated, moving from a trade balance of 75% of GNP in 1926 to only 54% by 1938. Future generations of policy-makers have, fortunately, learnt from this and realised that a certain level of trade is required for such a small country to prosper. This can be found in the motivation behind the European Union, which was set up primarily as a single market for goods and services. History has taught us the benefits of foreign direct investment if employment is to be created or output increased in an economy.

Students of history will testify that our knowledge of historical events and success rates is dependant on subjective interpretation. History, like statistics, can easily be manipulated to support one's intentions. We, however, must only concern ourselves with an informed view. The Fianna Fáil government of the thirties truly personifies the nationalistic view of history; Britain was alleged to have dramatically reduced the Irish economy's potential for growth in the past. The formation of the Free State saw agreement between the two countries that Ireland would repay land loans or annuities; nationalists were, in this context, angry that the State was in debt to Britain, repaying roughly 4% GDP per annum. De Valera, once in government, reneged on these annuities and caused the beginnings of a 'tariff war' between the two countries. With the Anglo-Irish Trade Agreement, nationalists believed that they had achieved complete success; a one-off lump sum of ten million pounds was paid to Britain out of a potential one hundred million. The terms of the agreement were not entirely favourable, however. Guinness, one of the larger industries in

Ireland, relocated to London, thus reducing Irish exports as agriculture stagnated. Many fallacies have been laid bare by historical research into past success rates.

It is part of human nature to be curious, although it will manifest itself in many different forms. In medicine, scholars are interested in our physical make-up. Economists are in general, fascinated by the roots of economics. This fascination is expressed in economic history. A brief example may be found in the dramatic increases in emigration to the U.K. in the eighties, which have interested many, economists and others. Government borrowing was vast and, by 1986, 94% of income from tax revenue was used to service debts. Despite government efforts to increase revenue by increasing taxes, the pound was devalued within the European Monetary Union and, in 1987, a restrictive budget was introduced to cut deficit. In relative terms, the U.K. was still growing; there were, therefore, a greater number of job opportunities across the Irish Sea. Many Irish people emigrated to British factory jobs, just as, in the past, their predecessors had travelled to Scotland as “tatty-pickers”. Given that recent economic developments have reversed this trend, it is important to acknowledge this one-time emigration flow; the very fact that it has been reversed is fascinating.

In conclusion, to study economic history in a full and fair manner, in-depth study of a vast time-frame is required. The scale of such a study incurs a cost, true, but it returns dividends. Economic history may develop policies, but, in a broader sense, it may be used to answer questions about the roots of our economy. In doing so, we better understand the hurdles overcome to produce the economy we now have.

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INFLATION AND DEARTH IN THE SIXTEENTH CENTURY - THE MODERN ECONOMIC PERSPECTIVE: VALID OR MISLEADING?

ROWENA GRAY

Junior Sophister

Here ye, here ye! Ye olde Gray metter is exercised in this review of the economy of sixteenth century England. Ms. Gray takes testimony from commentators as diverse as Shakespeare, sustainable developmentalist Douthwaite, and historian Outhwaite, who illustrate the behavioural ramifications arising out of the inflation crisis. In her quest to find the cause of this inflation, Rowena probes into farm enclosures, drunkenness, piracy, monopolistic middlemen, and militarism. She concludes that the most plausible cause was population growth and in so doing lays bare the continued relevance of economic history.

Nowadays, we all expect at least moderate rates of inflation and indeed some have described mild inflation as a socially acceptable and stabilising norm.[1] In sixteenth century economic history, what stands out both in contemporary and more recent comment is the dramatic response to fluctuations in prices and the speculation as to the causes and consequences arising thereof. This is because inflation was an extraordinary event in this period, the result of war or the extreme shortage of necessities. Historians have debated about the extent of the inflation and there is certainly some room for argument as there is a lack of accurate price information for most goods. Wiebe described the rise in prices as a '*preisrevolution*'[2] while others have claimed that, in comparison to the twentieth century, the changes experienced by the Tudors were not significant. Outhwaite, in the second edition of his book on the subject, points out that in the fourteen years since he penned the first edition, Britain had experienced as much inflation as in the whole of the sixteenth century.[3] But, such a comparison is not necessarily useful, as the economy of the early

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[1] Nigel Lawson, cited in Douthwaite, R., *The Growth Illusion* (Dublin, 2000. Previous ed. 1992) p. 63.
[2] Cited in Outhwaite, R.B., *Inflation in Tudor and Stuart England* (London and Basingstoke, 1982. First ed. 1969) p.11. From Wiebe, G., *Zur Geschichte der Preisrevolution des 16 und 17 Jahrhunderts* (Leipzig, 1895).
[3] *Ibid*, p. 57.

modern period was vastly different to that which prevailed thirty years ago, where it was the oil crises that had such an inflammatory effect on prices. Plus, what is more important than the actual extent of inflation is people's perception of it, as this changed behaviour, decisions and attitudes. Both eras share an increase in social change and conflict, to which inflation, as a divisive force, was a contributory factor. This was portrayed by William Forrest in the 1540s when he said: "The Worlde is changeth from that it hath beene, not to the bettre but to the warsse farre…. Unto the riche it maketh a great deale, but muche it marrethe to the Commune weale".[4]

One of the main reasons contemporaries gave for dearth was the enclosing of land by farmers and landlords. This was in spite of the fact that enclosure was not new to the Tudor period, as possibly one third of all enclosures had already been completed by this time and only about ten percent of enclosures occurred between 1500 and 1650.[5] Indeed, there does not appear to have been widespread objection to landowners who erected boundaries only on their own land. It must be recognised that enclosure improved the efficiency and productivity of the land and represents perhaps one of the first moves towards a more market-based and business orientated type of farming. People writing at this time do seem to have distinguished between these 'good' enclosures and others that were thought to usurp the traditional rights of smallholders. These were cases where one landlord enclosed, for his own use, the land formerly held in common. From the many petitions to parliament on this issue, it is clear that this process aroused much popular opposition. Smallholders had previously been able to graze animals on this land and felt that enclosure violated their rights and took away an element of diversity from their livelihoods, which would make them more vulnerable in times of scarcity. Some truth can be found in the contemporary arguments, although it is not true to say that enclosure led directly to dearth or inflation. It was the labour economies that resulted from the switch from arable to pastoral farming that typically led to a fall in the amount of jobs available in rural areas.[6] This also explains why many were forced to migrate to urban areas, where they were "compelled to fall, some to handicrafts, and some to day labour".[7] Nevertheless, enclosure cannot be blamed for the persistence of dearth in the Tudor period, even allowing for these debates about the switch to pastoral farming, because land that was used for arable farming was often enclosed as well, especially in the latter half of the century, when grain prices were rising more rapidly. There are even

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[4] Cited in eds. Power, E. and Tawney, R.H., *Tudor Economic Documents, Pamphlets, Memoranda and Literary Extracts*, vol. III (London, 1965. First ed. 1924) p. 40.
[5] DuPlessis, R., *Transitions to Capitalism in Early Modern Europe* (Cambridge, 1997) p. 66.
[6] Ramsey, P., *Tudor Economic Problems* (London, 1968) pp. 20-1.
[7] Crowley, R., *An Information and Peticion agaynst the oppressors of the pore Commons of this Realme*. From ed. Cowper, J.M., *The Select Works of Robert Crowley* (Early English Text Society, 1872) pp. 153-76.

some contemporary accounts in support of enclosure, such as that of Thomas Tusser from 1573, who advised that it led to higher yields and prosperity.[8] Perhaps so much contemporary attention was focussed upon enclosure because it was one of the main questions on which landlords and peasants had contact and conflict, or because it was a visible reminder of the affluence of some in society, but it is less plausible than other arguments as a cause of the economic and social problems of the era.

Another frequently mentioned explanation for the economic problems of the sixteenth century suggested by the people of the time is that the bad harvests that led to shortage were the result not of random unfavourable weather conditions but of the punishments of a judgmental God. Various vices were cited as reasons for the onset of dearth, including Sabbath-breaking and drunkenness, and in 1563, a sermon warned, "if we in eating and drinking exceed when God of his large liberality sendeth plenty, he will soon change plenty into scarceness".[9] This explanation undoubtedly appealed to the crown and upper classes of England, as the 1500s was a time of religious change and zeal and the solution that this interpretation suggests (i.e. the improvement of the moral character of the nation) did not affect the policies or incomes of the government. The religious argument was extended further by writers such as Robert Crowley, to discourage the masses from engaging in violent protest at their dwindling economic fortunes, as it was considered morally wrong to question the king whose power and authority were derived from God. It was believed that through quiet opposition, God would note their suffering and provide for them as the nobility had failed to do.[10] However, it is difficult to discover to what extent this exposition was accepted by those affected by inflation. It is likely that many did accept it at least in part, as in a pre-market society, God's was the only invisible hand at work. This point demonstrates the limitations of economic history and the danger of looking at it out of its historic context, as a purely modern approach cannot fully explain attitudes to the economy that have grown out of a different paradigm of thought, namely the religious one. Today, economists assume that rational individuals seek to maximise utility- such an assumption is worthless in a world where souls are considered more valuable than property. Nevertheless, the study of economic history remains relevant, as an aid to the understanding of history,

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[8] Cited in Power, E. and Tawney, R.H., *Tudor Economic Documents, Pamphlets, Memoranda and Literary Extracts*, vol. III (London, 1965. First ed. 1924) p. 64. From eds. Herrtage, S.J. and Payne, W., *Five Hundred Pointes of Good Husbandrie* (English Dialect Society, 1878) pp. 140-6.

[9] Walter, J. and Wrightson, K., 'Dearth and the Social Order in Early Modern England' in ed. P. Stack, *Rebellion, Popular Protest and the Social Order in Early Modern England* (Cambridge, 1984) p. 114.

[10] Crowley, R., *The Danger of Sedition*. From ed. Cowper, J.M., *The Select Works of Robert Crowley* (Early English Text Society, 1872) pp. 131-50.

if nothing else. In any event, the sixteenth century was a time of increasing petitions to government, accompanied by enhanced state regulation and interference in economic affairs.

This last point is illustrated in part by the fact that the government attempted to regulate the activities of merchants and traders during the sixteenth century. This was because many felt that the greed of these groups of entrepreneurs had caused inflation and hardship that affected so many poorer people. Several sources from the period describe the unethical practices and profiteering of merchants, and of landlords in the property market. This included the increasing of rents and entry fees and the introduction and increased use of leases. Brinkelowe provides an early explanation of cost-driven inflation, in his *Complaynt*, when he says:

> "This inordinate enhancing of rents… must needs make all things dear… for, as he increaseth his rent, so must the farmer the price of his wool, cattle, and all victuals, and likewise the merchant of his cloth, for else they could not maintain their living".[11]

A further example given of profiteering was the use of monopolies purchased from the state in the latter years of Henry VIII to raise prices,[12] while other merchants engaged in the practice of hoarding grain to depress supply and inflate prices (much as OPEC did in the oil market in the 1970s). A petition of Wiltshire craftsmen from 1614 demonstrates this point as it complains about middlemen "for their excessive buyinge hordinge and forestalling of Corne and other provisions which we truly knowe to be the originall cause of dearthe".[13] They felt that scarcity had been artificially created by the merchants for their own gain. This rationale was more typical of the grain-producing regions that exported much of their grain to urban centres, particularly in the Southeast, near London. There was some antipathy between grain producers and centres such as London, Bristol and Norwich, especially during times of want because at these times grain producers did not want to send produce to the urban areas, a problem which was exacerbated by the merchants' manipulations of the market. Profiteering did unquestionably occur during the century under review but was not the cause of inflation, rather a symptom of it. Inflation benefits those who are quick enough to capitalise on it, at the expense

[11] Brinkelowe, H., *Complaynt*. From ed. Cowper, J.M., *The Complaynt of Roderyck Mors* (Early English Text Society, 1874) pp. 5-14, 16-18, 37, 48-53.
[12] Kennedy, P., *The Rise and Fall of the Great Powers* (London, 1989) p. 79.
[13] Walter, J. and Wrightson, K., 'Dearth and the Social Order in Early Modern England' in ed. P. Stack, *Rebellion, Popular Protest and the Social Order in Early Modern England* (Cambridge, 1984) p. 116.

of those who are on fixed incomes or are slow to adjust to it. In the modern context, Douthwaite quotes Bach as saying that old people with few debts and fixed value assets lose proportionately more than young families with large debts, whose mortgage repayments will fall in value.[14] Tawney and Stone have put forward the thesis that the aristocracy were amongst those who failed to recognise and adapt to changes in the economic conditions and that in the century 1540-1640, they diminished in importance compared to the rising gentry, who gained from their loss.[15] Merchants then, as in every age, were in business to make money and the most that they can be blamed for is shrewd entrepreneurship rather than greediness, although the ethics of withholding grain from the general public when food is scarce are suspect. The proverb, "buy cheap, sell dear", originated in the sixteenth century, demonstrating the beginnings of a shift in attitudes, towards private enterprise and opportunism, which would place greater emphasis on capital accumulation. A further example of how attitudes were changing can be seen in Shakespeare's history plays, such as Richard II, where the usurper of the throne, despite being an unscrupulous character, is held up as a person who recognises and capitalises on an available opportunity.

The preferred argument of modern economists for the general increase in prices and consequent economic distress of many English people is that of the monetarist school.[16] This asserts that the increase in the money supply following the influx of Spanish-American bullion (via piracy) and the successive currency debasements conducted by Henry VIII, especially the Great Debasement of 1544-51, had, by the quantity theory of money, no real effects on the economy and only a price effect. This is by no means the typical view that comes out of Tudor literature. It was expounded in the *Discourse of the Common Weal*, published in 1581.[17] It is, however, a later Tudor conception, and the section in the Discourse that makes reference to it is probably an addition by Sir Thomas Smith, which Outhwaite suggests may have been influenced by the ideas of French philosopher Jean Bodin.[18] A subsequent mention of this argument was made by the merchant Gerard de Malynes, in 1601, who outlined how "plentie of money maketh generally things

[14] Douthwaite, R., *The Growth Illusion* (Dublin, 2000. Previous ed. 1992) p. 67.
[15] Ramsey, P., *Tudor Economic Problems* (London, 1968) pp. 122, 127.
[16] For example, Marshall, A., *Principles of Economics*, vol. I (London, 1898. First ed. 1890) p. 35.
[17] Cited in eds. Fisher, H.E.S and Jurica, A.R.J., *Documents of English Economic History: England from 1000 to 1760* (London, 1977) pp. 486-9. From ed. Lamond, E., *A Discourse of the Common Weal of this Realm of England* (Cambridge, 1929) pp. 69, 79-82, 104.
[18] Outhwaite, R.B., *Inflation in Tudor and Stuart England* (London and Basingstoke, 1982. First ed. 1969) pp. 24-5.

deare, and scarcity of money maketh likewise generally things good cheape".[19] It has since been argued that the monetary factors may have acted as a catalyst to inflation and that it persisted due to other elements, namely rising costs (through rents), bad harvests (during the 1550s and later in the 1590s) and war, as well as population increase. The theory is an interesting one in terms of modern monetarist thought, given that it was proposed by the ultra-conservative Thomas Smith, who sought above all to maintain the *status quo*. Perhaps it signals an inherent conservatism in monetarism, as it does after all advocate a policy neutrality position in relation to fiscal manoeuvres and strict control of the money supply on the monetary side. However, some historians, such as J.D. Gould, have contested this hypothesis, saying that the theory does not hold for several reasons.[20] Among these is the fact that inflation existed prior to the influx of bullion and all prices did not rise in line with each other- those of necessities rose proportionately more than those of luxuries. Furthermore, the extra specie need not have had an entirely inflationary effect as some may have been soaked up by an augmentation in trade, particularly in urban areas that were growing steadily, reflecting an under-monetised economy prior to the sixteenth century.

Other modern explanations for the Tudor inflation focus on the huge increases in government expenditure during the period, mostly to finance military expeditions, an enlarged state administration and building projects. For instance, in 1513, total Treasury outgoings were £700,000, with over £600,000 of that being spent on the war with France. During the 1540s, the wars in France and Scotland cost over two million pounds, which was ten times the normal crown revenue.[21] Luckily for Henry VIII, the English Reformation and Dissolution of the monasteries had doubled the funds available to the exchequer and monastic land was sold off at reduced rates. Other sources of finance included forced loans, the seizure of noble estates and the debasing of the coinage, which not only provided extra cash but also had an inflationary effect, which benefited the crown in its capacity as a borrower. This theory does seem to be borne out in the statistics for prices at the time, as the years of the greatest inflation do roughly correlate to the years when government expenditure, particularly for war, was at its highest, such as in the 1540s. There is then a levelling off in the data from the late 1550s until the 1580s, during which time Elizabeth did try to revalue the currency and built up surpluses in government

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19 Cited in eds. Power, E. and Tawney, R.H., *Tudor Economic Documents, Pamphlets, Memoranda and Literary Extracts*, vol. III (London, 1965. First ed. 1924) p. 387. From de Malynes, G., *A Treatise of the Canker of England's Commonwealth* (1601).

20 See Gould, J.D., 'The Price Revolution Reconsidered' in *Economic History Review* 17, no. 2 (1964) pp. 252-3.

21 Figures from Kennedy, P., *The Rise and Fall of the Great Powers* (London, 1989) pp. 76-7.

revenue. When, in the late 1580s, she increased expenditure in the order of two to three times, to fund the campaign in the Netherlands, inflation was seen to rise rapidly again. By the end of Elizabeth's reign, £500,000 was being spent annually, mainly on the struggle in Ireland.[22] Empirically, this treatment does look like a convincing one, and it also makes good intuitive sense economically, representing an historic instance of government induced inflation. Inflation can be seen as the consequence of successive injections of money into the economy by the government in the form of soldiers' wages and payments to businesses in the timber, shipbuilding, tin and lead industries. This stimulated demand in these sectors and may have placed upward pressure on prices, thus crowding out private demand. The sale at bargain prices of monastic lands created a boom on the property market. The easier availability of credit facilitated this and further contributed to inflation. While this extra money coming into the economy represented an opportunity for expansion, because the economy of the sixteenth century was not very developed, the point of capacity constraint was reached much sooner and from then on prices and not real output were effected by injections.

The main long-term explanation for increasing prices and the one that accounts best for its continuance into the seventeenth century, is the "imbalance between the growth of population and agricultural output".[23] There is evidence from official records as well as literary sources that population was rising at this stage, for example the comments of John Bayker from 1538, "I think thayr were never moo peoplle and fewer habitatyons".[24] The population increase pushed up demand for food and land at a time when it was difficult to expand supply of these factors. England was technically capable of supporting a larger population but took time to adapt, to bring more wasteland under cultivation and improve agricultural productivity. In the interim, small holders and wage earners suffered from a heightened cost of living during bad harvests due to shortage. The enlarged population could not all make a living on the land and migration was a feature of Tudor society.[25] Likewise, this placed pressure on the food supply because a smaller proportion of people produced their own food. The population argument is further bolstered by the price series from the mid-century which reveal a time of relative stability and even deflation. Fisher has linked this to a halt in population growth that

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[22] Figures from *ibid*, pp. 78-9.

[23] Outhwaite, R.B., *Inflation in Tudor and Stuart England* (London and Basingstoke, 1982. First ed. 1969) p. 50.

[24] Cited in eds. Power, E. and Tawney, R.H., *Tudor Economic Documents, Commerce, Finance and the Poor Law*, vol. II (London, 1965. First ed. 1924) pp. 302-5. From S.P. Henry VIII, vol. CXLI pp. 134-5 in F. Aydelotte, *Elizabethan Rogues and Vagabonds* (Oxford, 1913) pp. 145-7.

[25] Coleman, D.C, *The Economy of England, 1450-1750* (Oxford, 1977) p. 18.

was prompted by a flu epidemic following the bad harvests of 1555-6.[26] When population recovered from this, inflation was witnessed again. Real wages are thought to have declined during most of the sixteenth century, as nominal wages did not rise in line with prices, as Phelps Brown and Hopkins have shown.[27] However, these studies may have overstated the extent of this, as they looked at wholesale prices, which tended to rise faster than retail prices and ignored the fact that some wages were paid in food rather than money and so were not affected by inflation. Furthermore, as the prices of necessities and the cheapest cereals tended to rise most rapidly, people would undoubtedly have switched to consuming alternative foodstuffs. Population change can thus be seen as a primary factor in price movements, though it must be remembered that, whatever the hardships that faced people, there was no great crisis of subsistence- the inflation was fuelled by people's demands and abilities to pay inflated prices.

The contemporary arguments set out above give us insight into the thinking of people at the time and are products of their era. What is interesting from the modern perspective is the persistence of Tudor inflation, as it has now come to be an integral feature of developed economies, whereas it was unusual in the pre-industrial period. This suggests a new interpretation of the sixteenth century- that it was a time of economic growth and that inflation was an indicator of buoyancy. Keynes described this saying, "Never in the Annals of the modern world has there existed so prolonged and so rich an opportunity for the businessman, the speculator and the profiteer".[28] In other words, the possibility of development was created by the capital accumulation that resulted from the dissolution of the monasteries and the price increases. Perhaps if government had not been so concerned with war then more might have been achieved by way of increasing the general level of living in the land.

These days, economic history seems to have gone out of fashion. It appears that not many economists are thinking or writing on it. Unusual, given the fact that Alfred Marshall places such emphasis on history, race and culture as influences on economic affairs and given the importance of behavioural assumptions in economics, many of which must surely be as much a product of history as of sociological or anthropological factors. There are many intriguing anecdotes from economic history, and it may in certain cases, though not perhaps universally, provide valuable lessons for policy makers and economic theorists today. Any comparisons between life in

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[26] Fisher, F.J., 'Inflation and Influenza in Tudor England' in *Economic History Review* 18, Second Series (1965) p. 125.

[27] Hopkins, S. and Phelps Brown, E.H., 'Wage Rates and Prices: Evidence for Population Pressure in the Sixteenth Century' in *Economica* 24 (1957) pp. 289-306.

[28] Cited in Rowse, A.L., *The England of Elizabeth* (London, 1950) p. 109. From Keynes, J.M., *Treatise on Money* II, p. 159.

the sixteenth century, for example, and that of the modern world, must come with a note of caution, as attitudes and perceptions can change radically from one generation to the next. However, one general principle that economists would do well to note is that the voice of the ordinary person is often a useful one to listen to. The typical individual will always have on an opinion on a social issue that they believe affects them, as the adage goes:

"The rate of unemployment is 100 per cent if it is you that is unemployed."[29]

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[29] James, S., A *Dictionary of Economic Quotations* (London, 1981).

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ARE DEMOCRACY AND CAPITALISM INCOMPATIBLE?

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Democracy and capitalism are commonly perceived as part of modernisation. Lumped together in the political discourse, Sarah Lewis critically examines whether they form the "natural order of things". She concludes that the philosophical tenets of democracy and capital accumulation diverge sharply. She illustrates how crisis is averted through checking mechanisms and ideological indoctrination that combine to make the notion of citizenship a chimera.

Democracy and capitalism are key words in contemporary political discourse. Democracy is founded on the ideals of liberty, equality and popular sovereignty, whereby individuals have the freedom to act without social impediment and power is both equal and accountable to those affected by its exercise. It cannot be said of democracy, as Lord Acton said of liberty, that it "is not a means to a higher political end. It is itself the highest political end" Hayek (1944). Democracy is essentially a means, a utilitarian device for safeguarding internal peace and individual freedom, with a commitment to the progressive extension of people's capacity to govern their personal lives and social histories (Bowles and Gintis, 1986).

One of the most familiar perceptions of capitalism is as an economic system in which the economy is described in terms of markets. The government leaves the economy alone and free market forces operate along the lines of the laissez-faire model as expounded by Adam Smith (Bealey, 1993). 'Capitalism' is essentially derived from 'capital', an accretion of wealth (Bealey, 1993: 205).

It is acknowledged by most scholars that capitalism and democracy do not operate in separate spheres, the former relating solely to economics and the latter to politics. Historically, a correlation can be seen between economic growth and democratic values[1], and both terms are regularly encapsulated in the concept of liberalism. Both democracy and capitalism stress the realisation of individual capacities, individual preferences and individual participation. If the institutional framework in which both operate can be shown to be responsive to individual preferences in an egalitarian manner, then it can be said that the two concepts are

[1] Put forward by scholars such as Lipset (1978).

compatible. Analysis based on the works of Dahl, Green, Macpherson and others however shows that this is not the case. Due to the 'rule of privilege', that for Green (1986), is the essence of capitalism, the political sphere does not escape the effects of the inequalities created by capitalism. The adverse consequences for political equality lead us to conclude that democracy and capitalism are essentially incompatible.

Dahl (1998: 166) likens market capitalism and democracy to 'two persons bound in a tempestuous marriage that is riven by conflict and yet endures because neither partner wishes to separate from the other.' Historically, modern democracy rose alongside capitalism and, according to Schumpeter, in causal connection with it'[2] suggesting that modern democracy is the product of the capitalist system. Looking to history, Dahl (1998) points to the fact that democracy[3] has only ever endured in countries with a predominantly market economy and has never endured in a country with a predominantly non-market economy. This, according to Dahl, is because certain features of market capitalism are favourable with democratic institutions.

The private ownership of economic entities allows them to be guided solely by self-interested incentives. Hayek (1944: 73) goes so far to say that democracy is only possible within a capitalist system, if capitalism is taken to mean a competitive system based on free disposal over private property and economic entities. Decisions are made without central direction but the 'invisible hand' of the market serves to co-ordinate and control. As a result goods and services are produced 'much more efficiently than any known alternative' (Dahl, 1998: 167) and long run capitalism has typically led to economic growth.[4] By cutting acute poverty and improving living standards, economic growth helps reduce social and political tension. Growth also provides resources that are available should conflicts arise as

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[2] Quoted by Bealey (1993) in 'Capitalism and Democracy', *European Journal of Political Research*, 23,.

[3] This Dahl does limit to polyarchal democracy, though acknowledges that 'it also applies pretty well to the popular governments that developed in the city-states of Greece, Rome and medieval Italy and to the evolution of representative institutions and the growth of citizen participation in northern Europe' (Dahl, 1998: 166)

[4] It is not true to state forthright that economic growth is unique to democratic countries, and as Dahl himself points out: 'There appears to be no correlation between economic growth and a country's type of government or regime' (Dahl, 1998:170). Bealey (1993: 221) states non-democratic capitalism is as common as democratic capitalism and points to Taiwan and South Korea as examples of non-democratic countries with high growth rates. Huntington (1991) however contains that economic growth is unfavourable to non-democratic regimes, often undermining their legitimacy in the long run.

well as to provide individuals, groups and governments with resources for education which helps foster a literate and educated citizenry.

Market capitalism is also favourable for democracy because of its social and political consequences. A large middle stratum of property owners are created, that Dahl sees as typically seeking education, autonomy, personal freedom, property rights, the rule of law, and participation in government. The middle classes are the ‘natural allies’ of democratic ideas and institutions, as Aristotle first said. On this topic Bealey quotes Schumpeter, who argues that the rationalist scheme on which classical democracy rests is essentially bourgeois in origin. Milton Friedman (1962) points out the social benefits of the anonymity of exchange and the irrelevance of identities prevalent in the capitalist system. No one who buys bread knows whether the wheat from which it is made was grown by a Communist or a Republican, by a Constitutionalist or a Fascist, or for that matter, by a black or white person. This Friedman calls the staple of the liberal identification of capitalism and freedom.

The decentralised nature in which economic decisions are made in a capitalist economy is for Dahl the most important feature of the capitalist system that makes it compatible with democracy. This is because it avoids the need for a powerful central government. For a government to allocate scarce resources, a detailed and comprehensive central plan is needed, requiring a staggering amount of reliable information. Looking again to history, no government has proved up to the task. Dahl heeds that it is not the inefficiencies of a centrally planned economy that are most injurious to democratic prospects, but the social and political consequences of putting the resources of an entire economy at the disposal of government leaders, recalling the aphorism ‘power corrupts and absolute power corrupts absolutely’ (Dahl, 1998: 169).

Viewed as totally abstract, self enclosed decision-making processes, market capitalism and democracy have several common systemic features. In both individualism is at a premium, with the individual actor making a rational choice, thus there is an analogy between consumer sovereignty and voter sovereignty. In both cases the invisible hand is at work, with conflict between buyers and sellers being resolved by demand and supply and with the equilibrium price benefiting the greatest number. Here the analogy breaks down because the parallel with a democratic polity could only be sustained if voters did not have to accept policies they had not voted for in the same way that purchasers can exercise an effective veto by refusing to buy a particular product (Bealey, 1993). Manipulation however still exists in a ‘responsible and responsive way’ as in the democratic state political leaders control each other by exchanging favours, threatening and promising, organising alliances, opposing and supporting each other’s policies. These moves are only understandable against the background of the competition for votes (Lindblom, 1988: 28).

Whilst democratic capitalism suggests a set of harmonious and mutually supportive institutions, Bowles & Gintis (1986) argue that even proponents of capitalism as good for democracy realise this is not the case. Approaching market capitalism from a democratic point of view reveals it has 'two faces': one pointing towards democracy, the other pointing in the opposite direction (Dahl, 1998). Dahl argues that democracy and market capitalism are locked in a persistent battle in which each modifies and limits the other. The market brings gains for some, but also harm to others.

Economic actors motivated by self-interest have little incentive for taking the good of others into account; and on the contrary have powerful incentives for ignoring the good of others if by doing so they themselves stand to gain (Dahl, 1998: 174). When harm results from decisions determined by unregulated competition and markets, questions about democracy are bound to arise causing some who believe in the virtues of total equality to oppose laissez-faire economics. Regarding this effect, Dahl states that the democratic potential of polyarchal democracy is limited by the inevitable inequalities that market capitalism creates, that in turn generate inequalities in the distribution of political resources. Consequently citizens are not political equals, violating the moral foundation of democracy, political equality. 'Market-capitalism greatly favours the development of democracy up to the level of polyarchal democracy. But, because of its adverse consequences for political equality, it is unfavourable to the development of democracy beyond the level of polyarchy' (Dahl, 1998:178).

Historical examples have shown capitalism has aided democracy, serving as a vehicle for a revolutionary transformation of society and politics. It has helped bring about changes 'from landlords and peasants to employers, employees and workers; from uneducated rural masses barely capable of surviving… to a country of literate, moderately secure, urbanised inhabitants; from the monopolisation of almost all resources by a small elite… to a much wider dispersion of resources' (Dahl, 1998: 178). But once society and politics are transformed by market-capitalism and democratic institutions are in place, the outlook fundamentally changes. Now the inequalities in resources that market capitalism churns out produce serious political inequalities among citizens. This presents 'a formidable and persistent challenge to democratic goals and practices that existed throughout the twentieth century and continue into the twenty-first. This is apparent within the state and globally, 'free trade' not turning out to be the means of linking the nations of the world together peacefully and democratically in the way it was forecast to. Liberalism increasingly appears an 'apologia for economic privilege' (Bowles & Gintis, 1986: 11).

The discrepancy between the many who work hard for a passable and insecure living, and the few who need not work at all to maintain their grotesque wealth, always threatens to undermine the rule of capital (Green, 1985: 18). Yet if democracy and capitalism are incompatible, how have the two existed side by side for so long? Nineteenth and early twentieth century scholars forecasted the demise of capitalism yet they disregarded the elasticity and expansive capacity of capitalism. Productivity growth makes possible a simultaneous increase of both exploitation and real incomes of the exploited masses. This of course is not conducive to democracy. The minority is given unprecedented room for manoeuvre in dealing with the exploited majority (Therborn, 1977).

Some scholars believe that extensive government intervention and regulation can right the inequalities experienced. They believe whilst the market is not and cannot be self-regulating in that it lacks a single centre, some kind of elective, deliberative and representative political machinery will be able to ensure equality (e.g. Therborn, 1977). The causal arrow however goes both ways: from politics to economics and vice versa, and the existence of market capitalism greatly effects the operation of democratic political institutions.

Green (1985: 14) states that 'the inequalities in the distribution of economic capital are virtually reproduced in the distribution of political capital' and believes economic capital reproduces itself in the political realm with an even more decisive inequality. A society dominated by the interests of capital is a society whose goal is capital accumulation. This for Green is the result of the social division of labour. The central tactic of proponents of liberal capitalism has never been to deny the existence of the division but rather to deny that it determines the development of a similar structure within the strictly political institutions of liberal capitalist society. Rather it is suggested to be a side effect of human nature or the reality of large scale organisation. The social division of labour and the political division of labour are not identical; but 'their resemblance and inter-penetration are more than merely metaphysical' (Green, 1985: 14). Resources needed for both are time, skill or knowledge, money and property. The capitalist class has the greatest resources in time and money to spend on behalf of its interests. They do not depend on votes to underpin their power and influence; the other resources at their command are considerably more decisive. Many of its interests are also deeply entrenched in law and its methods for protecting those entrenched interests have become so intertwined with the accepted means for maximising the general welfare, that the costs of tampering with them will often seem too high, even to those who positively hate the existing distribution of power (Green, 1985). This rule of privilege is the very essence of capitalism, incompatible with democracy in the strongest sense. The kind of economic and social inequity that contemporary capitalism manifests makes the notion of citizenship a chimera (Green, 1985: 13).

Economists have for a long time seen command over property as not only the command over things, but also command over the powers of other men, with the accumulation of the material means of labour leading to a net transfer of powers (Macpherson 1973, Bowles and Gintis, 1986). In a similar vane to Green, Macpherson (1973) attributes this to society's decision to abide by the right of unlimited individual appropriation and the natural inequality of individual capacities. This right of unlimited individual appropriation gives man an 'admirable carrot' (Macpherson, 1973: 18). Man, as an infinitely desirous creature, is moved to continuous effort with the prospect of unlimited powers over things to satisfy his desire as a consumer, spurred on by the belief that at the individual level anyone with enough drive can make it.

The crux of Macpherson's point is that the acceptance of the belief that unlimited desire is natural and rational leads ultimately to the continual net transfer of powers. This transfer of powers contradicts the principle that all individuals should be equally able to use and develop their natural abilities, by denying the greater part of men equal access to the means of using and developing their natural capacities. Thus Macpherson concludes that the maximisation of utilities cannot serve as the criterion of a democratic society and thus capitalism and democracy are inherently incompatible.

If we accept the interconnectedness of the economic and political spheres we can conclude that for the major organising and co-ordinating tasks in society in market orientated systems, there are two major groups of leaders and rulers: holders of governmental authorities and businessmen. Neither exercises conspicuously less ruling authority than the other even if there are some functions that are entrusted to government officials exclusively.

If we look at the democratic rule in the market system we see a huge democratic deficit. With respect to employees, corporations are authoritarian rather than democratic. Labour union influence softens that authoritarianism but by no means eliminates it (Lindblom, 1988). To 'vote' with money rather than ballots in some circumstances is more effective yet is also 'curiously limiting'… 'You and I cannot vote in that way for our preferred technology, location of industry, organisation and discipline of the workforce, or preferred method of executive recruitment and remuneration' (Lindblom, 1988: 123).

Lindblom also points out how business corporations must be induced, gratified, indulged, or rewarded to give them incentive to perform necessary tasks of social organisation or coordination. Governmental rulers in the democracies are usually fearful of being turned out of office if the economy stagnates and unemployment rises. They therefore 'warp' democracy to give high priority to devising policies businessmen want. Businessmen consequently achieve not a complete domination of the state but a degree of control over the state entirely disproportionate to their numbers. As a result democracy suffers both from direct market rule by holders of propertied authority and from the influence of those same holders of property on the authority of the state (Lindblom, 1988: 128). Grant (1993: 18) describes this imbalance as 'debilitating and potentially dangerous'. Western democracies are social mechanisms through which people demand of their governments what they have been taught by their elites. Thus popular control is to a degree short-circuited; democracy becomes circular (Lindblom, 1988: 135).

In the nineteenth and early twentieth centuries, as both political practise and constitutional debate clearly demonstrate, prevailing bourgeois opinion held that democracy and capitalism (or private property) were incompatible. Even such a broad minded liberal as John Stuart Mill remained a considered opponent of democracy for this very reason (Therborn, 1977). Yet today 'capitalism' and 'democracy' are terms widely held to jointly characterise our society. Bealey (1993) suggests this may be due to the desire of people to associate entities of which they approve. 'Democracy and free markets are concepts that meet with so much approval that they have come to be regarded as part of the natural order of things (Bealey, 1993: 222).

In reality however the market system is a power system (Lindblom, 1988); it is a system for controlling behaviour; within it are to be found leaders or elites as well as a rank-and-file; and it embraces a variety of interpersonal controls, including coercion, that are profoundly undemocratic. Bowles and Gintis (1986) suggest that so stark an opposition between 'capitalism' and 'democracy' may appear unwarranted. But it remains the case that no capitalist society today may reasonably be called democratic in the straightforward sense of securing personal liberty and rendering the exercise of power socially accountable.

Both capitalism and democracy were revolutionary ideas, portending the breakdown of the old order of mercantilism, dynastic monarchy and repression of spoken and written thought. They signalled the end of the *ancien regime* and the rise of the common man. They can, therefore, both be regarded as aspects of 'liberalism', an umbrella term associated with so many of the radical notions of the nineteenth century (Bealey, 1993). One may therefore maintain that these notions were part of a process of 'modernisation'. However democracy and capitalism remain very much opposed at the grass roots level.

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HOW SWITCHING COSTS AFFECT THE WAY IN WHICH MARKETS WORK

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Cillian Byrnes explores the various forms of switching costs and their functions. He analyses the effects that switching costs have on the way markets operate, with particular regard to price strategies, product differentiation and entry deterrence and the repercussions these have for consumers. He ends by making policy recommendations, but has the good sense to question their workability.

Introduction

Switching costs are the costs a consumer or firm incurs when they transfer their business from one supplier to another. Klemperer (1995) identifies four types of switching costs. First, there are physical switching costs. An example of this is if a consumer invests in a Nintendo games console. This usually restricts the consumer to purchasing Nintendo computer games as, if he/she wants to buy games from Sega, he/she will have to incur the physical switching cost of investing in Sega's console as Sega's games are incompatible with the Nintendo console. Due to the cost of consoles consumers generally purchase one or the other (Garcia-Marinosa, 2001). Another example would be the cost of switching one's bank account. This would involve closing your existing account and opening a new account with a new bank. Learning costs are the second type of switching costs. This involves learning to use new brands of products e.g. if you switch word processing packages it will take time to learn how to use the new package. When purchasing a new product there is an uncertainty about the quality of the product. Consumers don't know how good a product is until after they have used it e.g. medicine. Thus switching to a new product introduces uncertainty. The next category of switching costs consists of those that are artificially created. There are numerous examples of these including loyalty card schemes in super markets, discount coupons for products and frequent flyer programmes run by airlines. The thinking behind these schemes is to lock consumers into purchasing the firm's product. The final type is psychological switching costs. These may not have a rational economic explanation. Consumers

sometimes feel a brand loyalty toward the product they consume although there is no compulsion for them to feel this. Brehm suggests another reason:
"Social psychologists cite evidence that people change their own preferences in favour of products that they have previously chosen or been given in order to reduce 'cognitive dissonance'"[Brehm (1956), Klemperer (1995)]. This means that people like to stick with the things that they know. In the course of this essay I intend to examine switching costs in detail. I will look at how they affect how markets work. Endogenous switching costs will be discussed and I shall identify if switching costs cause detriment to consumers. Thereafter, the various effects of switching costs in different markets will be investigated. The final two sections deal with actions that need to be taken, the measurement of switching costs and what remedies could be implemented to counter the harm they cause.

Effect on how markets work

Pricing strategies

Beggs and Klemperer (1995) identify a change in pricing strategies in markets with switching costs as opposed to markets without switching costs. The key to switching costs is that once a consumer has purchased a product, he/she is locked into purchasing this product unless they are willing to pay the switching cost resulting from changing products. This means that firms can charge higher prices to their existing customers than the prices of their competitors as long as the price difference is less than or equal to the switching cost. In equilibrium a firm wants to charge a price where the price difference between their price and their rivals equals the switching cost. Here the consumer is indifferent between switching or not and will rationally stay.

Beggs and Klemperer (1995) use a model of a multi-period duopoly to illustrate what happens in markets with switching costs. Firms know that once they have consumers locked in they can increase the profit they make on them. This means that in the first period, competition between the firms is intense, as both want this later benefit. Therefore first period prices would be lower than in a market without switching costs where unaltered competition is persistent. In the resulting periods firms then increase their prices to make their profit on the locked in consumers. Thus, future period prices are higher in this market than one without switching costs. As a result of this price differentiation, average price is probably higher in markets with switching costs than markets without switching costs. First period prices are lower but in all the resulting periods prices are higher in the market with switching costs as firms are earning profit from their customers. As an average, the higher resulting period prices outweigh the first period price meaning average price is higher in a market with switching costs than one without.

This ability to price differentiate leaves firms with a dilemma. In a growing market they face a choice between charging high prices to earn profit off their existing customers or attracting new customers by lowering their prices. It is assumed that the incentive to exploit existing customers dominates. This is because firms want to make profit where they can. Building market share is also important but this may not always result in future profits e.g. demand for the product could collapse. Thus firms will want to cash in to some extent when they can. The ability to discriminate between existing and new customers solves this problem and this is discussed further in section four. If firms know they can exploit customers once they are locked in, rational consumers will know this also. This makes consumers less responsive to price cuts in the first period as they know this leads to higher prices in the long run. Therefore first period prices wouldn't be as low as if all consumers were myopic.

Product differentiation

Product differentiation is a tool firms employ to dampen competition. It creates a market for their product on its own. Switching costs artificially differentiate functionally identical products. The products are no longer the same as for a consumer to buy the other product he/she has to incur the switching costs of changing from their current product. Firms therefore like switching costs as they dampen the level of competition they face. Klemperer (1995) found the surprising result that firms prefer head to head competition with identical products rather than competition with differentiated products. This is because after the initial period firms can exert their market power on their existing consumers. With product differentiation this market power isn't guaranteed, as consumers may be willing to switch products, as they now prefer the characteristics of the competing product than the one they currently use. Switching costs suggest that multi-product firms are the way to compete. Consumers don't want to incur shopping or transaction costs i.e. the costs resulting from going out and actually purchasing a product, but they also value variety. Hence it is logical that consumers would like to buy several different products from the one firm as opposed to having to get the same bundle of goods by going to for example four different suppliers. Now consumers obtain variety without having to incur the same level of switching costs. This gives multi-product firms an advantage over single product firms.

"The Airbus Consortium has explained that its reason for producing a full line of aircraft is that 'without a family of aeroplanes to rival Boeing's, Airbus would be at a serious disadvantage in the market." Economist 3/9/1988, Klemperer (1995)

Entry deterrence

Klemperer (1987b) looked at how switching costs could deter entry. The growth rate of a market is the crucial issue. By this I mean the amount of new customers entering the market. In a stagnant or low growth market, switching costs deter entry as the incumbent has the majority of the market covered and its profit margin equals the switching cost. Firms would have to run a loss to enter the market and it can be assumed that the incumbent will react aggressively to new entrants. In a market with above average growth middle range switching costs are the most conducive to entry. Low switching costs deter entry, as firms will have to run a loss in the initial entry period. Profits are lower as there is less scope to exploit locked in consumers. Incumbents are therefore more likely to invest in attracting new customers i.e. reacting aggressively to entrants. With high switching costs, firms earn good profit margins and may be willing to forego these temporarily in order to preserve their monopoly and so are hostile to entrants. With medium size switching costs, firms may be less aggressive towards entrants as they do not deem it worth their while to fight entrants as there is a low payoff and so they skim profits off their existing customers, leaving the new customers to the entrant.

Switching costs help explain limit pricing. In the first period when the firm is a monopolist, they charge a price below marginal cost so the market is fully covered. Firms don't enter as they feel the incumbent will continue this strategy. Even if the incumbent raises price to make a profit, the potential entrant feels the incumbent will revert to this strategy if they enter, so at best zero profits will be earned. This is a rational belief as a firm invests in excess capacity as a signal of strategic behaviour. It is sending a message to potential entrants that if they enter they will make it extremely difficult for the entrant to gain market share. The firm would not have invested in this excess capacity if it didn't plan to use it if its threat was questioned i.e. there was a new entrant to its market. However, there could come a time when the incumbent earns more by accommodating entry rather than trying to prevent it. If a potential entrant believes this to be the case they will enter the market. Limit over-pricing is the opposite. Here the incumbent charges a high price, which gives them a small customer base and entry is deterred due to the threat of the incumbant slashing their price. This is particularly relevant where a market grows significantly in the second period or later. As with limit pricing a firm limit over-pricing may give up this strategy when it becomes more profitable to facilitate entry. Until this is the case limit over-pricing is a credible threat to potential entrants and so it is rational for potential entrants to believe a limit over-pricer will cut its price should the potential entrant enter their market. Therefore limit pricing or limit over-pricing will only be practised when it increases the profits of the incumbent in the long-run. From this section it can be seen that switching costs do significantly affect how markets work.

Endogenous switching costs and consumer detriment

Endogenous switching costs

Endogenous switching costs result from an investment in a piece of equipment which is only compatible with complementary products produced by the same manufacturer. The switching cost is to be able to use complements produced by an alternative manufacturer. You need to purchase the initial product produced by this new manufacturer although you already have the initial product produced by their competitor. The Sega/Nintendo example in the introduction is a good illustration of this. Endogenous switching costs enable firms to exploit consumers. They charge a low price for the initial product and a high price for the complement e.g. a low price for a console with a high price for games. In the first period a consumer buys a Sega console, thus in the second period they face a choice between a Sega game or a Nintendo console with a Nintendo game. Provided the Sega game costs less than the Nintendo bundle the consumer will usually stay with Sega products unless they have a significant change in taste. Surprisingly it can be better for firms to have compatible products rather than incompatible ones. This dampens first period competition. If the cost of achieving compatibility is small, this benefit may outweigh the cost. In the second period both firms now have access to larger markets that could outweigh the now heightened competition. An example of this could be CD producers and sound systems; all brands of CDs work in all brands of sound systems.

Firms can manipulate switching costs by creating them artificially and then using them to create a price difference between their price and that of their competitors as outlined in section two. They can do this by making their products incompatible with competitors or by giving discounts to loyal customers e.g. supermarket value club cards etc.

Consumer detriment

Switching costs cause detriment to consumers when they enable firms to charge them above the competitive price for a product, that is where firms are able to earn super normal profits, as customers would lose out from switching to competitors, as the price difference is less than the switching cost they would incur. They may also deter entry, which means there is less pressure on the incumbent to innovate and thus consumers lose out on potential improvements of products. In some cases they don’t cause detriment. In some industries a manufacturer may need to invest significantly in a retail outlet and thus they impose a restriction on the retailer they employ e.g. they can only sell products supplied by them or they will be sued. Here the switching cost of the retailer to switch supplier outweighs any benefit. A good example of this is a petrol station. Statoil invest in a petrol station, which is expensive. They need to employ an exclusive purchasing agreement or in the future the retailer could switch to a competitor who can supply petrol cheaper as they don't have the investment costs of Statoil. If Statoil couldn't impose this restriction then they wouldn't invest in a petrol station as immediately after investing the retailer would switch to a competitor. Consumers benefit from this investment, thus in this case switching costs are to the benefit of rather than to the detriment of consumers.

Different effects in different markets

Switching costs have their greatest effect in markets where firms are able to discriminate between first time and repeat purchasers. This enables firms to charge a low introductory price to new customers while simultaneously charging a high price to repeat customers. Technical markets facilitate discrimination e.g. photocopiers are relatively cheap but the toner required to use them is subject to a large mark-up. Each photocopier is only compatible with its manufacturer's toner. Less technical industries such as the clothes industry can't do this and thus use tools such as advertising to differentiate their product. Markets with frequent repeat purchasers are able to discriminate also. For example supermarkets use loyalty cards to give loyal customers discounts. New customers obviously can't avail of these benefits immediately. This encourages consumers to concentrate their business with a single supermarket. Once supermarkets have enough consumers locked in they can exploit them. This scheme would not work for one-off or rare purchases, e.g. furniture, as customers would not purchase often enough to earn loyalty points. Another point about these markets is that switching costs are lower here, as the market may have changed in the interim between purchases, thus the new purchase may be independent of the initial purchase.

Switching costs have different effects when there are different quantities of goods being purchased. Switching costs are the same whether you purchase 1 unit or 1000 units. Thus switching costs per unit are lower for bulk buys than individual purchases. Switching could be more prevalent in these bulk purchase markets as there is more incentive to switch, as the cost per unit is lower e.g. buying a domestic computer versus buying 100 planks of timber.

Measurement of switching costs

In technical markets Garcia Marinosa (2001) identified the switching cost as that of replicating the initial purchase. Thus the switching costs in this market would be period one costs plus the transactions cost of buying the second piece of initial equipment. However it is difficult to put a figure on these shopping costs. In transport economics one of the benefits of a new motorway are time savings. These are given a monetary value by giving labour related time savings a value in accordance with an individual's rate of pay. Leisure time savings are evaluated according to the value the individual gives his/her leisure. This can be applied to measuring switching costs. All switching costs should be identified. Non-monetary costs could be given a time cost that could then be turned into a monetary cost e.g. the time it takes to close your account and open one with a new bank. A monetary cost would be the cost of telephoning the bank while a non-monetary cost would be the time spent making the telephone call.

Switching costs can be observed by analysing a market. In equilibrium the price difference between the incumbent and entrant equals the switching cost. (Nilssen, 1997) This can be used to analyse a market. The price differences in a mature duopoly with stable market shares can be explained by switching costs. Thus this difference could be evaluated as the switching cost for this market. The drawback of this method is that the firms need to be identical for this to hold.

Identifying markets where switching costs are a problem requires the profit levels of firms in a market to be known. Switching costs can only be causing detriment in a market where super normal profits are being earned. The next step is to identify how firms are able to maintain this level of profit. Some markets owe this to phenomena such as monopoly power, collusion or non-price competition. Markets in which switching costs are identified as the reason for super normal constitute a problem. Looking at markets informally could alert people's suspicions to switching costs being a problem. If this happens a formal, more detailed analysis could be employed to find out what exactly is happening in a market. If a problem is found then solutions need to be implemented.

Remedies

Klemperer (1995) suggests three methods to achieve reduce switching costs. The first is the standardisation of products. This is a synonym for compatibility. This means that complementary components will be compatible with all brands of primary products not just their own manufacturers. As discussed earlier this reduces switching costs. The second tool is a policy of quality regulation. This would set a minimum level of quality that all products have to attain or else they won't be allowed on the market. This takes some of the uncertainty out of switching products, as the consumer now knows the product has a certain level of quality. The last method he suggests is the promotion of consumer information magazines like the magazine 'Which?' These give consumers plenty of information about products. These magazines reduce consumers search costs significantly; hence their switching costs fall also. Lower switching costs reduce firms' ability to exploit consumers.

We have looked at how switching costs affect pricing strategies. From this a possible remedy would be to restrict firms' pricing strategies. Market studies would be undertaken to find out what the competitive price in a market is. The regulator could then add a mark-up he deemed appropriate e.g. 20% to obtain the maximum price firms are allowed to charge for the product. The mark-up is necessary, as entry must not be deterred completely. This price ceiling softens first period competition as the future benefit of market share is lessened so prices are higher in period one and lower in subsequent periods. The price fall after period one should outweigh the first period price rise. This solution would require a benevolent social planner. In reality it would be extremely difficult to get firms to agree to this price cap. If it was enforced the investment could be moved abroad where these restrictions don't exist. Also it would be difficult to have accurate estimates of the competitive price in a market, as access to data would prove problematic.

Finally industry studies cost money. For these to be prudent the benefits that they generate need to outweigh the costs i.e. it would be unwise to invest $100 million in a project that generates a $50 million benefit.

Conclusion

To conclude, I feel convinced that switching costs do affect the way in which markets operate. Switching costs facilitate the exploitation of consumers already committed to a product. Consumers also suffer a variety loss, as with switching costs firms prefer head-to-head competition, which gives them greater market power in the long run. Moreover, switching costs deter potential entrants as they cause the incumbent to be more aggressive to entrants than they would be without switching costs. Endogenous switching costs were discussed and found to exist in technical markets. Switching costs do not always cause detriment. In some cases they enable firms to undertake beneficial investment that without switching costs would not have been possible. Switching costs have different levels of importance for different markets but are at their most effective when firms can discriminate between new and old customers.

Measurement of switching costs is tricky but explaining profit levels and price differences is a useful rule of thumb. There is no quick fix for the harm caused by switching costs. Close study of markets is required to obtain the information needed to regulate the market. It is evident that switching costs are not of negligible value in a number of industries with banking being a prime example. The way forward in my opinion is to build up information on switching costs. This necessitates industry studies and consumer surveys. This will lead to the regulation of markets and enable consumers to obtain information they can use to decide on purchases.

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INEFFICIENCY IN THE FACE OF RATIONALITY: HOW GAME THEORY CAN INFORM ECONOMIC POLICY

BY GRELLAN MCGRATH

Senior Sophister

'A rational man often bases his move on fact, not emotion. Paradise Island often turns out to be volcanic as on closer inspection.'
Robert J. Ringer

In a well structured and easy to understand paper, Grellan McGrath lays out the application for Game Theory in formulating economic policy. He gives examples of quite topical issues such as debt forgiveness and Common Fisheries policies.

Introduction

It has been said of game theory that its greatest contribution to economics is its ability to give some explanation as to how intelligent people can produce ludicrous outputs. In fact, this is very close to the truth: it is precisely through game theory's ability to show how rational players can arrive at remarkably inefficient outcomes that it can inform economic policy. The spectrum of policies which game theory can influence now is much broader than even its founding fathers could have imagined in the 1940's and 50's: from wage negotiations to monetary policy, the auctioning of broadcasting rights to cross-jurisdictional tax harmonisation.

This paper examines three macroeconomic examples of how the simplest games can inform even global scale economic policies. Specifically, the success of games in trade and tariff negotiations, sovereign debt, and the rationing of natural resources will be seen. In each of these models we shall see how comparing the inefficient predictions of game theory to the socially optimal outcomes can inform economic policy. Of course it would be naïve to suggest that game theory is perfect, and as such some of its current limitations will be considered.

It is the contention of this paper that through models, which explain how inefficient equilibria can arise if rational players are left to their own devices, game theory has had an increasingly integral role to play in the formulation of economic policy.

Game Theory in Trade and Tariff Negotiations

One of the simplest examples of how game theory can inform economic policy-making has broad implications in the realm of international trade negotiations. Here a non-cooperative game is examined which clearly shows the benefits of free trade and cooperation among governments.

This game has two identical countries; i=1,2. Each has (i) a government which chooses a tariff; t_i (ii) a firm producing output for both home consumption and export; $q_i = h_i + e_i$ and (iii) consumers who buy on the home market either from the home or foreign firm; total quantity on the market in country i is $Q_i = h_i + e_j$.

For the first move in the game the governments simultaneously choose tariffs t_1 and t_2. These are observed by the firms who then simultaneously choose quantities (h_1,e_1) and (h_2, e_2). The payoff to firm i is given by its profit function. The payoff to the government is given by total welfare to the country, which is the sum of consumer surplus enjoyed in i, profit earned by firm i, and tariffs collected from firm j.

Equilibrium is found for this game by backwards induction. First find firm i's best response (h_i^*, e_i^*) in terms of chosen tariffs, then maximise the payoffs for the government with respect to t_i. The equilibrium outcome of the game is:[1]

$$\left(t_1^* = t_2^* = \frac{(a-c)}{3},\ h_1^* = h_2^* = \frac{4(a-c)}{9},\ e_1^* = e_2^* = \frac{(a-c)}{9} \right)$$

In order to evaluate this outcome it is important to see what it would have been without any government tariffs. The most suitable comparison to make is with that of Cournot equilibrium in which

$q_1^* = q_2^* = \frac{(a-c)}{3}$ in each market.[2]

Without tariffs total quantity on each market is $\frac{2(a-c)}{3}$. With tariffs, total quantity on each market is $\frac{5(a-c)}{9}$. So we can see that consumer surplus is reduced when governments choose their Nash Equilibrium tariffs. In fact the

[1] For a fuller mathematical derivation of this equilibrium, see Gibbons (1992). For our purposes however, it is sufficient just to know the rules and outcome of the game.

[2] For a complete derivation of Cournot equilibrium see Tirole (2000). Again, it is sufficient here just to know that this outcome will be reached.

socially optimal tariffs are $t_1=t_2=0$ because they solve the first order conditions for maximizing welfare across both countries.

By comparing the inefficient outcome predicted by non-cooperative game theory to the socially optimal one, we are informed that the best economic policy when it comes to trade negotiations is that of free trade. This is consistent with history, which correlates times of highly-protectionist policies with times of depression such as the period following World War I. Institutions such as the World Trade Organisation and Free Trade areas, which facilitate lowering of tariffs are also consistent with policy recommendations arising from game theory.

Sovereign Debt: An example of Credibilty

Bulow and Rogoff[3] use the tool of game theory to evaluate potential policy alternatives for dealing with the developing countries' debt problem. Traditional theory says a country makes repayments on its debt in order to preserve reputational "collateral" needed for future borrowing. Using a simple model however, the authors find that any contract based solely on reputation must have some state of nature in which the country will default, and by doing so they would have strictly higher consumption in each future period by using short-term "cash in advance" contracts. This means there is no punishment for default available in infinitely repeated games between debtor and creditor countries.

In order to give some credibility to their promise to repay, lending to LDC's must be supported by direct costs which lenders can impose on a country in the event of a default. This could be the ability to impede its trade or seize its financial assets abroad.

The policy implication reached is that debt forgiveness schemes will not adversely affect LDC's future access to world capital markets by hurting their reputations, since loans must be able to be re-enforced by punishments. Thus debt-forgiveness is advocated by game theory. This is an example of how the issue of credibility of threats and promises in games of incomplete information can inform policy.

Policies in the Economics of Natural Resources

One of the games with the most rustic roots has got important ramifications in international economic negotiations about the allocation of scarce resources: the

[3] Bulow and Rogoff (1989)

'problem of the commons' which was first expressed in terms of common pastures in old English villages. A simplified two-period model of the game is as follows:

Suppose there is a common property resource of size y. Each of two players can withdraw an amount c_1 or c_2 in period 1. When combined consumption is less than y the remaining amount $[y_1 - (c_1 + c_2)]$ forms the base resource for future consumption.

Since there are no more periods left after period 2, each player would like to consume as much as possible in that period, hence the total (period 2) amount is divided amongst them. Each gets

$$\frac{y-(c_1+c_2)}{2}$$

Now for period 1 reaction functions are derived:

$$R_1(c_2) = \frac{(y-c_2)}{2} \quad \text{and} \quad R_2(c_1) = \frac{(y-c_1)}{2}$$

$c_1^* = c_2^* = \dfrac{y}{3}$ is the Nash equilibrium.

In order to find the socially optimal levels we shall assume (for simplicity) that the Von Neumann Morgenstern utility function is of logarithmic form, i.e. if player 1 consumes c_1, his utility from doing so will be taken to be log c_1. A pattern of consumption $(\hat{c}_1, \hat{c}_2)$ is socially optimal if it maximises the sum of the players' utilities:

$$\hat{c}_1 = \hat{c}_2 = \frac{y}{4}$$

If the Nash equilibrium predicted by the game is compared to the socially optimal outcome, we see that rational players can reach an inefficient outcome and have an over-extraction of the resource, known as a 'tragedy of the commons.'

There are many examples of common property resources in the world today. Perhaps one of the most topical is that of international waters and who has the right to how many fish in them (the Common Fisheries Policy is currently under re-negotiation in the EU). Levhari and Mirman were the first to look at this issue from a game theoretical perspective.[4] They created a two-country dynamic model in which they reasonably assume the object of each country is to maximise the sum of discounted utilities and the welfare of its citizens. This model takes into account (i) the strategic aspect of the participants' actions and (ii) the fact that the underlying fish population is decreased by harvesting but has a limited ability to replenish.

Levhari and Mirman derive a Cournot-Nash equilibrium and the corresponding steady state quantity of fish (i.e. the equilibrium size of the fish population in a dynamic sense). They then compare this to the optimal outcome where both countries form a cooperative venture and pool their resources. They find that Cournot-Nash policies imply a greater harvest of fish and therefore a smaller steady state than socially optimal. In fact the fish population may even tend to zero. This is consistent with the predictions of our simple model. By combined management, the two countries will consume, for each level of the population of fish, smaller quantities, but will be able to achieve a higher "permanent" catch.

Thus the obvious policy implication for economics of natural resources is that international cooperation and pooling of resources will have greater long-term benefits than short-term maximisation of harvestation quotas. Again this is an example of how policy recommendations can be reached by comparing the predictions of non-cooperative game theory models to socially optimal outcomes.

Limitations

While the three games and their applications looked at are persuasive examples of how game theory can inform economic policy, it would be somewhat incomplete not to allude to the current limitations of the discipline. It's not within the scope of this paper to give a full description of the deficiencies of game theory, so instead Kreps' [5] limitations will be outlined. Firstly, game theorists unquestioningly accept exogenous rules, whose origins are vague at best. Secondly, in many games, multiple equilibria arise and we have no way of telling which will dominate. This is a contentious issue, which is shown in the application of the theory to time-consistent monetary policy.[6] Thirdly, it is not often taken into account the extent to which the rules that prevail are influenced by outcomes. Are they manipulated to get the desired outcomes, or perhaps to be 'predicted' by history?

[4] Levhari and Mirman (1980)
[5] Kreps, (1990)
[6] For a treatment of this issue see Rogoff, R. "Reputation, Coordination and Monetary Policy" in R. Barro, ed., *Modern Business Cycle Theory*. Cambridge, Mass.: the Harvard University Press, 1989 pp. 236-64

When looking at these and other criticisms, the relative youth of game theory must be remembered: Its formal beginnings are accredited to Von Neumann and Morgenstern in 1944, and it lay relatively idle until the 1970's. In fact when this is taken into account, it could be said that game theory has made remarkable advances in credibility and adaptability, as testified by the range of applications examined.

Conclusion

In this paper we have looked at just three of the innumerable examples of how game theory can inform economic policy. In the case of sovereign debt we saw how notions of credibility in threats and promises lead to an endorsement of debt-forgiveness schemes. In our other examples we saw how even simple models can be adapted to be useful in global economic policy contexts such as trade negotiations and the allocations of commonly owned international resources. On the basis of these models, I believe we can conclude that the most effective way in which game theory can inform economic policy is to show us how rational players can logically reach inefficient equilibria, and allow us to compare these equilibria to more socially desirable outcomes, which would arise under the correct economic policies.

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THE THEORY OF OPTIMUM CURRENCY AREAS

PAUL KENNY

In Paul's view, theories are made to be broken, or at least called into question. Based on the evidence, he presents a logical case against the continued relevance of Mundell's theory of optimum currency areas, and in particular challenges its use as means of assessment of European Monetary Union.

Introduction

The theory of Optimum Currency Areas was pioneered by Robert Mundell in 1961. Conceived during the Breton Woods system of fixed international exchange rates, it was Mundell's proposition that balance-of-payments disequilibria would remain "an integral feature of the international economic system as long as fixed exchange rates and rigid wage and price levels prevent the terms of trade from fulfilling a natural role in the adjustment process". Broadly speaking, Mundell's theory advocated a system of many freely floating currencies organised around so-called optimal currency areas – an area which he defined as "the region". Due to the impracticability of organising currencies around any basis other than the nation state, the theory of Optimum Currencies has only a limited practical application, in particular to nations intending to form a currency union or to other economies in a state of transition. Mundell's thesis thus often forms the basis of analyses of the costs and benefits of the clearest example of the creation of a currency union in practice, European Monetary Union (EMU).

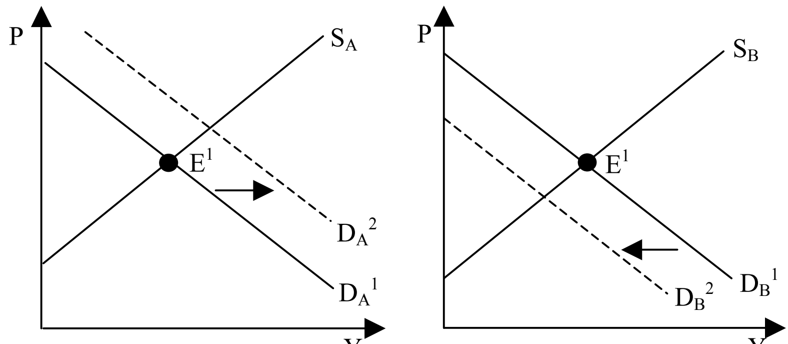
It should be first of all made clear that in this paper I do *not* aim to present an analysis of the costs and benefits of currency unions based on OCA; nor do I intend to address the question of whether the European Union constitutes an Optimum Currency Area, rather, I question the validity of the Theory of Optimum Currency Areas (OCA) itself. Having first outlined Mundell's (1961) model, I am to show that OCA is fundamentally deficient because of its roots in a static environment. I question the central assumption stemming from Mundell's early theory that exchange rate flexibility is the most effective way of adjusting for asymmetric shocks, and go on to challenge the relevance of such shocks in any case. I conclude that new measures of analysis should be sought that evaluate the greater economic implications of currency unions rather than the narrow cost benefit analyses that form the bases of current studies.

The Theory of Optimum Currency Areas (Mundell 1961)

Mundell's theory (1961) was formulated on the prevailing Keynesian belief in the ability of national monetary and fiscal policy to manage aggregate demand and offset supply-side shocks (McKinnon 2000). The goal of Mundell's original paper (1961) was to elucidate a theory on whether it is preferable for countries to adopt a system of flexible exchange rates or to operate under a system of fully fixed exchange rates. Arising from this discussion, he asks whether there is an ideal or optimal domain within which exchange rates should be fixed. He calls this an Optimum Currency Area. Mundell's ultimate conclusion, caveats aside, seemed to come down against the idea of fixed exchange rate regimes, advocating freely floating exchange rates based around the "region".

Mundell demonstrates his theory with the use of a simple model of two entities (regions or countries) in which there is a shift in aggregate demand for goods from one country to the other. This is illustrated in fig.1 (see De Grauwe 2000). Here there is an unspecified shift in demand, say due to a change in preferences, from country B to country A. The demand curve shifts outwards for A from D_A^1 to D_A^2, and inwards for B from D_B^1 to D_B^2, moving both countries from the initial full-employment equilibrium point, E^1. At full-employment, the increase in demand in A creates upward pressure on prices and wages. If A were to fully absorb the inflationary pressures of the increase in demand, B would quickly become more competitive causing an increase in aggregate demand and restoring equilibrium. However, the tendency is for A to resist a rise in the price level, resulting in a recessive tendency on B, (as prices are generally inflexible downwards). The result of this will be a current account surplus in A coupled with moderate inflation; while B on the other hand will likely experience a current account deficit and unemployment.

Fig.1 Aggregate Supply and Demand Curves for country A & country B



What mechanisms exist to restore equilibrium?

As implied above, if wages and prices in B were sufficiently flexible as to adjust to a lower level, then it could compete more effectively with A, restoring demand to its original level. Equilibrium would also be restored if labour were adequately mobile, such that those made unemployed in B could supply their labour in A. In this way wage pressure in A would be relieved, as would the excess labour situation in B. (Mundell makes no reference to the social desirability of the implicit shift in population from B to A.) A third means of restoring equilibrium would be if a system of fiscal transfers from the surplus country to the deficit country existed. Under a federal system, tax receipts in the surplus country would rise due to the increase in demand, financing such transfers, and ultimately facilitating B in restoring "domestic" demand.

Mundell argues that if one or more of these corrective conditions is not met, then a disequilibrium will persist in the absence of a change in exchange rate between country A and country B. "If demand shifts from the products of country B to the products of country A, a depreciation by country B or an appreciation by country A would correct the external imbalance and also relieve unemployment in country B and restrain inflation in country A. This is the most favourable case for flexible exchange rates based on national currencies" (Mundell 1961). If A were to revalue its currency, its exports would become relatively more expensive and imports relatively less expensive. This would have a downward effect on output and inflation. Concurrently, B's exports would become more competitive, and imports from A relatively more expensive thus increasing demand in B. This result would be a restoration of equilibrium.

Mundell (1961) concludes therefore that the optimal currency area is one in which there exists sufficient wage and price flexibility or labour mobility (or to a lesser extent a system of budgetary transfers), so as to negate the need for the exchange rate as an adjustment mechanism. Using Ricardo's definition of the region in terms of internal factor mobility and external factor immobility, he concludes that the optimal currency area is the region.

A critique of the Theory

In his 1961 paper, Mundell outlines the contrasting viewpoints of Meade[1] and Scitovsky[2] on a single currency for Europe. While the former believed that there was not sufficient factor mobility to consider Western Europe a region, the latter held that with monetary unification would come greater integration, provided measures were taken to facilitate labour mobility. Mundell concludes that whether or not Europe constitutes an optimum currency area is an empirical question. I do not believe that this is the case. Because of the inadequacy of OCA in a dynamic environment, most empirical studies of the EU as an optimal currency area have returned rather unconvincing results based on arbitrary measures. Here I do not intend to illustrate the various costs and benefits of currency union but to develop a criticism of the way in which these costs and benefits are formulated.

There are a number of areas of criticism of OCA theory, some of which Mundell includes as caveats to his seminal work. However, as these stipulations make OCA somewhat impractical as a means of evaluation, they do not sit well with proponents of the theory and are thus often simplified out of subsequent analyses. These criticisms can be analysed under two broad headings:

Static Analysis

- Mundell's (1961) analysis is carried out in a static environment, in which it is held that changes in the exchange rate can smooth economic shocks. This rests on the assumption that economic agents suffer from money illusion.
- I question the efficacy of the exchange rate as an adjustment mechanism.

Asymmetric Shocks

- Factor mobility is a relative rather than absolute concept. Mundell (1961) himself does not contend that "every minor pocket of unemployment arising

[1] J. E. Meade, (Sep 1957), 'The Balance of Payments Problems of a Free Trade Area', *Economic Journal*, pp. 385-86

[2] Tibor Scitovsky, (1958) *Economic Theory and Western European Integration*, Stanford.

from labour immobility [should be counted] as a separate region". Therefore, without an absolute definition of the region, analyses that seek to answer the question of whether the EU constitutes an OCA are arbitrary, and I believe insufficient.

- I challenge both the significance and likelihood of asymmetric shocks based on regional diversity

OCA as a Static Analysis

Mundell's (1961) theory is based on "a post-war Keynesian mindset in believing that national monetary and fiscal policies could successfully fine-tune aggregate demand to offset private sector shocks on the supply or demand sides." (McKinnon 2000). The theory of OCA therefore rests on the assumption of "stationary expectations", or in other words it presumes that agents do not try to anticipate future changes in the price level, exchange rates, interest rates or government policy. The essence of the theory is that the flexible exchange rate system can act a "device whereby depreciation can take the place of unemployment where the external balance is in deficit, and appreciation can replace inflation when it is in surplus." (Mundell 1961;657). Stemming from this, it is often considered that one of the costs of a monetary union is that countries have different preferences towards inflation on the one hand and unemployment on the other (De Grauwe 2000). This implies that there exists a trade off between the two. However, it is now widely accepted that in the long run the Phillips curve is vertical; or simply put, we now believe that in the long run such a trade off does not exist.

In any case one may question the validity of the use of exchange rate policy as an adjustment mechanism in the real world, and thus we are forced to question the basic tenet on which the argument for flexible exchange rates rests. Monetary policy can only be used to stabilise output and unemployment about their trend paths, but the paths themselves are determined by supply side factors; rate of capital formation, investment in human capital through training and education, technological progress and the size of the labour force. Monetary policy cannot in the long run alter real economic variables. Or in other words, in the long run, money is neutral (McDonald & Deardon 1999). If we held a monetarist viewpoint such as this, then the exchange rate would cease to have any role in stabilising the economy. Even if we accept the role of monetary policy in the short-term, one is forced to weigh the substantial longer-term costs verses the short-term benefits. As Mundell himself recognises,

> "The argument is based on money illusion: The community is unwilling to accept variations in real income through changes in money prices, but it

> will accept the same changes in real income through adjustments in the rate of exchange. A flexible exchange system may then be interpreted as a device for providing a more acceptable means (than employment changes) of altering the real income of the community. But what if money illusion is absent? Then, it is argued, there is no reason for changing to a system of flexible exchange rates: If internal prices were as flexible as exchange rates, it would make little economic difference whether adjustments were brought about by changes in exchange rates or by equivalent changes in internal prices."
>
> (Mundell 1968; 153)

Furthermore, historically there exists no evidence to support any relationship between observed exchange rate changes and external shocks that would have required such an adjustment. The result obtained by Canzoneri *et al*[3] that exchange rates rarely move in the direction that economic theory suggests, simply confirms the often observed phenomenon of volatile and irrational movements in bilateral exchange rates. This implies that flexible rates may exacerbate rather than smooth the consequences of economic shocks, entirely contradicting the key assumptions of OCA.

As Mundell stipulates in his original theory, there is an upper limit to the optimal number of currencies. As the currency area grows smaller, trade increases as a proportion of GDP, and "flexible exchange rates become both less effective as a control device for external balance and more damaging to internal price stability" (McKinnon 1963 pp.719). In other words, any degree of money illusion that existed in the short term would be quickly eroded. In the terminology of the model outlined above, it is assumed that the community in country B is unaware of the real effect on income of the devaluation. That is, while it would not accept a drop in nominal wages per se, it will tolerate a fall in the value of the currency, which translates into reduced purchasing power of imports. This effect is magnified when the proportion of imports is relatively larger in B, thus necessitating a limit to the optimum number of currency areas. As we will later see, the problem with OCA stems from the fact that there is no way of evaluating what this optimum number is.

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[3] Canzoneri M., Valles J., & Vinals J., (1996) *Do exchange rates move to address international macroeconomic imbalances?*, CEPR Discussion Paper no. 1498.

The Existence of Asymmetric Shocks

Mundell (1961) states, "The argument for flexible exchange rates based on national currencies is only as valid as the Ricardian assumption about factor mobility". Ricardo's definition of the region is as an area where the factors of production are internally mobile and externally immobile. The rationale for seeking a definition of the "region" or more particularly the "optimum currency area" is found in the belief that different regions will experience asymmetric economic shocks requiring independent exchange rate policy to deal with them. The question economists have since asked is whether the EU can be considered a region in this sense, and thus, an "optimum currency area".

Firstly, one should recognise that the region is a relative rather than absolute concept. There is no precise elucidation on what degree of factor mobility there should be to adequately constitute a "region". Therefore any attempts to empirically evaluate Mundell's theory return arbitrary results (notable examples are Bayoumi & Eichengreen (1994)[4] in Eichengreen [1997] & Von Hagen (1994)). Because it is not at all clear how much regional diversity should be tolerated before one considers there to exist multiple distinct economic entities, Eichengreen (1997) writes, "some standard of comparison is required" (pp.51). The most often used unit of comparison is the United States, where studies generally find there to be a marginally greater correlation of economic shocks than in the EU. This is generally the basis for concluding that the EU does not constitute an OCA, even though as McDonald & Deardon (1999) point out, the principal difference between the US and EU regarding unemployment is not in terms of divergence but rather flexibility of wages and labour markets. Either way, comparison of itself should not concern us as its results are subjective.

Once again, there is no prescription of how close the correlation of shocks should be. If one adopts a stringent interpretation, then many existing single currency areas are made up of multiple regions in themselves. (Examples include the UK, Canada or Italy prior to EMU.) Developments in Europe therefore pose greater problems. Undoubtedly, European integration, especially since the single market programme (1986-1992), has blurred the distinction between economic regions. De Grauwe (2000) acknowledges that economic and monetary integration (aside from the political connotations) are mutually reinforcing processes. Even though the impact of EMU on the integration of the labour market may prove to be negligible,

[4] Bayoumi, T & Eichengreen B., *Shocking aspects of European Monetary integration*, in Giavazzi F., & Torres F., (eds.) (1994), A*djustment and Growth in the European Monetary Union*, Centre for Economic Policy Research, Cambridge University Press:Cambridge.

given social and historical differences[5], monetary union does facilitate the full integration of capital markets and financial services with the subsequent benefits accruing from scale economies and the reduction in risk premium. Even though the greater integration of the European Union since the single market programme has led to limited convergence of key economic fundamentals such as unemployment and GDP growth, business cycles have become more correlated across the member states (McDonald & Deardon 1999). This process tends in turn to make a monetary union more attractive.

It is ironic that the one of the most convincing arguments against the validity of OCA comes from Mundell himself. In his Madrid papers of 1970[6], he adapts his analysis of exchange rate theory to factor-in uncertainty, and places the focus on the forward-looking nature of the foreign exchange market. He focused on how "future exchange rate uncertainty could disrupt the capital market by inhibiting international portfolio diversification and risk sharing." (McKinnon 2000). Most models based on OCA fail to adequately recognise such network effects. Dowd and Greenaway (1993) state, "The value of a particular currency to a user depends on how many others use it as well". In other words, currencies benefit from economies of scale. In this respect, we may in future see the Euro benefit in terms of the transition to an international currency, increasing liquidity and potentially lowering interest rates across the Eurozone.

Mundell argued in "Uncommon Arguments for Common Currencies" (1973 b) that, "Rather than moving toward more flexibility in exchange rates within Europe the economic arguments suggest less flexibility and a closer integration of capital markets."[7] Economic theory backs up the observation that that since EMU, governments are able to borrow on a unified EU capital market. This means if countries were to experience an asymmetric shock, the deficit financing associated with attempts to stabilise demand in one country will only have negligible impact on the interest rate and thus other countries (McDonald & Deardon 1999). Thus, it counters the idea that asymmetric shocks undermine a currency union by showing that a common currency can in fact mitigate against asymmetric shocks by portfolio diversification. Evidence of this can be found in that Eurozone interest rates are now lower than the prevailing average interest rate that persisted prior to unification

[5] Clearly only time will tell, as there is little worthwhile empirical evidence available as yet.
[6] Mundell R. A., (1973) (a), *Uncommon Arguments for Common Currencies*, in H.G. Johnson & A. K. Swoboda, *The Economics of Common Currencies*, Allen and Unwin, pp. 114-132
Mundell R. A., (1973) (b), *A Plan for a European Currency*, in H.G. Johnson & A. K. Swoboda, *The Economics of Common Currencies*, Allen and Unwin, pp. 143-172
[7] Mundell R. A., (1973) (a), *Uncommon Arguments for Common Currencies*, in H.G. Johnson & A. K. Swoboda, *The Economics of Common Currencies*, Allen and Unwin, p.150

(McKinnon 2000)[8]. Furthermore, the term structure of financing in Europe has been lengthened with lower portfolio risk. “Eliminating currency risk within the greater European Economy is a remarkable benefit – as Mundell correctly foresaw in his second incarnation” (McKinnon 2000).

“Only if one concludes that external shocks and the exchange rate are important for unemployment should one conclude that the costs of EMU could be high” (Gros & Thygesen 1998, p.271). We must therefore attempt to establish the likelihood and importance of asymmetric demand shocks. Gros & Thygesen (1998) go on to state that it is not at all clear “how such a shock could materialise in a modern environment, where all member countries export and import predominantly a large number of industrial products, only slightly differentiated from those of their trading partners.” Because the nature of trade in Europe is predominantly intra-industry, and most economies are based on a similar (although not identical) industrial structure, and because it is difficult to imagine economy wide changes that are caused by sudden changes in technology or tastes, it is more difficult to envisage a specific country shock in demand versus an industry shock that would affect a number of economies in the same way. If shocks are sector specific, then we are more likely to see shocks concentrated at regional rather than national level[9]. De Grauwe & Vanhaverbeke[10] show that there is greater diversity between the regions of countries than between the countries of the EU, indicating that the experience of shocks is likely to average out across the Union as a whole, neutralising their effect.

There is another important element to add to this discussion of asymmetric shocks. It is sometimes argued that the most significant domestic shocks we could envisage may in fact be caused by independent monetary and fiscal policies (McDonald & Deardon 1999). In this way, by sacrificing monetary policy and restraining fiscal policy as Euro members have, the possibility of self-induced asymmetric shocks may be reduced. This issue was brought to the fore by a recommendation from the ECOFIN Council to the ECB that, in January 2001, Ireland’s fiscal position was inappropriate and in need of retrenchment. This stemmed from its belief that excessive public sector spending was overheating the Irish economy and amplifying Ireland’s above-average inflation rate[11]. It seems however, that this prognosis was incorrect. The difference in inflation rates between

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[8] It should be stated however, that this is not conclusive evidence considering the slowdown of economic growth, which has prevailed across Europe from around the time the euro was introduced.

[9] This idea is often associated with Paul Krugman

[10] De Grauwe P., & Vanhaverbeke W., (1993) *Is Europe an Optimum currency area?: Evidence from regional data*, in Paul R. Mason and Mark P Taylor (eds) *Policy issues in the operation of currency unions*, Cambridge University Press:Cambridge, pp.111-129

[11] Euro area inflation averaged 2.5-3% while Irish inflation averaged 4.5-5% at this time.

Ireland and the EU is often explained via the operation of the Balassa-Samuelson hypothesis (see for example McCoille & McCoy 2002). It proposes that the inflation differential is due to higher productivity in the traded goods sector putting upward pressure on wages and prices across the economy. One may however doubt the significance of the Balassa-Samuelson effect in Ireland for a number of reasons[12].

It is my view that the situation arose neither from domestic fiscal policy, nor from differentials in productivity between the traded and non-traded sectors of the Irish economy, but from the country's disproportionate exposure to foreign currencies, in particular the US dollar and UK pound sterling. While there has been a moderate increase in the level of trade with fellow member states, Ireland's predominant trading partners remain the UK (c. 15% of Irish GDP) and the US (c. 8% of GDP). This contrasts with EU trade with the US of less than 1% (Gros 2001). Until recently, the Euro had persisted at an undervalued level against sterling and the dollar, which impacted greatly on Ireland's current account balance and placed upward pressure on prices and wages. The result has been a consistently higher rate of inflation prevailing in Ireland than in the EU.

At first glance, the inflation differential may seem attributable to an asymmetric demand shock, requiring independent exchange rate policy to deal with it; however, this need not be the case. If we agree with the supposition that the above average inflation rate is not a long-run state of equilibrium, then in the absence of labour mobility across the Union, flexible wages and prices are a necessary mechanism for Ireland to achieve an appreciation of its real exchange rate. As Irish competitiveness is eroded by inflation, the economy would be restored to a slower and more sustainable growth rate, with the inflation differential disappearing over time. The concern may be that while inflation is pushing Ireland towards that state of equilibrium, a rise in the value of the euro[13] could lead to a greatly overvalued

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[12] The reason for this is three-fold (Gros 2001)

i. Throughout the period 1991-2000, Ireland's exchange rate with the synthetic euro remained stable, and average inflation was the same for Ireland as in the Euro area.
ii. The Irish price level has always remained close to the Euro area, even when its income was much lower. The Balassa-Samuelson hypothesis would have anticipated Irish prices rising in relation to EU prices with the growth in Irish productivity since 1990, but this did not occur until more recently.
iii. Furthermore, the Balassa-Samuelson effect emphasises the role of labour immobility between states in maintaining wage and price differentials. However, this is not the case for Ireland because of the high degree of labour mobility between the UK and Ireland. Rising Irish wages thus reflect the higher productivity of the UK economy.

[13] It reached parity with the dollar in Q4 2002, and has remained above 1:1 in the early months of 2003. ECB Monthly Bulletin, December 2002, & February 2003.

Irish real exchange rate. Although economic theory suggests that this could bring about a quicker return to equilibrium at a lower rate of inflation, such a process would not be without its costs. Further unknowns are imposed by the threat of deflation in key euro member states,[14] as well as the uncertain outcome of War in the Middle East. Ultimately the point remains that inflation as a result of asymmetric trade profiles, or as implied by differential growth rates (the Balassa-Samuelson Hypothesis) need not be long-term in nature, and may be seen as part of an internal adjustment mechanism. Therefore, we may still view with some doubt the existence and importance of asymmetric shocks. Although the full implications of this are yet to play out, it does not appear to contradict the fundamentals of the critique as presented so far.

Conclusion

As Eichengreen describes, OCA is often used as the basis upon which a cost-benefit analysis of EMU is carried out. "In Mundell's paradigm, policymakers balance the saving in transactions costs from the creation of a single money against the consequences of diminished policy autonomy. The diminution of autonomy follows from the loss of the exchange rate and of an independent monetary policy as instruments of adjustment." (Eichengreen 1997 pp 1-2). I would rather analyse the implications of EMU within a much broader framework. Despite the desire to empirically quantify the costs and benefits of a currency union based on the original OCA, or even a modified OCA incorporating some of the dynamic factors outlined above, such analyses are still fundamentally flawed in the assumption that one can exclude the greater economic effects that evidently do exist. If this were not the case, countries would simply not consider the formation of a currency union or the adoption of an anchor currency. It is my conclusion that the costs and benefits presented by OCA analysis return only marginal results, which are in any case predicated upon arbitrary standards.

As yet, there does not appear to be a comprehensive alternative to OCA. However, if future attempts were to address the deficiencies in the theory outlined above, this would go some way to presenting a more complete case for or against EMU. Again, despite the multitude of empirical studies that have been carried out, most discussions of EMU are unfortunately driven towards the same vital, yet uninstructive conclusion,

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[14] The stance of the ECB has begun to move in response to this. ECB interest rates were cut to their current all time low of 2.5% on 6th Mar 2003 (Irish Times Business Supplement 7th Mar 2003, p.3).

"…EMU is about much more than a simple calculation of economic costs and benefits. For the EU, economic integration has always been a means to political unification, rather than an end in itself. The commitment of the key member states to the ideal of political union means that EMU must be seen as part of a wider commitment to a unified, peaceful Europe rather than a limited exercise in trading off economic costs for economic benefits."

(McDonald & Deardon, 1997;114)

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ECONOMIC EFFECTS OF LIBERALISATION OF THE BEEF MARKET ON THE IRELAND AND EU

BY DEREK MERNAGH

Senior Sophister

The EU has a political hot potato on its hands with CAP and in this essay Derek Mernagh examines what is at "steak" should the EU liberalise the market for beef. He takes the bull firmly by the horns from the outset with an analysis of current EU policies, which he finds to be not only inefficient, but also ineffective. Having applied an econometric model to both the Irish and EU cases, he surmises that the effect of liberalisation will turn the EU from a net-exporter to a net-importer and that the Irish economy, as the state that most successfully milks the EU cash cow, will bear the brunt of any welfare losses. Here's the beef:

Introduction

The aim of this paper is to estimate the price, quantity and welfare effects of moving to free trade in the beef market for the EU and Ireland. Beef/veal is the second largest production sector in the EU, making up 10% of EU agriculture[1]. Policymakers must decide whether the benefits of free trade outweigh the negative effects before agreeing its implementation. It is therefore necessary to measure the impact on producers, consumers and governments to ascertain an overall societal welfare effect. This will determine the eventual suitability, or not, of the proposal. A market simulation model is used in this analysis to determine the welfare effects for both the EU and Ireland.

The results for the EU will be representative of the 15 member states. There are, however, divergences within these states, with each country being either a net exporter or net importer making up a marginal self-sufficiency of just over 102% for the EU as a whole[2]. Ireland is a net exporter of beef, exporting almost 94% of its production[3]. Hence it can be expected that the effects of liberalisation will differ for

[1] http://europa.eu.int
[2] http://europa.eu.int
[3] http://www.cso.ie.

Ireland, each individual state and the EU as a whole. These discrepancies will be illustrated later.

The present regime for beef in the EU

The support for beef from the EU comes in four main ways: support prices through intervention buying, export subsidies, tariff and tariff rate quotas on imports and direct premium payments.[4] The intervention price paid to farmers is set by the Council of Ministers. It is paid when market prices fall below a certain pre-determined level. At this point the EU will buy excess beef, pay an intervention price for it and then the produce is put into storage. Intervention stocks have grown in recent years due to the BSE crisis in the mid- to late-nineties.

- Export subsidies are paid to beef farmers who export their produce outside the EU to make their exports more competitive, as internal prices are higher than world prices. For example, Ireland exports to Russia at a price lower than the Irish price. The EU will pay the Irish farmer based on the quantity exported, and based on a money limit. Therefore the Irish farmer will receive the lower market price from Russia and a refund from the EU based on the difference between the price received and the internal price.
- The EU also applies tariffs so that imports of beef cannot be sold in the EU below the desired internal market price.
- And finally, EU beef premiums make an important contribution to the income of farmers. Under this programme the farmer receives payment for each cow after 10 and 22 months[5]. These direct payment measures are aimed at extensification of livestock production, whereby producers must observe maximum stocking rates (livestock units per hectare) to qualify for payments[6]. These payments along with the export subsidies are paid out of the CAP budget, FEOGA. As Ireland is a member of the EU these rules and regulations apply.

Assumptions

Initially it was necessary to make the following assumptions in relation to the data required. These were the following:

[4] University of Manitoba, 2002
[5] R and H Hall Technical Bulletin 1998
[6] University of Manitoba, 2002

- **Changes in EU policy have no effect on the world price:** This simplifies the calculations, as it would be difficult to determine what effect this move would have on the world price. One would expect a price increase but for the purposes of this model we assume no change. This assumption is known as the small country assumption.
- **Only policy in the beef market is being changed:** Reforms to the CAP usually apply to an array of agricultural commodities. Liberalisation of the support structure for other commodities would make it difficult to quantify the effect on the beef market as both consumers and producers may switch respectively to the consumption and production of other commodities. Also beef and dairy production are linked so changes in milk policy will significantly impact on the beef market. There will be a certain level of substitution anyway, once the beef trade is liberalised; Supply will decrease as some beef farmers leave the market. However we are not concerned with any substitution from other production sectors in this case as it would be too complex to quantify in this model. Therefore we assume policy change only occurs in the beef market.
- **No compensation is paid to producers:** In general the farm lobby is quite strong and it would be highly unlikely that farmers would not be compensated. The implications of this would be a gain in the producer surplus but a corresponding decrease in government revenue, these would in effect cancel each other out. Therefore it should not distort the analysis but the welfare effects may be overstated as a result.
- **The marketing margin is assumed to be 100%:** This assumption recognises the inevitable difference in the price that the producer receives for his output, and the price consumers pay in the market. The difference is due to the costs incurred in the move from producer to retailer. These might be transport costs, refrigeration costs etc.

Procedure and Methodology

The procedure for finding data for the two countries was much the same, using various Irish, EU and World data from a selection of Internet sources and relevant national and international publications. These are shown in the following:

Table 1: Beef Market Data for 1999

Data	Source
EU Price	Agriculture in the European Union-Statistical and Economic Information 2001, Table 4.15.5.1
Irish Price	Same source as above, Table 4.15.5.1. Also www.cso.ie/publications/agriculture/oiifin/pdf.
EU Demand	Agricultural Situation in the EU 2000, p. T/299
EU Supply	Agricultural Situation in the EU 2000, p. T/299. IMF also provides a figure for the EU supply.
Irish Demand	www.cso.ie/publications/meatsup.pdf, Table 1
Irish Supply	www.cso.ie/publications/meatsup.pdf, Table 1
Demand Elasticity	"Disarray in world food markets" (1992),Tyers and Anderson p. 363
Supply Elasticity	"Disarray in world food markets" (1992), Tyers and Anderson p. 363
World Price	International Financial Statistics (2002), IMF, p. 72

It should be noted here that different sources provided varying information. The most up to date and relevant information was taken but some of the other sources will be used in the sensitivity analysis to test the results. This data was the basis for the model that was set up in Excel. Some of the data that was found had to be converted to euro[7] and euro per tonne[8].

Summary of results for the EU

The following table is a summary of the changes in the market for beef in the EU once liberalisation has taken place.

Table 2.

Change in Producer Price	-35.13
Change in Consumer Price	-35.13
Change in Quantity Supplied	-35.84
Change in Quantity Demanded	21.08

[7] using http://www.convert-me.com/en/convert/weight

[8] using http://www.econfinance.com/converters_currency.htm.

Prices in the market have decreased by over 35%. Customers are not very sensitive to price changes for beef as demand is inelastic at -0.60 (Tyers and Anderson). In general beef is slightly more elastic than other agricultural commodities, particularly some staple produce and also because of BSE scares and other health scares. However consumers only have to pay two thirds of what they used to pay so quantity demanded increases by 21%.

Producers who are used to having their produce supported at an EU level have to adapt to a situation where they are receiving just under two thirds of what they are used to. Supply elasticity is almost unit elastic, which means that supply will respond by proportionately the same as the change in price, which is evident from the above table where the reduction in quantity supplied is almost identical to the price decrease. It may be very difficult for many farmers to deal with this huge drop in revenue, so supply at an EU level drops by over one third as it has become less profitable to produce beef and the more inefficient farmers are forced to leave the market. The world price offered is much lower which reflects that the international market for beef is much more competitive with other countries maintaining a competitive advantage in its production in liberalised markets. The major producers of beef in the world are Australia/New Zealand, the USA, and Argentina. These countries may have the advantage of having adapted already to some form of free trade for example New Zealand whose subsidies in 1984 were slashed from 30% of farm income to 2%[9]. This radical move has helped encourage other types of farming as a substitute to beef. This may not be the desired policy of the EU though. At the new equilibrium level the EU becomes a huge net importer from being a net exporter pre liberalisation.

The following table illustrates the welfare effects for the EU after moving to free trade.

Table 3.

	€
Change in Consumer Surplus	13,507,856,682
Change in Producer Surplus	(6,223,665,889)
Change in Govt. Revenue	32,571,330
Overall Welfare Effect	7,316,762,123
Transfer Efficiency	46%

The change in consumer surplus is positive, to the tune of over €13 billion. This is the gain accruing to consumers resulting from the lower prices being charged

[9] International issues in the beef industry

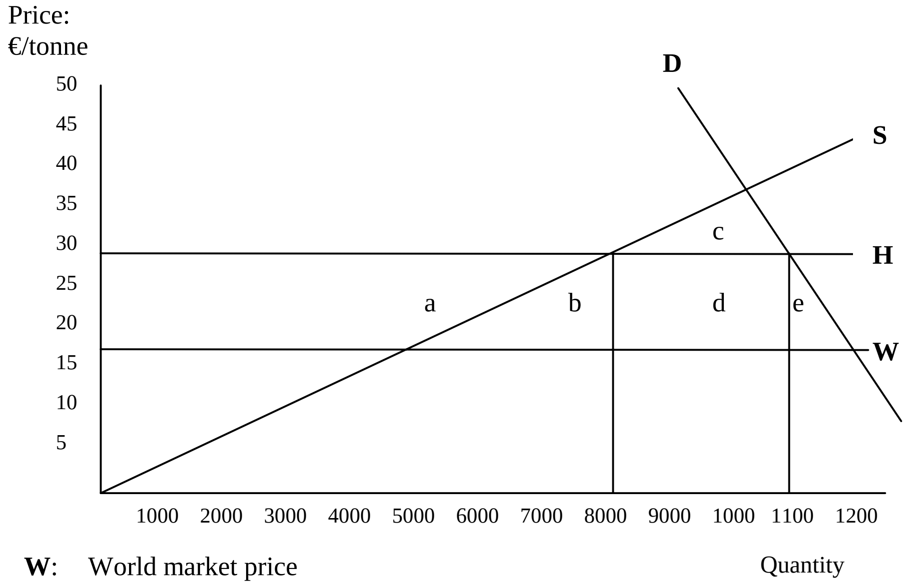
in the market. The producer surplus will obviously diminish as their price falls by over a third. There is an increase in government revenue, as European taxpayers do not have to support beef farmers anymore. The overall effect for society is a substantial increase in welfare of almost €7.3 billion. Transfer efficiency measures the income gain to beef farmers relative to consumer and taxpayer costs. So while the market was protected only 46% of the planned benefit was getting to farmers while the remaining 54% of the planned transfer is a deadweight loss. Therefore the protectionist policy of the EU was not benefiting those that it targeted successfully.

We can graphically display the welfare changes on the following graph. The change in consumer surplus is represented by the area underneath the demand curve between the two price ranges (area A+B+D+E on the diagram). The change in producer surplus is the area above the supply curve between the two price ranges (area A on the diagram) and the change in government revenue is the difference in demand and supply at the original price multiplied by the difference in the two prices (area C+D on the diagram). The overall welfare effect can be calculated as follows:

Table 4.

ΔCS	A+B+D+E
ΔPS	(A)
ΔGR	C+D
ΔW	B+C+2D+E

Fig. 1. European Beef Market



W: World market price
H: Domestic price
D: Demand curve
S: Supply curve

Summary of results for Ireland

Liberalisation had the following effects on Ireland:

Table 5.

Change in Producer Price	-19.22
Change in Consumer Price	-19.22
Change in Quantity Supplied	-19.6
Change in Quantity Demanded	11.5

Once again there is a price decrease but much smaller than that for the EU as the Irish price is closer to the world price. This may indicate that Irish producers are some of the more efficient in the EU and should be able to handle this move better than most. Indeed we see a much smaller reduction in the quantity supplied than for the EU. As Irish consumers are used to paying lower prices than the EU the price reduction does not have as significant an impact on quantity demanded which increases by 12.5%. Ireland is a massive net exporter with supply far outstripping demand; so Irish producers are highly dependent on exports. Supply contracts by almost 20%, which may indicate that the less efficient have left the market leaving the efficient and more specialised farmers. The welfare effects for Ireland are as follows:

Table 6.

	€
Change in Consumer Surplus	59,020,657
Change in Producer Surplus	(250,698,955)
Change in Government Revenue	-
Overall Welfare Effect	(191,678,298)
Transfer Efficiency	425%

There is a small increase in the consumer surplus relative to the very large decrease in the producer surplus. Indeed a move to free trade would cost Irish beef farmers over €250 million. Ireland as a whole would loose over €190 million as there is no gain in government expenditure. The reason for this is the fact that each year EU members pay into the CAP fund. Ireland only makes a small contribution to this fund as it is a net exporter and it has a small proportionate population. Therefore Ireland is a net beneficiary of the CAP payments. So in the event of free trade the government will not have to pay into the fund, but as the payment is so small we do not recognise any gain in government revenue. Even if there were it would accrue to the EU anyway. The reason why Ireland would lose out is that we are a huge net exporter so our producers are used to being supported. As can be seen from the transfer efficiency, the intended benefit of this policy transfer is more than reaching Irish producers. There is a graph for the Irish model, which is in the spreadsheet sheet 3. The welfare effects are not shown graphically in this case but they are negative as can be seen from the table above.

Sensitivity analysis of the model

In order to assess the validity of this model we need to make adjustments to some of the variables by using some of the other sources available. Once the model has been made then this is quite simple as it is just a matter of analysing the effects that different data has on welfare. These different data should have roughly equated to the same overall welfare effect if the model is accurate. The lower the variance of the results, then the more confident we can be that the assumptions we made are justifiable.

In the first test an alternative world price is used. It is the US price as opposed to the Australia/New Zealand price.

Table 7.

Welfare effects	**EU** **€**	**Ireland** **€**
Change in Consumer Surplus	8,657,489,443	6,687,481
Change in Producer Surplus	(4,137,233,531)	(32,696,037)
Change in Government Revenue	19,965,330.00	-
Overall Welfare Effect	4,540,221,242	(26,008,556)

The US price is closer to the EU and Irish price, so the expected result would be to have a smaller overall welfare increase for the EU and a reduced loss of welfare for Irish farmers as they would receive a higher price in this case.

Then the EU and Irish prices were changed. The EU intervention price which was used was higher than the original figure used increases the welfare effect. For Ireland the unit value approach is used as an alternative to the Irish price from the original market model.

Table 8.

Welfare effects	**EU** **€**	**Ireland** **€**
Change in Consumer Surplus	21,674,663,387	93,573,214
Change in Producer Surplus	(9,616,203,021)	(371,905,352)
Change in Government Revenue	54,536,130	-
Overall Welfare Effect	12,112,996,496	(278,332,138)

The higher the Irish price, the greater the loss to society so this expands the welfare loss. For the EU we see a high welfare gain as the reduction from the intervention price to the world level creates a massive consumer surplus.

The final test was to change the supply elasticity to the short run value found in Tyers and Anderson (1992).

Table 9.

Welfare effects	**The EU** **€**	**Ireland** **€**
Change in Consumer Surplus	13,507,856,682	59,020,657.09
Change in Producer Surplus	(7,422,382,005)	(274,738,709.41)
Change in Government Revenue	32,571,330	-
Overall Welfare Effect	6,118,046,008	(215,718,052.32)

This decreases the welfare gain as not as many producers leave the beef market as they are not as sensitive in the short run. Therefore there are more producers chasing a lower price so producer surplus increases.

The overall effect of the changes in the respective parameters is still positive for the EU and negative for Ireland but the magnitude of the gains and losses change. Therefore it is obvious that the result that we found with the original model is realistic and so the sensitivity analysis shows that we can be more confident that this will be the actual effect of trade liberalisation in theses markets.

Conclusion

The effects of liberalisation have been clearly outlined and some interesting results have been found. The EU benefits from free trade in this market as prices are reduced which benefits consumers, and government revenue has increased. Beef farmers are worse off but the lower price means that some will not survive and have to cease production. The ones who stay have to be more efficient if they are going to survive under competitive conditions. We recognise an overall positive welfare effect to society, the main cost of which is the reduction in EU supply. The EU becomes a net importer from being a net exporter. This scenario would mean that the EU would have to change their mission of support from "promoting the development of an efficient primary agricultural sector, while ensuring the retention as far as possible, of the highest number of farm households".

If we shift the focus to individual member states focusing on Ireland we find a negative welfare effect. The Irish case is extraordinary however. Ireland is a huge net exporter, as domestic demand is very small in relation to supply. In fact Ireland is the largest exporter of beef in the EU in real terms, as domestic demand in other larger countries matches domestic supply a lot more closely. Irish beef producers would seek a slower move to liberalisation on the basis that the CAP still provides significant support to Irish farmers. Also as Ireland exports so much then they will seek to minimise restrictions on exports.

According to R and H Hall, Agricultural Ministers have decided to support the European model of Agriculture, based on the family farm, the multifunctional role of farmers in society, the rural economy and the environment. Therefore a move to liberalisation would require a gradual adjustment process. Also the vested interests of the beef lobby are influential. In theory there may be a case for free trade but in practice this may be very difficult to achieve.

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WILL FISCAL POLICY IN THE EURO AREA BE SUFFICIENTLY FLEXIBLE TO COPE WITH A MAJOR RECESSION?

BY REETTA SUONPERÄ

Junior Sophister

The current economic downturn has led to countries in the EU exceeding the stability and growth pact. Reetta Suonperä examines the reasons for introducing such a pact, followed by the possible mistakes of EU policy makers, in the way in which the pact has been implemented.

Introduction

The Maastricht Treaty sets limits for government deficits and debt/GDP ratios that should not be exceeded other than in 'exceptional and temporary circumstances', thus setting the rules for fiscal policy in the Euro Area. These regulations are further detailed in the Stability and Growth Pact, which also gives a specification for when the rules can be breached without repercussions. The aim is to achieve fiscal stability, while still maintaining sufficient flexibility to deal with business cycles (IMF, 1997). However, many people now argue that the treaty is too rigid and does not provide sufficient scope for member states to deal with an economic downturn. The debate took a new turn in October 2002, when Romano Prodi, the head of the European Commission, said in an interview with 'Le Monde' that the Stability and Growth Pact is 'stupid' (The Economist, 26.10.2002). His view is that the pact is quite simply too rigid, and that to follow it dogmatically in a changing economic environment would not be wise (Helsingin Sanomat, 22.10.1997).

With the economy in a downturn and the tensions between the US and Iraq increasing insecurity and instability, the ability of the Euro Zone to cope with a major recession is crucial. This essay will attempt to shed some light over this issue by considering the rationale for fiscal rules, both in the general case and for the EMU in particular. Then the Maastricht Treaty and the Stability and Growth Pact will be examined in detail, followed by an exploration of why fiscal flexibility is necessary. Finally, the case of flexibility of the Stability and Growth Pact will be examined, yielding a judgement on whether the pact is sufficiently flexible.

Rationale for Fiscal Policy Rules

Fiscal rules and institutions serve to create the setting in which policy makers operate, and also provide the incentives and constraints for their actions. As these rules and institutions play a large part in determining whether public spending is excessive, resulting in high deficits and accumulating public debt, or moderate, and perhaps more efficient, it is crucial that they are set appropriately (Tanzi and Schuknecht, 2000). Small and effective governments are more conducive to economic growth than large and inefficient governments; high government spending has generally been found to be a net tax on society with few benefits to offer. However, it is important to make a distinction between public consumption and public investment; the former can be detrimental at high levels, whereas the latter tends to have a positive effect on growth (World Bank, 1997).

There is a special need for fiscal rules in the EMU as the creation of a monetary union may result in governments pursuing less prudent fiscal policies. This occurs because governments will find it easier to borrow as the 'domestic' capital market becomes much bigger. Thus the government is able to increase its borrowing without taking on any exchange rate risk, which is associated with borrowing in a foreign currency (Eijffinger and De Haan, 2000). Unsustainable government debt of one country also creates negative spillover effects for the monetary union. The union interest rate will be driven upwards, thus increasing the burden of government debt in other union countries. Now if the other countries have chosen to stabilise their debt-GDP ratios, they will be forced to follow more restrictive fiscal policies. A second spillover effect is that, as a result of the upward movement of union interest rate, countries hurt by this higher interest rate may put pressure on the ECB to relax its monetary stance, thus interfering with European monetary policy (De Grauwe, 2000). It has also been argued that the 'no bailout' clause of the Maastricht Treaty is not credible and that the EMU will essentially provide an implicit guarantee of its members' debts. Thus the risk premium of a heavy borrower would effectively disappear, encouraging the government to borrow more (Eijffinger and De Haan, 2000).

The Maastricht Treaty and the Stability and Growth Pact

The Maastricht Treaty consists of five articles detailing the parameters for fiscal policy as a macroeconomic tool. Article 99 is concerned with policy coordination and surveillance; Article 101 bans monetary financing of a budget deficit; Article 102 prevents governments from having privileged access to credit; Article 103 lays down the 'no bailout' clause, hindering governments from bailing out a member state facing serious financial problems; and Article 104 compels member state governments to avoid excessive budget deficits, with an attached protocol quantifying the criteria for member states' deficits and debt (Brits and De Vor, 2000). These stipulate that government deficit should not exceed 3% of GDP and government gross debt should not exceed 60% of GPD, other than in 'exceptional and temporary' circumstances. These have been specified as either an unusual event outside the control of the member state in question, or a severe economic downturn (IMF, 1997).

The Stability and Growth Pact, which was agreed upon in 1997, clarifies the rules set out in the treaty. The pact pays particular attention to the circumstances where the 3% rule for budget deficits can be exceeded, and details timing and magnitude for sanctions imposed on a member state with an excessive budget deficit. Further, members of EMU commit to having a budget 'close to balance or surplus' in the medium term. The objective is to allow governments to deal with normal cyclical fluctuations, while still keeping to the reference value for budget deficits (Eijffinger and De Haan, 2000).

The most important elements of the Stability and Growth Pact are laid down in two Council regulations (Numbers 1466 and 1467, 1997). The first Regulation strengthens the surveillance of budgetary policies, requiring members of the EMU to submit to stability programmes, which are made public and must be updated annually. The second Regulation was created to speed up and clarify the sanctioning process in case of excessive deficits. It also details that a budget deficit in excess of 3% is allowed only when this is caused by an unusual event outside the control of the member state, or by a severe economic downturn. The latter is defined as an annual decline of at least 2% of real GDP (Brits and De Vor, 2000).

Why is Fiscal Flexibility Necessary?

The Stability and Growth Pact focuses on achieving fiscal discipline in the EMU, while still allowing governments sufficient flexibility to deal with normal business cycle fluctuations (IMF, 1997). It is essential that this flexibility be maintained, since the use of monetary policy is no longer an option for members of EMU (De Grauwe, 2000). Government spending acts as an automatic stabiliser. Tax revenues decrease in a recession while public spending increases and the opposite happens when the economy is thriving; the effects of the cyclical nature of the economy are dampened by budget deficits. A budget in deficit is therefore not necessarily a sign of imprudence on the part of the government and an active fiscal policy is revealed by changes in non-automatic budget balances, also called the structural component. Fiscal activism was very popular after World War II, especially in the 1970s and 1980s, but tends to be frowned at today because of the risk of amassing unsustainable government debts. However, it is important to note that active fiscal policy may be required to deal with a severe recession (McAleese, 1997).

The need for fiscal intervention can be caused by external or internal shocks (McAleese, 1997). Shocks can be symmetric or asymmetric in nature, as well as permanent or temporary. Different types of shocks require different types of measures. Shocks that are symmetrically distributed across EU countries should not be very difficult to deal with; however, external leakages of fiscal stabilisation may pose a problem, especially to smaller, open economies. It is also worth noting that countries' ability to deal with symmetric shocks is dependent on the degree of structural flexibility in the country; thus, the greater the flexibility in national markets, the less likely that significant deviations in performance will occur. Asymmetric shocks are more serious in nature, as common policy responses can be less effective and loss of independent monetary and exchange rate policies at the national level may prove to be more constraining. The nature and magnitude of problems arising due to asymmetric shocks will depend on whether they are temporary or permanent, the scope for fiscal policy to cushion shocks and structural flexibility (IMF, 1997). It is uncertain whether EMU will increase or decrease the likelihood for asymmetric shocks. On the one hand, it can be argued that a macroeconomic policy striving towards stability, will reduce policy induced shocks and that monetary integration will lead to an intensification of intra-industry trade, resulting in greater cross-country symmetry. On the other hand, in the long run EMU might result in regional specialisation, resulting in an increased likelihood for asymmetric shocks (Brits and De Vor, 2000).

A factor that causes the Euro Area to be vulnerable to asymmetric shocks is the lack of labour market mobility. Monetary policy can no longer be used as a tool to cope with shocks and fiscal policy is subject to restraints. As a result, labour mobility would appear to increase in importance. However, the labour markets within the EU are faced with linguistic and cultural barriers, making a substantial increase in labour mobility across state borders unlikely. This takes the focus back on fiscal transfers. There are two schools of thought here, one arguing for increased fiscal flexibility and one proposing a centralised, federal fiscal authority. As the latter alternative is extremely politically sensitive, and any proposal to increase the EU budget has been met by strong opposition, it would seem that increased fiscal flexibility is the only viable alternative (Dyson, 2000).

Is the Stability and Growth Pact Sufficiently Flexible?

National fiscal policies in the EMU must find a balance between two conflicting objectives, sufficient budgetary flexibility cope with asymmetric shocks and the need and desire to avoid unsustainable government debts. The stability and growth pact has been guided more by the fear of unsustainable debt rather than the need for fiscal flexibility. This can reduce the capacity of national budgets to act as automatic stabilisers during recession, thus protracting the downturn. The question is to what extent this is the case. Experience from the period 1991-1993 shows that budget deficits in excess of 3% are not uncommon. Of the nine EU countries, six exceeded the 3% rule, while only three would have been able to invoke the exceptional circumstances clause, suggesting that the pact goes too far in reducing budgetary flexibility and interferes with the role of national budgets as automatic stabilisers (De Grauwe, 2000).

However, these figures are from a time when fiscal balance was not yet a significant objective for governments. Estimates by IMF staff (1997) show that, on average, a 1% shortfall in output from potential worsens the fiscal balance by 0.6%, with the impact being of the order of 0.75% or higher for Denmark, the Netherlands, Sweden, and the UK. In other words, where the budget is in structural balance and the cyclical response parameter is of average size, automatic stabilisers accommodate an output gap of 5% with the budget deficit remaining below 3% of GDP. In countries with a higher response parameter, an underlying surplus of 1% of GDP is required in order to provide the same buffer. Thus it would appear that the Stability and Growth Pact provides adequate scope for automatic stabilisers to function appropriately, given that countries maintain balanced medium term structural balances, or a small surplus in the case of above-average sensitivity to fiscal fluctuations. Nevertheless, it should be noted that countries with high potential output levels could face problems in keeping to the 3% rule in a severe downturn.

However, one problematic scenario that could arise is if a cyclical downturn were to occur soon after the start of the EMU, when many countries have not yet reached the medium term goal for fiscal balances. Enforcing the Stability and Growth Pact in such circumstances would be likely to result in public and political discontentment, but not adhering to the Pact could erode the credibility of the Pact (IMF, 1997). This is described by the IMF as 'a particularly difficult case — though not one envisaged in the IMF staff's projections' (IMF, 1997; 60). However, most member states entered the EMU with government deficits just below the 3% limit, and a distinct lack of ambition to achieve a budgetary position 'close to balance or in surplus' was widespread (Brits and De Vor, 2000).

Currently the economy is experiencing a downturn and the target for medium term budget balances have not been reached. As a result the Stability and

Growth Pact is facing serious problems. Portugal had a deficit of 4.1% in 2001, Germany estimates that its deficit will be of the order of 3.7%, while France and Italy are coming dangerously close to the limit (Economist, 26/10/2002). Some call for changes in the pact, whereas others question the shortsightedness of those responsible for the pact. As MEP Helsingin Samomat said to Romano Prodi whilst as one of his criticisms of the pact: 'It should not come as a surprise for the Ministers of Finance or the Commission that after economic growth comes a downturn' (22/10/2002). This is the main problem with the pact; the estimations for economic growth were overly optimistic at the time when it was agreed upon and a downturn has occurred before any sort of medium term balance has been achieved. Thus the problem is not the pact itself, or the allowances it makes towards flexibility, but rather the overly optimistic assumptions behind it. The pact has the potential to deliver, but due to unforeseen changes in the economic climate, it may not able to do so. The question remains, why was the possibility of an economic downturn not taken into account while the pact was being devised. The most likely answer is given by Sanomat, when he told Romano Prodi that downturns follow growth and as a result, shortsightedness could be blamed for the pact's current breaches. Perhaps when the pact was introduced, it should have been phased in more slowly, to allow for budgetary readjustment.

Conclusion

There is no doubt that the Stability and Growth Pact is in crisis. With several countries either very close to, or surpassing the 3% rule, the credibility of and commitment to fiscal stability in the EMU is being called into question. Fiscal rules seem to be a necessity, given the track record of excessive budget deficits and the unsustainably high levels of government debt in many European Union countries, but having a system that can so blatantly be ignored is not what the EU needs. However, it is not the Stability and Growth Pact itself which is faulty. The pact does provide a sufficient degree of flexibility to deal with a recession, even a major one; it was with such a scenario in mind that the 'temporary and exceptional circumstances' clause was designed. What the architects of the pact did not envisage was the downturn in the economy that has occurred since the year 2000 and as medium term budgetary balance has not yet been achieved, many countries face problems. The best approach in this situation may be to acknowledge the mistakes that have been made and to devise ways of improving the situation. A short-term loss in credibility will be paid off in the long term with a functioning European Union and perhaps a lesson has been learned with respect to myopia in the design of long-term policies.

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EASTERN ENLARGEMENT OF THE EUROPEAN UNION: LESSONS FROM THE PAST AND THE ECONOMIC IMPACT

BY ALAN DE BROMHEAD

Junior Sophister

Introduction

In December of 2002, in the Danish capital Copenhagen, the future of the continent of Europe was changed forever. Ten countries, Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Latvia, Lithuania, Estonia, Cyprus and Malta, were invited to join the European Union in the summer of 2004. Europe, for fifty years divided between east and west, would finally be reunited; but at what cost? Would Europe prosper or be ruined? It is clear that the prospect of a twenty-five member EU poses many questions. The purpose of this piece is to try to shed light on the important issues surrounding the enlargement process and come to some conclusions regarding its likely impact on the economy of the Union. We will also examine past enlargements of the EU, in particular the 1980s Southern enlargement involving Spain, Greece and Portugal, as a benchmark by which to make predictions regarding the likely effects the wave of current enlargement will have.

Lessons from the Past: Uncharted Waters or Just Another Enlargement?

The southern enlargement[1] of the European Union during the 1980s has been used by many commentators as a benchmark for the assessment of the current wave of enlargement.[2] The reasons for doing so are apparent. For both the Southern and Eastern enlargements, the applicant countries were all going through the process of transition to democracy. In fact the time period between the end of the respective totalitarian regimes and induction into the Union are remarkably similar. In Spain, Greece and Portugal democracy emerged at the end of eras of dictatorship in the mid

[1] For reasons of clarity, 'southern enlargement' hitherto refers to the accession of Greece, Spain and Portugal to the European Union. The current wave of enlargement, although including Malta and Cyprus, will be referred to as the 'eastern enlargement'.
[2] Benton, P. (2002)

1970's. A decade later membership of the Union was achieved. In the Eastern candidate countries, membership was granted roughly a decade after the collapse of communism. The ten year period between the introduction of democracy and EU membership proved to be a testing time, both politically and economically, for both Southern and Eastern applicants.

Another interesting comparison that can be made between the two waves of enlargement involves the size of population and economic power. The population of Spain, Greece and Portugal in 1980 vis-à-vis the then other nine EU members and the population of the twelve applicant countries in 1998 (Romania and Bulgaria were not invited to join in 2002) vis-à-vis the current EU fifteen are relatively similar (28% for the latter, 22% for the former)[3]. As regards GDP, the size of the twelve applicant countries in 1998 in respect of the current EU fifteen was about 11% (PPS). Compare this with the figure from 1980 of 14% (PPS) for Spain, Greece and Portugal in relation to the then EU nine[4] and it is clear that, for the purposes of examination, both waves of enlargement had similar population size and national income significance.

A final important similarity regards the relative importance of agriculture in the economies of the applicant countries. Agriculture represents about 8% of GDP and 17% of total employment in the CEECs today. This is a very similar figure to that of Spain, Greece and Portugal in 1980. In 2000 however, the share of GDP of the agriculture sector for Spain was 3.7% while agriculture's share of total employment was 6.8%.[5] Figures for Greece and Portugal in 2000 were also significantly lower than in 1980. It is clear that since EU membership, the countries of the Southern enlargement have drastically reduced their dependence on agriculture, a sector which is inherently price unstable and exhibits low productivity. Through membership of the Union many of the CEECs will wish to follow the example of Spain, Greece and Portugal and reduce the share of agriculture in their national income figures.

Having examined many of the similarities between the two waves of enlargement it would be unwise to ignore the important differences between them, and to assess whether they are actually more different than they are alike.

The first notable difference between the southern and eastern experience is that of the transition to the market economy. Although Spain, Greece and Portugal emerged from periods of dictatorship into democracy, essentially the economic structural changes were minimal. In stark contrast the transition from fifty years of central planning in the ex-Soviet satellite countries represented a complete sea

[3] Roccas, M. and Padou-Schioppa, T. (2001)
[4] *ibid.*
[5] DG ECFIN Study, (2001)

change in the economic structure of the countries. During the 1990s the eastern European countries suffered many setbacks in trying to nurture the embryonic market system. Inflation and unemployment soared and deindustrialisation, due to receding demand, caused industrial output to plummet by an average of 20% per annum between 1990 and 1993.[6] In this sense the southern and eastern countries experienced incomparable fortunes in the decade before membership.

The second problem which arises when comparing the accession of the southern and eastern candidates is the difference between the respective levels of income per capita in relation to the EU average at the time of accession. In 1980 the average GDP per capita of Greece, Spain and Portugal was 66% of that of the then EU nine.[7] In contrast, the average GDP per capita of the twelve candidate countries vis-à-vis the EU fifteen was only 38% in 1998.[8] The invitation of membership offered to the ten successful applicants will therefore have the result of lowering the average income of the EU-25 significantly. This will make the challenge of income homogenisation across the Union a difficult and costly task.

A final difference between the two waves of enlargement concerns geographical location. With the enlargement eastwards, the locus of the EU is likely to shift to a more central European position, with Germany and Austria expected to be at the core of a new 'Mitteleuropa'. In contrast the southern enlargement did not switch the geographical core of the Union significantly to the south. This expected relocation may well have strong implications for future investment decisions as well as determining labour migration flows within an enlarged Union. This possibility has again raised the debate over the increasing gap between the core and periphery regions of the EU.

In summary, it is clear that many similarities exist between the southern and eastern waves of enlargement. It is also quite evident however, that the eastern enlargement poses some very significant obstacles, quite different from the southern enlargement experience. Although the southern enlargement offers some useful insights into what some aspects of the enlargement process are likely to bring about, it is not a sufficient benchmark by which to asses the likely implications of an EU comprising 25 countries and a combined population of some 500 million. In many areas, the EU is most definitely sailing into uncharted waters.

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[6] McDonald, F & Dearden. S, (1998)
[7] DG ECFIN Study, (2001)
[8] Benton, P. (2002)

Economic Impacts: Can the European Union cope?

An enlarged EU is now a reality. The ten candidate countries will join the existing fifteen members by the summer of 2004. But what effects will such a monumental change to the make-up of the Union have? Will the Union be able to cope with such changes financially? To answer these questions we must examine more closely the impact of enlargement on the EU policy areas most likely to be affected.

The main, and most discussed, area of policy that is likely to be affected by enlargement is the EU budget. At present, the two main areas of EU expenditure are the Common Agricultural Policy and the Structural Fund, accounting for about 45% and 35% of the budget respectively.[9] The application of the CAP to future members was the final stumbling block in the pre-accession negotiations. Particularly vocal in this respect were Poland, the largest applicant and the biggest agricultural producer. At the Copenhagen Summit in December 2002, an agriculture package for the ten applicants was agreed: each candidate would receive a rural development package specifically tailored to their needs. Total expenditure on the new ten members was fixed at €5.1 billion for 2004-2006.[10] Direct aids for new members would be phased in over a ten-year time period, starting at 25% for 2004 and reaching 100% by 2013.[11] This will, it is hoped, help to ensure that maximum modernisation is achieved. The Copenhagen Agreement also established the ceiling on CAP market measures and direct aids for 2007-2013 at the level agreed at the Agenda 2000 meeting, but with the added increase of 1% per annum to allow for inflation[12]. As current CAP expenditure is approximately €2.6 billion below the Agenda 2000 ceiling, the cost of accession may not require the restructuring of the financing arrangements.[13]

As regards the Structural Fund, similar agreements were reached at the Brussels meeting in October 2002. Total expenditure on structural fund for the ten new members was established at €23 billion for the period 2004-2006. Each candidate would receive structural funding of 4% of GDP (agreed at the Berlin summit 1999). The arrangements for structural funding after 2006 are to be agreed sometime in 2004. The Second Cohesion report will establish the possible adjustment of the current structural funds eligibility threshold as its main objective.

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[9] McDonald, F & Dearden. S, (1998)
[10] http://www.europa.eu.int
[11] *ibid.*
[12] *ibid.*
[13] Benton, P. (2002)

Overall, the costs of enlargement do not look like exceeding the ceiling set by the EU on the budget (agreed in Agenda 2000) of 1.27% of EU GDP. Given an EU GDP of about €8 trillion (EU-15) this represents a budget of about €100 billion. As the EU is only currently spending around €80bn there remains a surplus of some €20 billion that can be used to fund enlargement.[14] According to Gros,[15] a rough estimate of the costs of enlargement would be about €20 billion in transfers from the EU-15 to the new members. With an increased budget however the question will again arise regarding funding for the budget, with many countries likely to maintain that their contribution is disproportionately high. The enlargement of the Union therefore is not likely to be financially impossible, but it will put pressure on already weak budgetary funding arrangements.

Another important subject that must be addressed in view of the forthcoming enlargement of the Union is its effect on labour migration. Elementary microeconomic theory would profess that labour will relocate to wherever wages are highest. The net result would be a new wage level at which there would be no incentive to migrate. With wages in EU-15 five to ten times higher than the CEEC[16] average, are we to expect a flood of Polish workers to arrive on Irish shores willing to undercut our wage demands as the theory would suggest? This is unlikely. What microeconomic theory fails to recognise is that the vast majority of people are naturally migration-averse. It would be particularly surprising if large numbers of workers would wish to leave their own countries who have just become full members of the EU and were poised to reap the benefits of increased growth and productivity. Although workers from the applicant countries will have free access to the Irish labour market as soon as full membership is granted (Ireland is one of the few countries who will allow this), it is unlikely that we shall see many more migrants from the CEEC than we currently see from the EU-15. Although the net levels of labour migration for the European Union are expected to be low, it is most likely that labour outflows from new members will tend to be concentrated in a small number of regions, particularly in those regions that are closest geographically to the new members. The impact of this is that Germany and Austria, who share long stretches of border with Poland and the Czech Republic for example, may well suffer labour market adjustment problems, particularly in border regions. In the long run however, the advantages of labour migration east to west are expected to outweigh the disadvantages, as inflows of labour may go some way to easing the potentially enfeebling effects of the forecasted high dependency ratios of the EU-15

[14] DG ECFIN Study, (2001)
[15] Gros, D. (2001)
[16] DG ECFIN Study, (2001)

A final area worthy of examination is the likely impact of enlargement on trade and investment within the Union. Trade, and in particular intra-EU trade, is not expected to be effected greatly by enlargement. Through the various Europe agreements signed during the early and mid-1990s, formal trade barriers in the EU to imports of industrial products have now been completely dismantled. A similar situation exists in the CEECs (a notable exception to this is agricultural produce where abolition is reserved until full membership). What continues to hamper the prospect of an enlarged single market however, are those problems by which the existing single market is already plagued, namely informal barriers to trade. Although many attempts are being made with increasing regularity to break down these barriers, particularly surrounding technical standards and the principle of mutual recognition, obstacles still remain in achieving an efficient single market. This is the case now for the EU-15 and, unless serious inroads are made into the resolution of the issue, it will remain the case when the eastern applicant countries gain full membership in 2004. The impact on the movement of capital into and within the EU is likely to be more pronounced. Over the last twenty years probably the biggest change in the world economic make up is the dramatic increase in the mobility of capital. The effect of this increased mobility is that the CEECs are likely to see large increases of inflows of foreign direct investment arising from full membership of the EU This capital is likely to originate in countries that currently enjoy strong economic ties to the eastern applicants, in particular Germany and Austria. Much discussion has arisen, especially in Ireland and other FDI dependent countries, regarding the potential for capital relocation towards the new eastern members and the detrimental effect such changes are likely to have on their economies. We must remember however, that although the eastern countries are likely to become more attractive to FDI when in receipt of full membership, the capital absorption capabilities of most of these countries is relatively low in comparison with the current EU FDI dependent countries. For this reason, it is accurate to say that EU membership for the CEECs is likely to greatly increase their attractiveness to FDI, but generally will not have a disastrous effect on the economies of current FDI dependent countries within the EU

Conclusion

So where do we stand? We have seen that analysis of previous enlargement is not sufficient to determine the full impact of the eastern enlargement. Although the similarities between the two waves allow us to make some general inferences, the differences between them are too great to allow for the prediction of specific economic outcomes. We have also looked at what is likely to happen to trade and investment in the Union, possible labour migratory effects and also the likely impact on the budget of the EU Stemming from this analysis, the most problematic and most discussed question has been answered. Enlargement can be afforded in the short term. However this is all we can be sure of. The future will bring about many unpredictable challenges for Europe. We now prepare to sail towards these challenges with neither map nor compass.

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THE ROLE OF MICROFINANCE IN ECONOMIC DEVELOPMENT

TARA MITCHELL

Senior Sophister

Tara Mitchell shows the importance of credit and financial-sector stability for macroeconomic success and the symbiotic relationship between the two. With this in mind, she explores innovative techniques of credit creation and distribution and questions the aptness of the assumptions that underpin the finance industry. Finally she analyses the results of microfinance.

Introduction

Economists have been searching for centuries for the recipe containing that magical mix of ingredients that can ensure economic growth and prosperity. With such a large proportion of the world's population living in poverty, finding ways to reduce poverty and encourage economic growth should be a key focus of economic research. One relatively new approach to achieving this is the use of microfinance. The validity of this approach is based on the belief that a well-developed financial system, that provides a medium of exchange and the mechanism for saving and investment, is an essential ingredient for economic growth. As Hulme and Mosley (1996;1) have made clear, "capital investment is a key factor in determining economic growth and raising incomes".

Most of us in the developed world take for granted the fact that we have access to financial intermediaries. Children can open savings accounts, students can take out loans in order to travel during the summer months and credit transactions are a part of everyday life. For many in the developing world however, although greatly desired, this access to financial services is not possible. According to the Virtual Library on Microcredit "under 10 million of the 500 million people who run micro and small enterprises have access to financial support for their businesses."[1]

The demand for financial services in developing countries is huge and microfinance institutions are slowly starting to meet that demand. "The World Bank estimates that there are now over seven thousand microfinance institutions serving

[1] http://www.gdrc.org

some sixteen million poor people in developing countries. The total cash turnover is estimated at $2.5 billion and the potential for new growth is outstanding."[2]

The main focus of this essay will be on microfinance, how effective it is at reducing poverty and its possible effect on growth. It will begin by looking at the role that financial development plays in promoting growth and it will go on to discuss the lack of financial services available in developing countries. It will examine microfinance in terms of what it actually does and its impact at both an individual and a macro level. It will conclude by looking at what the future holds for the world of microfinance.

The impact of financial development on economic growth

Idealistic people sometimes like to say that money does not matter, but if you are without any then it suddenly takes on a whole new importance. Every day we in the developed world take advantage of financial services that are available to us without even thinking about it, but how would our daily lives change if we did not have access to those services? How would it affect the working of our economy? John Kenneth Galbraith defined economic growth as an increase in the quantity or quality of a country's capital stock, adding that,

> "The increase in quantity is capital formation. The increase in quality is technological advance… In the earliest stages of economic development… the simple and sufficient way of getting more growth was to have more saving and therefore more material capital."
>
> (Galbraith, 1985; 205).

Schumpeter also recognised the important role of credit in enabling entrepreneurs to create new products and thus stimulate economic growth. (Schumpeter, 1983; 102).

Berthelemy and Varoudakis (1996) highlight a number of different ways in which a developed financial system contributes to the efficiency of the economy. Firstly, it provides an efficient and adaptable system of payments, which is essential for any growing economy. Secondly, the existence of financial intermediaries can result in a better mobilisation of savings. By bringing individuals' savings together, they can finance investment in more efficient technologies that require a higher level of initial investment. In addition, financial intermediaries can improve the allocation of resources. The return on investment projects is subject to risks. Financial intermediaries can help to reduce these risks for individual investors. They can

[2] http://www.gdrc.org

provide the possibility of risk diversification, help to manage liquidity risks and spread the costs of finding information on potential investments over a large number of individuals. By managing these risks, financial intermediaries encourage investment in riskier but more productive technologies, which can help to promote economic growth.

Furthermore, Berthelemy and Varoudakis support the conclusion that the development of the financial system can have a causal effect on economic growth. This relationship is not one-way however, and it can prove difficult to separate one from the other. They put forward the possibility of multiple equilibria in financial and economic development. One possibility is a ‘low equilibrium’ where “the underdevelopment of the financial system leads to an inefficient productive structure which in turn justifies the absence of financial development” (Berthelemy and Varoudakis, 1996; 19). Alternatively, the case may prevail where

> “the existence of a developed financial system encourages the selection of more specialised and also more productive technologies. The resulting increase in risk justifies the existence of a developed financial system despite the cost involved.”
>
> (Berthelemy and Varoudakis, 1996; 19)

The conclusion is that a well-developed financial system will not in itself guarantee economic growth but it can contribute to it. The lack of it, however, will almost certainly be a severe obstacle to growth.

Financial systems in developing countries.

Seeing as financial development and economic growth often move together and can have positive effects on each other, it is not surprising to find that financial systems are not highly advanced in the poorer regions of the world. According to Hulme and Mosley (1996; 1), “The further one proceeds down the income spectrum, the harder it becomes to finance investment through borrowing from private banks, and the enterprises of the poor – both in rural areas and in the shanty towns on the edge of the cities – generally have no access to them at all.” They highlight two main problems that prevent the poor from having access to formal financial services. The first is the ‘screening problem’. Most low-income households are seen as being ‘too poor’ to save. Lenders may be discouraged from providing loans to the poor because they are not personally known to them, have not furnished them with a business plan or wish to borrow small and uneconomical sums of money. It is easy to see why the lender considers it too risky to allow them to borrow money.

Secondly, there is the ‘enforcement problem’. Banks are unable to shield themselves from these risks. Borrowers are generally too poor to offer collateral, courts are too weak to repossess any collateral which is offered and insurance against the natural disasters which commonly affect small producers in developing countries is generally unavailable.

Even if banks were willing to make loans to poorer borrowers, the poor themselves may be unable to borrow for other reasons. For example, borrowers may face high transactions costs of seeking loans, which could include the “time, travel and paperwork involved in obtaining credit”, especially if they are located in an isolated area (Johnson and Rogaly, 1997; 6).

If the impoverished in developing countries do manage to make use of financial services, they are far more likely to be in the informal lending market, which are usually monopolistic and inefficient. This may be due to the fact that they,

> “are based on moneylending in which the lender makes advances only from his own resources, rather than deposit banking, where the lender also borrows, and can relend the funds deposited with him. Thus, there is no credit multiplier.”
>
> (Austin and Sugihara, 1993; 1)

Do the poor need financial services?

There is a common belief that the poor are ‘too poor’ to save. This is untrue. Not only are the poor able to save but they willingly go to great lengths to find ways of saving. According to Johnson and Rogaly (1997; 1), “financial services are about enabling people to amass usefully large sums of cash”. All individuals have periods in their lives when they need a larger lump sum of money, for example, to protect them from disaster or to pay for events like a wedding or a funeral. Even though it may be very difficult for them, the poor in developing countries regularly try to save money. They greatly value services which allow them to save their money in a secure environment. They even go so far as to pay local deposit-takers to keep their money for them. They often may keep savings in a clay pot in their home but the temptation to spend the savings and the fear that they might be stolen mean that they place much value on services that guard their savings outside of the home, even if it means a negative rate of interest.

Despite the fact that most banks consider it too risky to lend money to the poor, research has shown that often they can be most reliable when it comes to repaying loans. According to Hulme and Mosley (1996), the Grameen Bank in Bangladesh, BancoSol in Bolivia and BKK in Indonesia, all of which target very poor borrowers, have higher repayment rates than any LDC commercial bank in those countries. They point out some possible reasons to explain why this may be the case. Firstly, the less well off do not have any political influence with which to influence loan repayments. Secondly, the poor do not have access to any other sources of finance and so need to maintain their loan repayments in order to have access to future loans. Finally, and more speculatively, these schemes are better at reaching women and generally women have better repayment rates than men.

The evidence suggests that the poor not only need and desire access to financial services but that despite their poverty, they are able to save and to reliably make repayments on loans.

What is microfinance?

"Microfinance is defined as formal schemes designed to improve the well-being of the poor through better access to saving services and loans" (Schreiner, 2000; 2) The idea behind microfinance is to provide the poor with access to those financial services which they are otherwise unable to access, with the aim of reducing poverty.

Microcredit is an aspect of microfinance. It focuses on the provision of small loans to help the poor to develop microenterprises in order to increase their income and their well-being. McKernan (2002) describes the Grameen Bank of Bangladesh, the most well-known and pioneering microcredit programme in its role of providing "credit to the poor for the purchase of capital inputs in order to promote productive self-employment. They also provide noncredit services (also referred to as social development programs) such as vocational training, information in areas of health, civil responsibilities and rights, and information sharing and monitoring among members" (McKernan, 2000; 93).

Over the last few years in particular, microfinance has grown in popularity and in importance. According to Wright (2000; 4), "There is scarcely a multilateral, bilateral or private development donor organisation not involved in the promotion (in one form or another) of a Microfinance Programme." Other examples of microcredit institutions include Bank Rakyet Indonesia, Bangladesh Rural Advancement Committee (BRAC), Federation of Thrift and Credit Co-Operative Societies (SANASA) in Sri Lanka and the Malawi Mudzi Fund.

Being a successful microcredit organisation involves adapting new and innovative methods to designing programmes which fit the needs of the less fortunate sections of society. The majority of the poor cannot supply physical collateral so some institutions substitute methods such as character references or locally-recruited lending agents who know the potential borrowers, in an attempt to screen borrowers. Institutions which follow the Grameen Bank model use peer-group monitoring to aid the selection process and to give an incentive for repayment. Groups are self-selected and contain five members with a similar economic background. The group is responsible for the repayment of the loan and no member of the group may borrow in the future if one member of the group defaults. This aspect of peer pressure is reinforced by public meetings to collect savings and loan repayments where everyone notices if someone does not make a payment and the shame that this would cause is very strong. Many microcredit institutions insist on compulsory weekly savings as security against default. These restrictions help to ensure that only the poor take out loans, as the rich will be put off by the ideas of group lending and weekly public meetings. Also, many institutions specifically target the poor by placing a limit on wealth, measured by income, land or state of housing, above which loans will not be granted. (Johnson and Rogaly, 1997)

It is clear that microcredit institutions have been successful in giving loans to the poor and achieving repayment (Grameen borrowers keep up repayment at a rate of around 98%. The Bank lends US$30 million a month to 1.8 million needy borrowers[3]). That is not, however, their goal in itself. Remenyi and Quinones (2000; 7) state that "central to the concept of microfinance is the idea that poverty can be effectively and permanently reduced or eliminated within a reasonable period of time by providing the poor with access to such financial services." A question mark remains as to whether or not this has been truly achieved.

The impact of microfinance

Although the theory of microfinance is a simple one, theories often yield unexpected results, when put in to practice. This section will look at the practical effects of microfinance: whether it has resulted in a significant change in income for its beneficiaries, its impact on production and the general effect it has on the well-being of the poor. It will also look at the macro level to see if there has been an overall reduction in poverty.

Has microfinance reached the poorest?

While many microfinance institutions have been able to profitably lend money to the poor in developing countries, the poorest of the poor, generally, have not been reached. Hulme and Mosley (1996) suggest a number of reasons for this. First of all, the emphasis of many institutions is on providing credit to finance self-employment opportunities. For the most destitute people, however, these

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[3] http://www.gdrc.org

opportunities are limited and the risks are too high so that they choose not to take loans because they do not see them as the solution to their problems. Secondly, in the case of group schemes, groups are self-selected and so some members may decide that others are 'too poor' to take part, either for economic or for social reasons. Lastly, as credit programmes expand, it seems that the incentives for staff favour a focus on those who are not the poorest, due to the set-up of performance targets (Hulme and Mosley, 1996; 32).

There is much debate over whether or not the goals of outreach to the poorest and financial sustainability are incompatible. Some believe that if a microfinance institution wishes to be financially viable then it must expand its members. This will often result in a movement away from the poorest in order to gain a broader more profitable range of clients (Sharif, 1997). In practice, most microfinance providers have not achieved financial viability. According to Hulme and Mosley (1996; 12), "Not more than one in five microfinance providers function on a basis that covers all their operating costs. The remaining four in five are dependent on continuing access to donor grants and/or subsidized loans to remain in operation". For microfinance providers to remain operational in the long run, they must try to achieve financial viability. In Hulme and Mosley's study (1996), they made a distinction between 'successful' and 'unsuccessful' schemes in terms of financial performance. They concluded that there was no significant difference in poverty impact between these different schemes and that improved financial performance was not a conflicting goal with outreach to the poor. The main differences were in aspects of design: greater incentives to repay, intensive loan collection and positive real interest rates. They discovered that there was not a strong relationship between default and the interest rate charged but that there was a strong inverse relationship between the level of costs on administration and the default rate. The poor are willing to pay the interest rate necessary to cover the costs in order to have access to credit. According to Gibbons and Meehan (2000; 4), "it is not the clientele served that determines an MFI's potential for IFS (Institutional Financial Self-Sufficiency), but the degree to which its financial services program is well-designed and managed."

What has been the impact of microfinance on incomes, production and employment?

The main idea behind microcredit programmes is to provide loans to those on low-incomes, and to invest in self-employment opportunities with the aim of raising their living standards. Hulme and Mosley (1996; 87) assert that, "there is every likelihood that the receipt of credit did directly increase the income of assisted enterprises". However the effect varied greatly from individual to individual. The income earning opportunities available to enterprises depends on a number of factors. Their access to financial services *is* an important factor. However, there are other influences such as the state of technologies available to the borrower and the relative prices of capital, labour and other inputs. Factors which influence the impact of different schemes in different countries include the rate of growth in the local economy, the rate at which credit is being invested in new technology and the extent to which credit creates employment within the assisted family.

The use to which loans are put varies between borrowers and can be related to borrowers' initial level of income. Credit can perform two roles- a protectional role and a promotional role. Poorer clients are likely to use loans for protectional purposes. For example they may use credit for capital widening which does not involve an increase in risks or they may even use credit to reduce their risks and vulnerability but leave their incomes unchanged. Wealthier clients are more likely to use their credit for promotional purposes. For example, for capital deepening, which increases their expectations of income and risk at the same time. Borrowers often face a trade-off between expected value and variance of income. Poorer borrowers cannot afford to take risks even if it means an expected increase in income. Even though credit used for promotional purposes is more likely to increase productivity, this does not mean that loans for protectional purposes do not perform an important function. Hulme and Mosley's findings show that there is a correlation between the borrower's initial income and the likelihood of investing in new technology. They also show that those who have taken a series of loans are more likely to adopt new technology but that in general, the use of loans for the purpose of capital deepening is the exception rather than the rule.

The impact that loans will have on employment depends on the technology that the loan is invested in. As the majority of loans have not had a huge impact in terms of technological change, the effect on employment outside the family has not been dramatic (Hulme and Mosley, 1996). Despite the fact that most microfinance institutions issue loans to be spent on investment, Wright (2000) claims that his research shows that many loans are in fact being spent on consumption. He states that this is not necessarily a bad thing. This consumption can help to create the security necessary before the poor can begin to invest in income-creating opportunities.

What has been the impact of microfinance on vulnerability?

One of the consequences of poverty is the feeling of vulnerability and helplessness. If this is seen as being important, then microfinance institutions need not only to provide credit for income *generation* but also to try and reduce *fluctuations* in income. One way of doing this is through voluntary savings schemes and the availability of emergency consumption loans. According to Hulme and Mosley (1996; 115), "the evidence available from our case studies reveals their relatively limited contribution to reducing the vulnerability of the poor households to a sudden dramatic decline in income and consumption levels."

In a minority of cases it has been shown that borrowers' vulnerability has actually been *increased* by loans from microfinance institutions. Evidence from Hulme and Mosley's (1996) case studies shows that BancoSol staff report that 10-15% of borrowers' enterprises go bankrupt. Also, BRAC borrowers reported cases of the seizure of defaulters' assets and their sale in order to cover the costs of loans that were not repaid. There have also been several reports in the Bangladeshi media of 'Grameen bank suicides' as a result of peer-group pressure to repay loans.

For the majority of cases however, by increasing incomes loans from microfinance institutions, can help towards reducing the vulnerability of the poor. In order to really reduce this vulnerability however, more emphasis needs to be placed on the savings side of microfinance.

What has been the impact of microfinance at a macro level?

If microfinance institutions are successfully reaching large numbers of poor households and increasing their incomes by giving them access to credit to fund private enterprises, then one would expect to see some kind of change at the macro level. Sobhan illustrates this point,

> "One would assume that with twenty-five years of micro-credit going into a particular area certain transformatory effects on the macro-economy should have been felt. I am not merely referring to the village economy, a macro-entity in itself, but also to the national economy, where the poverty alleviating impact at a macro level of credit interventions and the social transformatory effect of this particular process should be felt."
>
> Sobhan (1997; 134)

Can it be that so many individuals can benefit from microcredit yet the impact at a macro level be so small? This does indeed seem to be the case, as studies such as that of BIDS/The World Bank have revealed. There has been no wholesale reduction in poverty across a significant area (Sobhan, 1997; 134).

Microcredit alone is not enough to reduce poverty at a macro-level. Hulme and Mosley (1996) showed that the technological increase and the increase in the level of employment due to microcredit has been very small. The impact of microcredit depends on various factors in the macro economy, such as the demand for the goods produced by the borrowers, which will increase the return on investment and provide more opportunities for expansion.

> "While much attention gets focused upon the institutional options for the provision of financial services to the poor, there can be little doubt that the overall performance of the macro economy is the key to any micro success. Thus an element in the linkage between credit and employment creation is lobbying for the appropriate national level policies, conducive to securing the best multipliers on micro forms of investment."
>
> (Wood, 1997; 297)

Wright (2000) suggests that there has been more of an impact at a macro level than has been believed, citing the case of Grameen Bank, which has accounted for between 1.1 and 1.5% of GDP compared to agriculture and fisheries, which makes up a mere 3% of GDP (Wright, 2000; 16). He also claims that a big part of the picture is lost when looking at the macro level because policy-makers often see the poor as a homogenous group. This is not the case; there are many different levels of poverty. An individual may move from being one of the core poor to one of the upper poor, involving a significant rise in living standards from the point of view of that individual, yet still be seen as poor by an outsider.

Conclusion: The Future of Microfinance

When it comes to economic growth, access to good quality financial services plays a large role. However the relationship is complex. Financial development may help growth but a financial system develops in response to the economic environment and because of this, economies can get stuck in a poor financial services – poor growth equilibrium. Access to formal financial services is very poor in developing countries. Entrepreneurs often find themselves in situations where they have no funds to finance income–generating opportunities. Microfinance emerged in response to this need. Its goal is to provide financial services to the poor with the aim of reducing poverty.

Much research has been done on microfinance but because it is a relatively new area, many questions remain unanswered. Some believe that outreach to the very poor can be achieved simultaneously with financial self-sustainability. Others believe that these are conflicting goals. Some suggest that the focus should be placed on savings services rather than credit, while others see only credit, for use in investment, as the way forward.

However A number of clear points seem to have emerged from the literature on microfinance. Firstly, the poor are not a homogenous group. There are very many different types of poor people. Some are much poorer than others, some are more willing to take risks, some have better entrepreneurial ability and some value access to savings facilities more highly than access to loans. They should not be treated as a homogenous group. Microfinance institutions need to provide a range of opportunities that cater to the needs of the clients they are trying to serve. Particularly, when it comes to the very poor, microcredit for the purpose of investment may not be the solution. The poorest are too vulnerable to invest and are far more likely to spend loans on consumption. A focus needs to be placed on services such as providing basic healthcare and education rather than credit.

Secondly, from the point of view of both the borrowers and the microfinance institutions, a bigger emphasis needs to be placed on the role of savings, in particular voluntary, open-access savings. The poor place enormous value on the provision of these services and in turn they could play a role in helping institutions to achieve financial self-sustainability. Thirdly, great care must be taken when dealing with people who are already extremely vulnerable. Microfinance institutions must be careful to never increase the vulnerability of individuals in any way or encourage them to take loans which will be too difficult for them to repay. They must also take care to fully understand the effects of peer pressure in the situation of group lending.

Microfinance institutions have successfully reached millions of poor people all over the world. If access to finance can play an important role in economic growth then why have larger changes at the macro level not been seen? There are many more factors involved in promoting economic growth and if those factors are missing then microfinance alone cannot solve the problem. The overall structure of the macro economy is extremely influential in terms of the impact of microfinance. The level of education, the demand for goods and services and access to new technologies all play a role in determining the impact of microfinance.

> "Macroeconomic stability is an important pre-requisite for getting a scheme off the ground. Hyper-inflation and economic instability do not encourage individuals to save, and loans under such circumstances are difficult to manage"
>
> (Johnson and Rogaly, 1997; 27)

But maybe microfinance is still too young for us to judge its impact. The number of microfinance institutions and the level of funding devoted to them are growing all the time. Perhaps, with co-operation, sharing of information and a genuine devotion to the services that the poor really need, microfinance can go a long way to the alleviation of poverty in the future. In itself, microfinance is not a panacea but it certainly is a first step.

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JAPAN IN THE DOLDRUMS: A STUDY OF DEFLATION AND RECESSION

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Japan's dream deflates
Interest rates and Keiretsu
Dan Baker blames you

Introduction

This essay examines the performance of the Japanese economy over the period 1985 to 2002 with reference to key economic variables, such as GDP growth, price stability performance, employment, and the public debt to GDP ratio, etc. We focus on the path the economy has taken since the bursting of the "bubble economy" early in 1990, and in particular on the phenomenon of deflation, which appeared as a persistent problem towards the end of the 1990s. This paper will investigate the underlying causes of recession and deflation in Japan, and examine the main problems associated with the latter. Finally, a number of policy solutions will be suggested to combat the deflationary pressures in Japan, and more generally, to help stimulate economic growth.

What's wrong with Japan?

Before the bubble burst - Japan as Number One

During the 1980s it was a popularly held belief that Japan was rapidly and inexorably catching up on America as the world's number one economy. From a state of near-complete devastation at the end of World War II, Japan had transformed itself into a global economic powerhouse second only to America in terms of productive output, and unequalled in terms of growth[1]. Not surprisingly, Japan was considered by many to be the model economy, which "year after year

[1] During the 1960s, Japan's GDP growth amounted to over 10% per annum as compared to 3% in the USA. (Jones)

managed to hit simultaneously all the major macro economic targets - fast growth, low inflation, full employment and a current account surplus." (Jones, 2001) Such was the seemingly endless capacity of the Japanese economy for growth that certain commentators, particularly in America, began to predict the absolute economic domination of Japan. These predictions seemed to be borne out when, in 1985, three American icons - the Rockefeller Center in New York, Pebble Beach golf course in California, and Columbia studios - fell in quick succession into Japanese hands. Indeed, the title of Ezra Vogel's book, *Japan as Number One*, captured perfectly the consensus regarding Japan's ascendancy as a global economic superpower. In Japan itself, the confidence of businesses and investors in the Japanese model was demonstrated in the stratospheric rise in the value of the stock market[2] and in the price of urban land between 1986 and 1989. In fact, it seemed to many as if Japan's economy had somehow managed to escape the economic laws of gravity, which were at that time causing slowdowns in Europe and America. Such optimism proved misplaced, however, as a rise in interest rates by the Bank of Japan, aimed at cooling the economy, caused a collapse in the stock market early in 1990.

Since the bubble burst - the slow, relentless decline

After the bursting of the bubble economy, Japan experienced a slowdown that initially followed the usual pattern of business cycles in industrial countries. (Ahearne *et al* 2002; p.8) Asset prices fell, credit tightened, growth in corporate profits contracted, and consumer and investment spending declined. Considering the size of Japan's bubble, however, the subsequent recession was relatively mild. Unlike the depression following America's stock market crash of 1929, which was characterised by a large drop in consumer prices, unemployment rates of up to 25%, and a fall by half in economic output, the slowdown in Japan was marked instead by a overall price stability[3], ongoing growth in GDP (albeit at a slower rate), and negligible changes in employment rates. Initially it appeared as if the application of fiscal and monetary policy had been successful in minimising the after-effects of the boom. But as the nineties wore on, it became clear that Japan's economy, far from regaining health, was actually in the grip of a slow, relentless decline. As *The Economist* (2 March, 2002) reported: "Twelve years after America's bubble burst, output was more than 40% higher than at the start." In contrast, "Japan's output today is about 10% below its level in 1989." *The Economist* estimates, furthermore, that Japan's output gap currently exceeds 30% of GDP based on the 4% annual

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[2]The Nikkei 225 index reached an all-time high of 38,915 in December 1989 up from around 13,000 at the start of 1986. (Okabe 1995, p. 235)

[3]Inflation peaked at around 4% in 1990, but following a rise in interest rates, it moderated to around 2% in 1992.

trend growth rate posted throughout the 1980s[4]. (*The Economist*, 2 March, 2002) Tellingly, Japan's robust GDP growth rates of the 1980s gave way, over the past decade, to an average annual growth rate of less than 1%. (*The Economist*, 28 September, 2002)

The signs of Japan's economic malaise can be seen in more than just the current stagnation of industrial output, however. Undoubtedly the first indicator that the bubble had burst was the rapid fall in the value of the Nikkei 225, which within a matter of months of its zenith – it reached 38,915 in December 1989 – had plummeted to approximately one half its value. After hovering around the 15,000-17,000 mark for the remainder of the 1990s, the Nikkei 225 recorded a further slide to about 8,600 at the end of 2002. In a similar fashion, land prices slumped throughout the nineties, rapidly at first and then more gently as time went on. *The Economist* (A survey of Japan, April 2002, p. 3) reported that property prices in Japan's six biggest cities had dropped an average of 84% since 1991. At the same time, labour statistics showed unemployment standing at 5.3%, up from a slim 2% in 1990. A further witness to Japan's current woes is the level of government debt, which grew steadily throughout the 1990s to its present position of nearly 150% of GDP, up from just 60% of GDP at the start of the decade. (*The Economist Global Agenda*, 21 November, 2002) And whereas in 1990 the government budget boasted a surplus of 2% of GDP, it now runs a deficit of 8% of GDP[5]. (*The Economist*, September 28th, 2002)

Perhaps a more alarming symptom of Japan's economic plight, however, is the phenomenon of deflation. Deflation is defined as a persistent decline in the general price level. (McAleese 2001; p. 304) Although it is common for the price of individual goods to fall over time as, for instance, increased manufacturing efficiency and new technologies translate into lower production costs, it is relatively rare for the overall level of prices across an entire economy to fall on a consistent basis. By and large, the most common affliction of the world's industrial economies during the twentieth century was high inflation. The experiences of both hyperinflation in inter war Germany and the sustained levels of high inflation in the majority of developed countries during the 1970s led the public and politicians of most democracies to view inflation as "public enemy number one." This mind set was evident in the actions of Japan's policymakers following the boom of the late 1980s: so intent were they on choking off nascent inflation that they completely overlooked the possibility of a deflationary slump. From a peak of around 4% in

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[4]Output gap is defined as the difference between potential GDP and actual GDP. An OECD estimate of Japan's output gap, assuming a fall in the potential GDP growth rate along with actual growth, is just 3% of GDP. (*The Economist*, September 28th, 2002)

[5]By way of comparison, the EU growth and stability pact requires member states to limit budget deficits to 3% of GDP.

1990, inflation steadily declined until it moved into negative territory in 1995, where it has largely remained ever since.

Recession and deflation - An analysis of the problem

Having briefly outlined the main problems facing Japan's economy – in the broadest sense, recession and deflation – we shall now turn our attention to the factors which led to these problems and in the case of deflation, to the ensuing effects.

Roots of the recession

Low interest rates, excessive capital spending and bullish profit expectation: To understand why the Japanese economy remains trapped in a decline, we need to examine the factors that fed into the boom of the late 1980s. On a macro economic level, a prima facie cause for the boom was low interest rates. From a level of 5% in 1985, Japan's official discount rate fell to 2.5% in 1987[6], where it stayed until mid-1989. As economic theory would predict, a fall in interest rates fed into an increase in aggregate demand through an upward shift in both the investment and consumption components. As a result of mainly cultural and historical factors, capital spending has always comprised of a relatively large component of aggregate demand in Japan. This preference stems from the traditionally long-termist view of economic growth taken by both government and business, and is evident in the dominance of producer interests over consumer interests[7]. (Preston 2000, p.116) The result of the fall in interest rates in 1987 was therefore to provide a further stimulus to the corporate sector's already strong investment demand. The consequences for the bubble economy were significant. As *The Economist* reported in February 1990: "Japan's boom has been driven by capital spending. Last year Japan's investment ratio (i.e. capital spending as a percentage of GNP) reached nearly 23%, its highest level since 1955."

A further boost to Japan's capital spending spree was the strong growth in corporate profits between 1986 and the end of the decade (*The Economist*, February

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[6]According to Christopher Wood (1992), this was the lowest interest rate in Japanese history up to that point.

[7]Japan's traditionally high savings rate also confirms this fact. According to the NLI Research Institute, "workers' households [in Japan] have continued to increase their savings rate from 22.1 percent in 1980 to 24.7 percent in 1990, and 27.9 percent in2000." By comparison, the US savings rates fell from over 12% in 1980 to less than 1% at the start of 2001 (Milleker 2002, p. 4)

1990; p. 63). Such was the expectation that this growth would continue for the foreseeable future that the drive to build new factories and expand productive capacity assumed nonsensical proportions. The high level of capital spending between 1986 and 1989 had two important consequences for the recession and deflationary slump that followed: firstly, Japan's corporate sector was burdened with huge debts; and secondly, the economy as a whole suffered from chronic overcapacity.

Japan's banks – too much easy money, too little self-control: Another important factor in Japan's boom and subsequent recession was the role played by the banks. For a start, the banking system in Japan is inefficient by international standards (*The Economist*: A survey of Japan, April 2002; p. 5). It is also characterised by a system of cross-holdings, whereby a group of companies and a major bank will form an alliance (a *keiretsu*) and agree to hold significant numbers of each others shares. If a company needs a loan, instead of searching for the most competitive rates on the open market, it will automatically "apply" to its partner bank. Although this system has several advantages, it can also serve to hamper an economy's flexibility and distort the efficient operation of the market system. The disadvantages of the *keiretsu* system were brought forcibly to light during the bubble economy, and remain a problem to this day. Specifically, most of Japan's banks engaged in injudicious lending during the boom. As a consequence of both the *keiretsu* system and the seemingly endless supply of cheap credit, Japan's banks made big loans to partner companies, which were in many cases inefficiently run. Instead of money being awarded to companies that were well-managed and competitively run, loans were funnelled indiscriminately to alliance partners and to companies run by business cronies. A result of this impaired judgment was that money was frequently put into projects with below-average profit potential, or worse still, it was simply squandered; this in turn meant that firms were often unable to cover the cost of capital when interest rates finally rose - which left banks with a large number of non-performing loans on their balance sheets[8].

However, it was not only the features of the *keiretsu* system and the supply of easy credit that propelled banks towards commercial imprudence; the banks' own faulty prescriptions for growth were equally to blame. In his book, *The Bubble Economy*, Christopher Wood (1992) explains that, at the time of the boom, the yardstick for growth used by management in the banking sector was the increase in assets (i.e. loans) on the banks' balance sheets – rather than the more sensible measure of growth in profits. As a result, banks would do almost anything to

[8]In 2002 official estimates of bad loans stood at Y37 trillion (or 7% of GDP). Other sources say the true figure is closer to Y70-80 trillion. (*The Economist*: A survey of Japan, April 2002, p.3)

increase their portfolio of loans, even if it meant putting their profitability and solvency at risk. According to the capital adequacy requirements stipulated in the 1988 Basle Accord, however, central banks of participating countries (which includes Japan) are required to ensure that commercial banks under their jurisdiction maintain a minimum capital-to-loans ratio of 8%[9]. Ideally this capital cushion should comprise cash reserves, but at that time, most of Japan's banks were reluctant to sacrifice their ability to make new loans by adhering to this (newly agreed) requirement. A compromise of sorts was reached, whereby the banks were permitted to meet 45% of their capital reserve obligation through unrealised profits on investments, i.e. on the value of shares and land held. The astronomical rise in the value of both the stock market and land prices[10] during the boom meant that, as a result of this compromise, many banks were in reality vastly undercapitalised[11] and therefore highly vulnerable to the risk of bad loans. As we have already mentioned, the foolish lending undertaken by Japan's banks almost guaranteed that bad loans would emerge as a major problem – as indeed has been the case.

A final comment can be made about the banking industry in Japan. It has already been noted that the Japanese economy is marked by strong producer, and weak consumer, interests. A corollary to this situation is the comparative underdevelopment of the market for consumer credit – a business with much higher margins than commercial lending. The near wholesale neglect of the consumer credit market, therefore, meant that in addition to being undercapitalised and having a portfolio of high-risk loans, Japan's banks were operating in a low-profit market – a further threat to their solvency and their ability to act as financial intermediaries.

Deflation revisited – Causes and effects

Having analysed a number of factors that contributed to Japan's bubble economy, and by extension to its ongoing recession, we now return to the subject of deflation. We have already defined deflation as a persistent fall in the general price level, and we have hinted that a proximate cause for Japan's current deflationary

[9]Full compliance with the stipulations of the Basle Accord was not required until 1992 - at which time, the damage to Japan's banking system had been done.

[10]Between 1980 and 1990, the value of the Nikkei 225 index increased by circa 600%, and Japanese land prices by over 400%.

[11] Although officially the big banks have about Y19 trillion of core capital (implying capital-adequacy ratios of about 10%), if public funds received in 1998, deferred taxes, and unrealised gains on assets are subtracted, this figure comes down to just Y5 trillion, which translates into an average capital-adequacy ratio of about 2%. (*The Economist*, April 18th, 2002)

slump might be found in the misjudged monetary and fiscal policies implemented by the Bank of Japan (BOJ) and the government during the 1990s. In this section, we consider in more detail the factors that may have led to deflation; we explain how policymakers may have unwittingly contributed to the downward pressure on prices; and finally, we outline the problems associated with deflation.

Causes of deflation

Overcapacity in the real economy: It has been suggested that a contributory factor in Japan's deflationary trend was the large-scale overcapacity in the real economy created by the boom. Excess capacity means that the supply of goods and services produced by the economy is greater than the corresponding demand. The laws of supply and demand indicate that in such a situation, prices will fall until both sides of the market reach equilibrium. While incomplete, this analysis goes part way towards explaining the downward pressure on prices experienced by Japan. Interestingly, empirical evidence shows that there is a close relationship between the size of a country's output gap and changes in the inflation rate. (*The Economist*, October 12th, 2002) In accordance with this rule, it follows that Japan's negative output gap would tend to push inflation down.

Misjudged monetary policy: With hindsight, we can also attribute part of the blame for Japan's deflationary slump and recession on the monetary policy employed by the central bank after the end of the boom. A recent study by economists at the Federal Reserve (Ahearne *et al* 2002) concluded that, because Japan's deflationary slump was not anticipated by policymakers, the lowering of interest rates and loosening of monetary policy in response to the fall in inflation in the early 1990s was insufficient for the purposes of reviving the economy. Had the dangers of deflation been appreciated earlier on, a judicious use of interest rates and quantitative easing could probably have averted the problem. However, the BOJ was so preoccupied with preventing another bubble in asset and land prices that monetary policy was kept tight. Inasmuch as interest rates followed inflation down to zero during the early 1990s, when the BOJ finally wanted to open the throttle on the economy using interest rates, it was prevented from doing so because they had already reached the zero lower bound - and nominal interest rates can never be negative. Then as deflation set in, even though nominal interest rates were virtually 0%, real interest rates turned positive (the real interest rate equals the nominal interest rate minus the rate of inflation or plus the rate of deflation). Theory suggests that when this situation occurs, the other tool of monetary policy open to a central bank – namely adjustments in the monetary base – also becomes ineffective. Under normal circumstances, an increase in the money supply leads to a fall in interest rates, which in turn leads to an increase in consumption and investment spending. However, when interest rates have already reached zero, monetary easing is powerless to drive up aggregate demand or to spark a rise in the rate of inflation. This case is the so-called "liquidity trap." The telltale evidence of this phenomenon is when the monetary base in an economy expands at a faster rate than the broader money stock. Empirical evidence indicates that this exact scenario occurred in Japan. As the economists at the Federal Reserve report: "Beginning in late 1995...after the call money interest rate had fallen nearly to zero, base money started growing at roughly double the rate of the broader aggregates." (Ahearne *et al* 2002, p. 26) The inability of Japan's banks to extend new credit because of their own financial weakness also served to make the BOJ's monetary policy during the 1990s yet more ineffective.

Flawed fiscal policy: Although the role of fiscal policy tends to be less important than monetary policy in the maintenance of price stability, it is nevertheless critical to the attainment of long-term economic growth. We shall therefore evaluate the main features of Japan's fiscal policy during the 1990s.

Broadly speaking, the response of the Japanese government to the bursting of the bubble was to adopt an expansionary fiscal policy along Keynesian lines. By increasing government spending, the authorities hoped to compensate for the fall in private consumption, and thereby to shift the aggregate demand curve to the right. Between 1992 and 2000, over Y132 trillion was injected into the Japanese economy either through extra spending or tax cuts. (Ahearne *et al* 2002, Exhibit V.1) As has been previously noted, Japan's government budget went from a 2% surplus in 1990 to an 8% deficit in 2001; and the ratio of public debt to GDP increased from 60% to nearly 150% over the same time.

So how successful was this policy? Apart from a growth spurt of around 4% per annum in 1995/96 and 2000, Japan's real GDP grew very sluggishly for most of the 1990s; and by the end of 2001, the economy had begun to shrink. In spite of this bleak picture, it is almost certain that without the government's fiscal stimulus, Japan's GDP would have contracted much more than it did. But Japan's fiscal policy contained several flaws. Firstly, much of public spending went towards unproductive public works projects and pork barrel schemes. Secondly, most of the increase in the budget deficit was caused not by public spending increases or tax cuts, but because tax revenue automatically shrank as output fell. And thirdly, according to the Federal Reserve economists, since "Japanese fiscal policy was reacting to large and sustained shortfalls in private demand...increases in the fiscal deficits generally were offset by reductions in private spending." (Ahearne *et al* 2002; p. 36).

Effects of deflation

Consumers' delight - watch the money grow: We now turn our attention to the effects that deflation can have on an economy. For consumers, deflation is a delight because it means the purchasing power of the money sitting in their pockets increases with time. Since the general price level is falling, the cost of a good or service will be less tomorrow than it is today. This trend affects consumer behaviour in an important way, because it encourages people to delay their purchases until the future, when the goods they wish to buy will be cheaper. Unfortunately, what for the individual consumer is good, for the economy as a whole is bad. The nature of deflation depresses consumption, which feeds into lower national income, which itself reduces consumption – and so the vicious circle continues. What is more, the greater the rate of deflation, the greater the inclination for consumers to "purchase tomorrow," and the more deleterious the ultimate effect on GDP. In the end, depressed profits for firms means less income for households, and this in turn means less money to spend on goods and services. In Japan's case, deflation is reinforcing the tendency of consumers to save, rather than spend their incomes, with the result that domestic demand is sluggish.

Bad for borrowers – watch the debt grow: Most other effects associated with deflation are unequivocally bad. Perhaps the hardest hit by falling prices are borrowers. Whereas inflation is a debtor's friend, deflation is his enemy, because it increases the real value of money owed. Since debts are denominated in nominal currency, the real value of a debt (and therefore the repayments) increases in line with each fall in the price level. This outcome has had huge implications for Japan's debt-laden companies and overexposed banks. Not surprisingly, deflation in Japan has had the effect of steadily increasing the number of non-performing loans on bank balance sheets as indebted companies get pushed towards insolvency by the added burden of "deflation payments." The resultant undermining of banks' capitalisation not only threatens their continued viability, but also limits their ability to act as financial intermediaries.

The profit squeeze: Deflation can affect companies in another way. As prices across the economy fall, there is usually a corresponding decline in corporate profits, at least in nominal terms. However, corporate profits may suffer a real squeeze if wages are not scaled down in line with commodity prices. In practice, wages tend to be sticky, so corporate profits can often be adversely affected by a deflationary slump.

Interest rates affected: Finally, as we have already mentioned, deflation can have an undesirable effect on interest rates. Although the nominal rate of interest may be zero, the real rate of interest may amount to several percentage points given deflationary circumstances. This factor, together with an associated fall in national income, can lead to a decline in investment – which is liable to further damage an economy.

What is to be done with Japan? - Policy suggestions

Any worthwhile policy solutions for Japan must address the twin problems of shrinking GDP and deflation. To be effective, these solutions need to be combined into a comprehensive reform package that tackles both Japan's macroeconomic and structural problems. Based on the investigation and analysis we have done, we would like to make the following proposals.

Macro measures

Supply-side policies - not appropriate: On the macro side, there are two basic channels through which policymakers can attempt to stimulate growth: either through the demand side or the supply side of the economy. Supply-side economics attempts to stimulate growth in an economy by altering the level of full employment, the level of potential output and the natural rate of unemployment. Typical supply-side policies include cuts in income tax[12], greater labour market flexibility[13], and increases in worker productivity through improving the capital stock. In Japan's case, however, it is unlikely that supply-side policies would have much effect since: both natural and structural unemployment are relatively low; wages have shown themselves to be flexible in response to deflationary pressures; trade union power in Japan is traditionally weak; and there is already excessive spending on capital goods. Clearly, supply-side policies will be of limited value.

Demand-side policies - use with care: We must therefore turn to demand-side polices to revitalise growth. The use of both fiscal and monetary policy by the Japanese authorities has already been detailed, and it is clear that the effectiveness of both these instruments is severely limited: in the case of fiscal policy by the towering level of government debt, and in the case of monetary policy by the problem of zero nominal interest rates and the liquidity trap. These constraints notwithstanding, it is vital that the government maintain its commitment to stimulate aggregate demand and reverse deflation. This end can only be achieved through continued government spending, both in the form of actual spending and tax cuts. However, it is important that public money be channelled into "more visibly

[12]Lower tax rates encourage more people to join the work force.

[13]Methods include reducing the burden of labour market regulations, weakening trade union power and running programmes to increase workers' employability through training and education.

productive projects, which, in addition to raising productivity, might [boost] consumption by increasing confidence in the future growth potential of the economy." (Ahearne *et al* 2002; p.31) The economists of the Federal Reserve also suggest that a "temporary consumption tax cut" might be more effective than income tax cuts in stimulating private demand, on the basis that "consumers are more likely to spend money now if they believe that goods will be more expensive later." (Ahearne *et al* 2002; p. 32)

As far as monetary policy is concerned, we rely on analysis undertaken by the economist, Paul Krugman (1999), who suggests that the "correct" answer to a liquidity trap is a credible commitment by the central bank to future monetary expansion. Krugman points out that, while quantitative easing in a liquidity trap may theoretically have no effect on spending (because the excess liquidity will simply be held by the banks), in practice a long-term commitment to expanding the monetary base may play a role in changing expectations – specifically with regard to future inflation. A similar rationale can be applied to open-market operations, which under conditions of a zero interest rate, would not be expected to boost private consumption. Krugman argues, however, that by engaging in "unconventional open-market operations" e.g. through the purchase of foreign exchange and long-term bonds, the central bank will be able to drive down the currency and long-term interest rate, thereby giving the economy a fillip. The critical point in pursuing both these policies, however, is to "change expectations" about future economic performance and inflation, with the aim of actually calling these scenarios into being. Krugman emphasises that for these policies to be successful, the central bank must "change its spots" and "credibly promise to be irresponsible," so that consumers really believe that inflation is just around the corner. To quote from Krugman's concluding remarks: "Virtues like saving, or a central bank known to be strongly committed to price stability, become vices; to get out of the trap a country must loosen its belt, persuade its citizens to forget about the future, and convince the private sector that the government and central bank aren't as serious and austere as they seem." (Krugman 1999; p. 5)

Structural measures

To complete our reform package for Japan, we need to add one final element: structural change. The area in most urgent need of reform is Japan's banking system, which is not only inefficiently organised, but is also crippled by a mountain of bad debt. However politically painful it may be, the dead wood in the banking industry has to be chopped out, so that the current plethora of weak, undercapitalised banks can be replaced by a smaller number of larger, well-capitalised ones. In order for this change to happen, the problem of the banks' non-performing loans must be dealt with. Quite simply, dud loans must be written off rather than be continually rolled over or renewed. This in turn means that many of Japan's large, but chronically weak companies must be allowed to go bust, regardless of the implications for unemployment. Japan's bloated construction industry (the chief agent through which politicians' pork barrel projects are carried out) is particularly in need of slimming down, as is the retail industry. An important benefit of allowing Japan's weakest companies to fail is that the current problem of overcapacity (and excess supply) in the economy would be at least partially solved. Clearly, the political will must exist to face the short-term pain of a rise in unemployment in order to secure the country's long-term health.

Conclusion

Our investigation and analysis of Japan's economic performance since the bursting of the bubble economy at the start of the 1990s is now complete. We have examined certain traits of the boom economy and how they contributed to Japan's current recession and deflationary slump. We have also described in detail the problems associated with deflation, and their specific role in Japan. Likewise, the effects of fiscal and monetary policy on GDP and price stability have been discussed, with particular reference to the way in which policies adopted during the 1990s may have actually contributed to the ongoing bout of recession and deflation. Finally, we have presented a reform package, which includes proposals for both macroeconomic and structural reform.

Our last comment is simply to stress the urgency of the reforms we have suggested. Despite twelve years of slow decline, Japan remains the world's second largest economy. Japanese society enjoys high levels of affluence, and poverty is minimal; education and public services are excellent; and life expectancy continues to rise. The problem is that the public and politicians alike are too comfortable with their lot, and neither really wants to take the painful, but necessary, measures to restore their economy to full health. Unless these measures are taken, however, Japan will almost certainly sink further into recession and deflation, and ultimately, the party will end. Though reform today may be painful, economic collapse tomorrow will certainly be more so.

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DOLLARISATION: THE CASE OF ECUADOR

BY BARRY JOHN RAFFERTY

Junior Sophister

Barry John Rafferty provides a theoretically sound treatment of dollarisation in Ecuador, backed up with a plethora of facts from reliable sources.

Introduction

Official dollarisation is a monetary regime under which a government adopts foreign currency, the dollar, as the predominant or exclusive legal tender.[1] The rationale for dollarisation lies mainly in availing of the monetary stability it provides. Many relatively small countries have used and continue to use foreign currency as legal tender, including such diverse countries as Panama, Liechtenstein, and now East Timor.

President Jamil Mahuad announced in January 2003 that Ecuador was to dollarise, replacing the sucre with the US dollar, in a bid to restore stability to an economy in the midst of a severe crisis. On September 13, 2000, the sucre ceased to be legal tender and Ecuador (with a population of nearly 13 million) became the most populous dollarised country in the world. Ecuador therefore provides an ideal test case to evaluate the efficacy of dollarisation as a monetary regime and its capacity to induce positive economic growth.

The Crisis

In January 2000, Ecuador was battling with an economic crisis that had been building up over the previous two to three years. Indeed, GDP fell by some 7.3 % in 1999.[2] Unemployment and underemployment were particularly high, at 15.1% and 46% respectively.[3] The primary causes of this crisis consisted of a number of

[1] Joint Economic Council, Washington D.C., (July 1999).
[2] Economist.com, *Country data, Ecuador*.
[3] Schuler, (2002).

exogenous shocks. These included falling oil prices; the effects of El Niño induced flooding; and a series of financial crises in East Asia, Russia, and of particular importance in Brazil. These shocks were exacerbated by public sector dependence on oil, the political fragmentation of Congress and weak administration, as well as a weak banking system that was characterised by semi dollarisation. With reference to the last point, 60% of bank loans were denominated in dollars by December 1998 and this had risen to 91% by March 2000.[4]

Falling oil and tax revenue as a result of declining oil prices in 1998 caused the fiscal deficit to widen to 5.7%.[5] Decreasing oil export revenue and fears of devaluation also induced the current account deficit to widen to a massive 10.7%.[6] Banks accumulated large proportions of bad loans as private borrowers began to default on their debt. This saw a decline in banks' assets. Capital began to flow out of Ecuador. Savers in banks began to fear that the banks might fail and began to remove savings, fearing a devaluation. The Treasury sought to dispel such fears by guaranteeing all bank deposits. The Deposit Guarantee Agency was set up and put failing banks into public hands. Indeed, by January 2000, banks representing 60% of total commercial bank assets were in public hands.[7]

In February 1999, the Central Bank floated the exchange rate, to limit foreign reserve losses, thus ending the crawling peg band system.[8] Massive depreciation and hyperinflation ensued. Private borrowers with sucre incomes were forced to default on dollar loans and banks were hit hard once again. In March 1999, a bank holiday was declared and bank deposits were frozen. The banks were recapitalised via a $1.6 billion Treasury bond issue and liquidated by a 136% increase in the monetary base for 1999.[9]

In August 1999, the government was forced to default on its external Brady Bond debt. This exacerbated depreciation of the sucre. By the end of 1999, the sucre had depreciated from 6825 per dollar to 20243 per dollar, and during the first week of January 2000 it fell to as much as 28000 per dollar in the interbank market.[10] Inflation jumped to 60.7% in 1999.[11] It is quite clear that the economy was in crisis, with monetary instability aggravating the situation. The decision to restore monetary stability via dollarisation should therefore be viewed against this backdrop.

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4 Beckerman, (2001).
5 Economist.com, *Country data, Ecuador*.
6 Economist.com, *Country data, Ecuador*.
7 Beckerman, (2001).
8 Beckerman, (2001).
9 Beckerman, (2001).
10 Schuler, (2002).
11 Economist.com, *Country data, Ecuador*.

Dollarisation Goals

Dollarisation was adopted to try to restore monetary stability and confidence in the Ecuadorian economy, thus attracting FDI into the country whilst also stemming capital outflows. It was hoped that inflation would fall to levels compatible with price stability and thus rid Ecuador of the harmful effects of hyperinflation. Lower inflation and a stable currency could furthermore encourage saving and private investment and lead to a lower rate of interest. In short, it was intended that dollarisation would provide a platform for the economy to return to growth.

Dollarisation in Ecuador: Results

Dollarisation has been fairly successful in relation to achieving the goals set out for it. GDP has returned to growth, with a rate of increase of 5.6% for 2001.[12] The unemployment and underemployment rates were also down to 8.5% and 30.5% by 2002.[13] This is in part due to dollarisation, but also due to a rise in the price of oil, resulting in increased oil revenue, and also some domestic reform. The benefits that can be attributed to Ecuador are as follows:

- Inflation has been reduced from 60.7% in 1999 to 23.5% in 2001. The reduction has not been as quick as expected mainly due to the choice of exchange rate at which dollarisation took place. The choice of 25000 sucres per US dollar significantly undervalued the sucre. Also, taking a US Dollar base, consumer prices actually fell by 45.4% in 1999.[14] Therefore, given the exchange rate that was chosen, and the fact that inflation tended to lag the exchange rate, it was inevitable that inflation would take a while to fall to levels comparable to the US. The US dollar base fall in consumer prices in 1999 gave some room for inflation given the exchange rate without eroding competitiveness too much.
- Capital channels were reopened and Ecuador's credit rating improved. Ecuador's foreign debt was renegotiated and a 40% nominal reduction was agreed to by creditors. The IMF also extended a three year standby loan. FDI was encouraged by monetary stability and increased from $636 million in 1999 to $1369 million in 2001.[15] A significant amount of this increase went towards the construction of a new oil pipeline which will nearly double oil output when completed and opened in 2004.

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[12] Economist.com, *Country data, Ecuador*.
[13] Schuler, (2002).
[14] Schuler, (2002).
[15] Latin Business Chronicle.com.

- The budget deficit has been transformed into small surpluses in 2000 and 2001.
- Interest rates have fallen and business confidence has increased. Loans to firms have increased and a rise in investment has been the overall result.

Dollarisation: Future prospects

In terms of whether dollarisation will be successful in the future in facilitating sustained growth to occur in Ecuador, a number of concerns have arisen.

- Should inflation continue to exceed the American level, or should rival countries devalue their currencies, Ecuador could face a loss of competitiveness. Without the option to devalue, Ecuador could end up in another economic crisis. However, Schuler (2002) points out that a stable currency will benefit a country more in the long run than competitive devaluations which elicit only short-run gains. Schuler indicates that the sucre depreciated by a factor of around 3 in 1999, but prices only increased by a factor of around 0.6. Despite the resultant gain in competitiveness, Ecuador suffered its worst economic year in history. This should highlight that it is more important to have a stable currency as opposed to resorting to competitive devaluations, where inflation often erodes the competitiveness gain. Panama is an example of a country that has done better, with greater price stability than neighbouring countries.
- The banking system still hasn't fully recovered from the crisis preceding dollarisation. A key indicator is the large difference between interbank interest rates (which fell to 4.92% in 2002) and the lending rate to private borrowers (which stood at 13.09% in 2002).[16] This is partly due to an attempt by the banks to recapitalise their assets, but more so, it is due to the lack of international banks operating freely in Ecuador, competing away interest rates on private loans in excess of those found in the US.
- Ecuador remains extremely vulnerable to external shocks. The dependence on oil and other commodities can result in large falls in export and public revenue when commodity prices fall. Also, Ecuador's climate leaves it open to the harmful effects of earthquakes and the phenomenon of El Niño.
- Ecuador still lacks the structural reform necessary to maintain stable growth over a long period of time. A fragmented congress makes legislation very difficult to get passed and undermines the efforts and effectiveness of the administration. The tax system is inefficient and should be replaced with a broader tax base featuring lower tax rates spread across more items. The government is strongly lacking in transparency. Indeed, Ecuador ranked 89th of

[16] Schuler, (2002).

102 countries surveyed by Transparency International.[17] As a consequence, inefficient use is made of public funds. In addition to this, Ecuador is also characterised by a legal system which is often arbitrary, making it very difficult for creditors to collect debts.[18]

Conclusion

From the example of Ecuador, it is evident that dollarisation can succeed in providing greater monetary stability. In an area where monetary instability has been the norm, dollarisation can have the effect of substantially ameliorating economic performance. Monetary stability is however no guarantee of good economic performance. To be successful over the long-term, dollarisation must be matched by a commitment to ensure that efficiency and competitiveness are paramount. A good institutional framework, with efficient and transparent public decision making and intervention are a major priority. So too is an efficient and just legal system and the internationalisation and strengthening of the banking system. Whilst dollarisation is no guarantee of success, it can provide the platform of monetary stability from which economic growth can take off if the appropriate policies are subsequently adopted and implemented. However, without monetary stability, it is highly unlikely that such a growth take-off will occur regardless of what other reforms are implemented.

The effect of dollarisation in Ecuador has been to hurl the country towards monetary stability. Whilst the initial outlook is an improvement, ultimate success will depend on real factors affecting the efficiency and productivity of the country. In this context, monetary stability can be seen as a prerequisite for growth, and dollarisation as an effective means of achieving the prerequisite. Ultimately though, the success of dollarisation will depend upon whether the opportunity is fully grasped to tackle remaining inefficiencies and hindrances to an efficient, productive economy, and to build upon a platform of monetary stability.

[17] Beckerman, (2001).

Statistical Appendix

	1998	1999	2000	2001
Exchange Rate,E.O.P. (Sucres per US$)	6825	20,243	Dollarised at 25000 sucres	Dollarised at 25000 sucres
GDP (% real change per annum)	0.4	-7.3	2.3	5.6
Inflation (consumer prices, %, sucre base)	43.4	60.7	91.0	23.5
Budget balance (% GDP)	-5.7	-4.8	1.7	0.7
Current Account Balance/GDP	-10.7	6.9	6.8	-4.2

Sources: Economist.com, *Country Data, Ecuador*. Schuler, (2001).

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TOURISM DEVELOPMENT IN IRELAND: AN ECONOMIC PERSPECTIVE

BY ALEXANDER GOROKHOVSKY

Junior Sophister

Alexander Gorokhovsky gives a detailed explanation of the role of the tourism sector in Ireland, with particular emphasis on the history of the development of tourism in the Irish economy, state intervention and the integral part played by women in tourism.

Introduction

Tourism is a significant sector of the modern Irish economy, representing 5% of total exports and 6.4% of GNP. Its unprecedented growth, which began in the late 1980s, had an impact on many aspects of the economy and society, assuming a greatly enhanced profile in Irish affairs. This essay provides a study of the industry and its contribution to economic development in Ireland. We will examine the background of the development of tourism in Ireland and its current composition and performance. Then we will concentrate on the role played by the government in the industry. Finally, the structure of tourism employment will be considered, particularly the role played by women in the Irish tourism development.

Background and performance

Today, taking a holiday is a central characteristic of modern societies. Every year millions of people travel away from home for the purposes of pleasure and recreation. Underlying the modern mass tourism phenomenon is a widespread assumption that people need to 'get away from it all' for the sake of their physical and mental health and to rest from the pressures of everyday life.

This goes back to the 18th century when only a minority of the population could enjoy a period of time away from home for reasons unconnected with work. The grand tour, the spas and the popular fashion for gazing on the wonders of nature were all elitist activities.

In Ireland during the 1700s, spas had developed at Lucan, Mallow and Castleconnell, among other places (Heuston, 1993). Although limited in comparison with continental and English spa centres, the Irish spas were, in effect, the first Irish holiday resorts. Towards the end of the eighteenth century, sea-bathing became popular among Anglo-Irish social elite, for 'taking the waters' was recommended by the medical profession of the time as a remedy for a range of physical disorders (Urry, 1990). Visitors began to frequent coastal villages such as Malahide, Skerries and Tramore. Furthermore, the intellectual climate of the time led to the development of scenic tourism among the upper class, stimulating an appreciation of rivers, mountains, lakes, the sea and magnificent stretches of coastline.

Industrial revolution in Britain and in other European countries in the course of the 19th century made holidays possible for the middle class and, somewhat later, for the working class. In Ireland, however, holidaymaking was confined for the relatively small minority of the population until the middle of the last century. Ireland traditionally has been host to more international tourists than it has sent abroad. This reflected "relatively low levels of economic development until the internationalisation of the economy in the 1960s led to increased real incomes, which was reinforced by the benefits which followed EC membership in 1973" (Williams and Gillmor, 1995: p. 69). Rising living standards brought an increase in the numbers of Irish people able to take holidays abroad. This was facilitated by the growth of charter tours, which accounted for more then half of the holidays to Europe (Gillmor, 1993).

Ireland, itself, did not become a significant tourist destination until very recently, mainly because it didn't possess climatic conditions conducive to mass tourism. Also, even the modest growth in the foreign arrivals was disrupted by the Troubles. As a result, the rates of growth were among the lowest in Europe during much of the 1970s (Williams and Gillmor, 1995).

However, in the 1980s there was a strong recovery in the Irish international tourist industry. Recurring recession and growing unemployment urged the government to seek out new areas for development. Owing to its strong performance in the international economy, tourism was targeted as a key vehicle for the attainment of economic growth.

An 'Operational Programme' for tourism was devised for the period 1989-1993 with substantial financial support from the structural funds of the EC. Ireland qualified as an Objective 1 region for which Community Support Frameworks (CSFs) were drawn up.[1] The programme provided for a total investment in the sector of some IR £300 millions over the period of the plan and set targets for the doubling of overseas tourist numbers to 4.2 million, increasing tourism revenues to IR£500

[1] Deegan and Dineen, 2000

millions, and creating 25,000 additional jobs.[2] These were very ambitious goals; however, the Operational Programme for Tourism, 1989-1993, has been a major success and the strategic targets set for the development of tourism in Ireland have been substantially met.

Building on the achievements of the tourism industry to 1993, a second Operational Programme document went on to stress that there are still some major problems to be tackled. The new programme emphasised the need to increase marketing spending to promote facilities developed under the First Operational Programme, improve facilities at major national cultural institutions and to upgrade training for the sector. A significant investment programme of IR £652 millions endorsed the commitment to tourism.

Another very important factor in the development of tourism in the Republic of Ireland has been substantial reduction in the problem of the country's accessibility, in terms of both the reduced real cost of transport and a greater range of services (Gillmor, 1998). The level of air fares declined and new scheduled and charter routes were developed. In 1986, Ryanair was established, providing an alternative to Aer Lingus. These extensions have been encouraged by growing demand for holidays in Ireland and facilitated by the development of the airports in the West.

The growing demand for holidays in Ireland at the time could be explained by the fact that Ireland can offer those tourist products, which have been increasingly attractive in recent decades, namely, opportunities for 'green' and rural tourism, as well as cultural tourism in Dublin, Kilkenny, Cashel, Blarney and many other places. Also important is language study, which accounts for about 9% of all visitors from mainland Europe (Williams and Gillmor, 1995).

The recovery in international arrivals was also associated with a change in market composition. There has been a decline in the share of the UK, and a major decrease in the share of the rest of Europe.

The UK has always been by far the most important source area of overseas tourists visiting Ireland (88% in 1960); in this context, the 'ethnic market' consisting of Irish emigrants and their descendants has been very important. However, over the last decades, while the British market has continued to grow in absolute terms, its share of the overall market has shrunk, as other source areas have grown even more rapidly. Up to the late 1970s, the North American market was the main growth area; since then, the most rapid growth has come from mainland Europe, which now accounts for a quarter of the total, compared with 57% for the UK and 15% for North America.[3]

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[2] *Ibid.*

[3] Figures based on the information provided by Bord Fáilte and CSO.

The proportionate shares of total tourist arrivals accounted for by the market sources are not matched by their shares of revenue generated, mainly because a considerable amount of visitors from the UK, who still constitute the majority of those coming to Ireland, stay with relatives and friends rather than in hotels and B&Bs.

Until very recently, visiting friends and relatives remained the single most important reason for people to come to Ireland; in 1990, 46% of surveyed overseas visitors gave this as the purpose of their visit. However, in 2000, only 25% of all the visitors came to see friends and relatives. The share of those coming purely for holiday, leisure and recreation has hugely increased (53% in 2000) - this is a significant improvement, which confirms the effectiveness of the measures undertaken on the international marketing arena and the growing competitiveness of Ireland as a tourist destination[4].

Role of the state: towards increased interventionism

Governments' approaches to tourism in the EC have changed in three significant ways over the past few decades. First, there has been a significant increase in the government attention. Second, this attention has been more associated with deliberate acts of policy related to tourism itself rather than the side effects of policy measures aimed at other issues. Third, there has been a tendency for government involvement to be concerned with more than the purely economic aspects of tourism. Commenting on the European situation, one study suggested that "tourism has grown at a rapid rate and now impinges on a great many aspects of national life which require government intervention in the interest of general, social or economic policy" (Airey, 1983). The underlying change is that as tourism has grown and increased in importance, so governments have become increasingly aware and sensitive to its various aspects and have reacted accordingly.

As we have seen, tourism occupies an important position in the Irish economy and that by and large this importance has been increasing over the past decade. This economic importance, however, is just one facet of the overall significance of an increase in tourism activities. Tourism brings with it a range of other issues including social and environmental implications (Mathieson and Wall, 1986). The emergence of government involvement points to a recognition of their existence and the need to respond.

Involvement by governments in tourism can broadly be grouped into two types. The first is indirect, whereby measures introduced by government influence

[4] Figures based on the information provided by CSO.

tourism as a by-product of its primary aim. Measures to tighten up immigration procedures, for instance, might influence tourism flows. The second is direct involvement, whereby governments actively seek to influence tourism. Promoting overseas tourism in order to earn foreign exchange is an example of this kind of involvement.

As governments have extended their involvement in the community and as tourism has increased in dimensions and significance, so governments have almost inevitably become involved in tourism. Initially this involvement may have been indirect; but as tourism has grown and has been recognised as a discrete and significant area of activity, so there have been attempts to provide a tourism focus to some of this indirect involvement. At the same time there has been an increase in direct involvement; initially it was very much rooted in economic issues, but as tourism has grown it has tended to broaden out into a wider range of issues.

The nature of involvement in this context varies widely, ranging from government legislation, directives and guidance, fiscal and monetary measures to the creation of special bodies, which become a component of the state bureaucracy (Hall, 1994). The concern of this involvement also covers a very broad area. The more obvious are likely to include a concern for foreign exchange earnings, employment, regional development, environmental and consumer protection. Less obvious might be a concern for small businesses, of which there are a high percentage in tourism, or a concern for energy consumption. Across countries, the scope for variation in the nature and concerns of government involvement in tourism is clearly vast.

In Ireland, overall control of tourism policy and its implementation has been the responsibility of Bord Fáilte, a semi-state organisation, which has played an important role in the development of Irish tourism. Among its activities are planning, research, development and regulation, in addition to the primary functions of promotion and marketing. In the early 1990s, the Irish government began to bring policy more firmly under its own control than has been the case previously. Bord Fáilte's activities have become focused more specifically on its core functions of overseas promotion and consumer marketing; various services, which it had performed for the industry, have been allocated to commercial suppliers and independent bodies. A separate organisation, CERT (established in 1963) is responsible for recruiting and training workers for the tourism sector. The Irish Tourist Industry Confederation, which was established in 1984, represents the main private participants in the industry and brings together the many strands that make up the weave of tourism in Ireland. Following the recommendation of the Tourism Task Force (1992), the National Tourism Council was established in 1993 to provide a forum for consultation between the industry, the state tourism agencies and the government.

The Irish government role in tourism was always relatively interventionist, but prior to the late 1980s the attention given to tourism in government planning and policy had been minimal, particularly in contrast with the focus on agriculture and manufacturing. This changed significantly as a result of several influences. Perhaps, the most important was the economic and employment difficulties experienced by Ireland at the time. Unemployment was rising ultimately to about 20%, and emigration was at a level which had not been reached since 1950s (Gillmor, 1998). As jobs were being lost in agriculture and manufacturing, tourism with its high labour intensity and export earnings seemed to offer an obvious alternative.

The national plan for tourism was approved and adopted by the EU in 1989 as the Operational Programme for Tourism, 1989-1993. We discussed the role that this programme played in subsequent tourism performance earlier, and the government was in no doubt as to the line of the causation.

Tourism employment: gender analysis

Tourism is an effective and efficient tool in creating new jobs and thus decreasing unemployment. That is why it has been targeted as a sector which is central to the government's policy objectives and which lends itself to varying degrees of intervention in pursuit of these objectives.

Tourism employment in Ireland had significantly increased during the recent decade, contributing nearly one-third of all new jobs created in the country over the last years. The benefits of tourism employment are moderated by tendencies to less than full-time jobs and comparatively low wages. The extent of temporary, seasonal and casual employment is partly related to the predominantly small scale of Irish tourism enterprises, which are often family-based (Gillmor, 1998). It must be recognised, however, that some of those who work in tourism on a seasonal or part-time basis would not wish for full-time employment in the industry or lack alternative opportunities. First and foremost this refers to the role of women in tourism employment, and in Irish employment, in general.

The modernisation of the Irish economy and society in the twentieth century has not, as elsewhere, been accompanied by a sharp rise in female participation in the labour force. In 1998, Ireland's female labour force participation rate (the proportion of the female population aged 15-64 in the paid labour force) was one of the lowest in the OECD countries, although it has increased considerably since 1987 (Deegan and Dineen, 2000).

To a significant extent, the low level of involvement by Irish women in paid labour could have been attributed to a lack of labour market pressures, in that the Irish economy has portrayed a chronic historical inability to provide its population with adequate employment, which was reflected in high levels of emigration.

More importantly, in the past Irish women have been excluded from the labour force by a range of legislative measures, including a discriminatory social welfare system and obligatory retirement on marriage for female public servants (Breathnach *et al*., 1994).

However, a series of laws establishing formal equality for female workers was enacted in the 1970s, arising from EC membership in 1973, while equality of treatment under the social welfare code was gradually extended in the 1980s. The slow growth in women's employment in response to these measures has been due to traditional social and cultural value systems, and first of all the Irish Roman Catholic church's emphasis on a family-centred role for Irish women. This is reflected in the Irish constitution of 1937, which specifically states that the place of women is the home and seeks to 'ensure that mothers shall not be obliged by economic necessity to engage in labour to the neglect of their duties in the home' (*Constitution of Ireland*, pp. 136-138).

Not surprisingly, those women who *are* engaged in paid work are concentrated in the service sector. Within the sector, women are particularly strongly represented in personal services such as hotels and restaurants, professional services such as teaching and nursing, financial and business services, and the lower echelons of the civil service. They are poorly represented in wholesale distribution, transportation, and the security forces, which is typical of advanced economies.

The labour market options available to Irish women are circumscribed by the stereotyping of an educational system, which steers women away from technical and skilled manual operations and towards a narrow range of service occupations. This is further enhanced by the predisposition of recruiting agencies. As a result, many Irish women must either accept poorly paid unskilled work or quit the workforce.

Part-time employment in Ireland is also dominated by women workers. Since the 1997 the part-time share of total male employment in Ireland decreased from 7 to 6.3% while that for females increased from 27.2 to almost 30% (Deegan and Dineen, 2000). The vast majority of those in part time jobs (which particularly suit married women) in 1999 indicated that they were satisfied with their hours of work and were classified as *not* underemployed.

Women also constitute a majority of temporary workers. However, in this case most of them are in temporary employment because of an inability to find permanent jobs (although older women in particular are more inclined to opt for temporary work by choice). Particular reference has been made here to both part-time and temporary employment not only because of the fact that they are dominated by female workers, but also because of their significance in the tourism industry.

Concluding comments

The expansion of tourism in Ireland has significantly contributed to the country's performance throughout the 1990s and will undoubtedly remain a major factor in the Irish economy in the years to come. It offers opportunities for developing cultural awareness and international exchanges and provides employment and income. The country was fortunate in that trends in international tourism favoured Ireland, however, there can be no guarantee that the popularity of Ireland as a tourism destination will continue forever. It is essential that the quality of the Irish tourism product should be continuously improved and extended to meet the increasing tourist expectations.

Moreover, unspoilt environment and friendly people are fragile resources which can be threatened by high tourism growth rates. This must be taken into account when tourism policy is being devised, as to ignore these long-term considerations would be unwise and prove ultimately fatal for the industry itself.

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ACCOMODATING A CRISIS: A CRITIQUE OF IRISH HOUSING POLICY

BY NICK HODSMAN AND DAVID COMERFORD

Junior Sophister

In this essay, Nick Hodsman and David Comerford review the effectiveness of Irish housing policy in tackling the problems of house price inflation, homelessness and an underdeveloped rental sector. They consider policymakers to be idle & ignorant at their best. More often than not, they claim, government policies are complicit in house price inflation. In response, they recommend a publicly funded and privately administered cost-price rental scheme.

The Plot

It is a testament to the fact that there exists in Ireland a housing crisis that over the course of the past decade housing has been catapulted up the political agenda. This is not the only place where housing has been hastily put up, as a quick peripatetic of Dublin's peripheries will reveal. This is a problem more fully dealt with in Laura Watts' essay in this very review. For our part, Nick and myself first seek to account for the housing crisis as we perceive it. Next, current housing policy is examined, along with the repercussions this has had for those who demand housing. Finally, we propose what other, and in our opinion better, policies might be considered. It is worth noting at this stage that we are all counted among those who demand housing, insofar as we *need* housing. We therefore have little compunction in defining housing as a merit good, that is a good which is deemed to have sufficient social benefits to warrant production beyond that level which the market advocates.

Foundations

Despite the fact that every indicator shows the Irish people to be enjoying an unprecedented level of material well-being, the number of homeless people in Ireland is over twice the 1996 level[1]. In the same period, national income has risen by on average 10%. Most economists will have noticed a causal link between the

[1] Focus Ireland, 2003.

first sentence and the second. Income growth such as that which we enjoyed throughout the nineties leads to inflation. Inflation is of no great concern to those people who earn inflation-adjusted wages, but those on fixed incomes, or no incomes, are relegated out of the market by housing price increases.

A core problem here is that housing is treated as a marketable good. Indeed, it is an especially lucrative one given the reliably predictable demand booms consistent with population increase, rising incomes and an ever diminishing supply of land. By way of indication, the average price of a new house in 1996 was €76,439. Today the very same house costs €180,000.[2]

This absurd increase can only be referred to as a market failure. The question that arises then is how to set about rectifying this failure. The first thing to do is lay bare its source. Punch and Drudy show us that house building costs have risen by under 20% since 1991, while house prices have risen by over 120%.[3] Policymakers perceive this as a boon to the 80% of householders who are categorised as owner occupants (and tacitly as victims of price illusion) by the Department of the Environment. However, as the homeless figure would suggest, this is a problem which permeates the housing sector and not merely the market for house purchases.

House prices are traditionally gauged by economists as investments. Hence, net present evaluation takes rents accruing over the duration of the tenure, which, given the resilience of bricks and mortar, can be a very long time indeed. These rents are then discounted by the real interest rate (the opportunity cost or cost of borrowing) and taxes. One might also add servicing and maintenance costs. What is noteworthy in the Irish case, however, is that real interest rates have been negative since Ireland ceded monetary control to the European Central Bank. Moreover, and this is something on which a considerable portion of our policy discussion will be devoted, Ireland offers tax incentives to home owners, regardless of whether they are owner-occupiers, speculators or that rarest of breeds, magnanimous landlords.

The point here is that people must live somewhere. If house prices are pushed up, so too are rents, due to substitution effects. Given the more flexible nature of rental tenure, real price increases frequently manifest themselves in lax provision of housing services and maintenance rather than through the nominal price. Anecdotally, complaints regarding plumbing, heating and other such perfunctory issues are on the increase. In a bid to keep costs down, landlords discriminate against potential tenants who they perceive as imposing higher maintenance costs. These include students, a group who are vocal and active in the housing sector.

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[2] Department of the Environment, *Annual housing statistics bulletin 2000*; Property section, *The Irish Times*, 13-3-03.

[3] Rich and Poor, Cantillon et al.

These selecting mechanisms, monetary and otherwise, create a caste who cannot afford appropriate housing. The government has long been aware of the existence of such people. Indeed, in 1961, 18.4% of Irish households lived in accommodation owned by the local authority.[4] Despite the all too apparent need for social housing in a society where in excess of 5,000 people are homeless and over 48,000 are on waiting lists for local authority housing,[5] fewer than 8% of the Irish population are currently housed in such schemes. This compares with a figure of 36% for Holland.[6]

Culturally, such a discrepancy may be explained by Ireland’s history. Having been raised to believe that an English man’s home is his castle, framers of the Irish constitution enshrined protection of the dwelling of every citizen as “inviolable”.[7] Moreover, the fact that the independence movement arose out of one for land rights has rendered the Irish population more attuned to property possession than may be the case elsewhere. These initial conditions have been compounded by government policies that have favoured owner-occupancy ever since. This stance has in turn stigmatised social and, to a lesser extent, rented housing.

The Walled Constructs of Irish Policy

There are organic developments at work that boost the costs of housing in Ireland. The invisible hand is adept at moulding these natural undulations but not the sheer rise in house prices we have experienced of late. It is government policy that has made a mountain out of this molehill. If we refer to the equation for net present value of a house (P), we see that government has adopted policies that will spur demand for housing rather than quench it:

$$P = \frac{\text{Rents accruing over lifespan of house}}{\text{(interest rates + marginal taxes)}}$$

Costs of ownership are reduced by the remission of rates, the repeal of residential property tax and the repeal of the stamp duty on new housing for owner occupation. Demand for owner-occupied housing was further stimulated by mortgage interest relief and cash subsidies for first time buyers. Matters are further exacerbated by policies which favour speculation, such as the abolition of capital

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[4] Statistics from the Department of the Environment and Local Government.
[5] Focus Ireland quoting Department of the Environment figures for March 2002.
[6] Drudy, P.J., (2000; 2)
[7] Bunreacht na hEireann, art. 40.5

gains tax on the sale of the principal residence, the abolition of rent controls and section 23 and section 27 income tax relief for rental accomodation. All of these policies coincide to make marginal taxes to the property owners, the divisor in the equation above negative. Since real interest rates are negative, we can see that property prices are higher than the rents accruing from them over the lifespan of a property. This fact in turn makes property an excellent investment, and people are keen to take advantage of it. 25% of houses bought in 2000 were bought as a speculative property by current owner occupiers.[8]

These pro-cyclical policies could not have come at a worse time. Unprecedented economic growth in the 1990s did not vent itself through inflation in consumer goods as the European Common market ensures a ready supply of tradeable imports are available. Moreover, real negative interest rates since the launch of EMU have rendered saving a mug's game. South-East Asian, Latin American crises, Brown Monday and the bursting of the technology bubble have made Irish investors wary of international speculation. Hence, excess liquidity was mopped up by the housing market.

A roof to cap it off

The results of these inappropriate policies are those outlined in the opening paragraph: embarrassing blights on Irish society such as homelessness, unsatisfactory housing conditions and an embarrassment of riches for the wealthiest members of society. Given that property is the form of collateral favoured by banks, it is those in possession of a house already who are best placed to take advantage of the housing boom through remortgaging a first property with a view to purchasing a second. The disparity between rich and poor is hence compounded, as the ivory compounds of the rich become an increasingly remote dream for those not on the property ladder.

Since property has become the investment of choice, those responsible for it have seen their political stock grow. With that power comes corruption and as the planning and payments tribunal reveals every day, such corruption is rife. It is not entirely true to say that the market failed because a brown envelope was spirited into the invisible hand, but it undoubtedly contributed. Where are the solutions then? Housing policy remains as wrongheaded as ever. The Irish government continues to sell off local authority housing on the grounds of efficiency, but such concerns fly in the face of equity considerations.

Dublin saw a net growth in local authority housing of 1,527 between 1995 and 1999. In the same period they sold 2,755 houses.[9] Bearing in mind that there are

[8] Drudy; 2000: 6

[9] Dept. of Environment, 2000

currently 48,000 people waiting to be housed, and Dublin is the most intensely desired area in which to live, the lack of logic here is plain to see, yet the local authorities still offer very favourable terms on house sales and mortgages.

Room for Improvement

Having established that there is indeed a housing problem in section one, and examined some of the government policies that may have exacerbated the problems in section two, it is necessary to offer alternative policy measures in order to cure the acute housing shortage in the Dublin area. Whilst levels of social housing may be a primary necessity for those on local authority waiting lists, it is our belief that these needs must be met by capital expenditure, and provision made to those who really need it. The only way to do this is to either allocate a larger section of the budget to social housing, or to raise taxes in order to pay for it. The justification for this comes from having established housing as a “need” in section one and it therefore must be regarded in the same light as health or education. Therefore, in the same way that if there are not enough schools for children to be educated in or enough hospital facilities to cope with those suffering from heart attacks, there should be enough housing space to put roofs over peoples’ heads, whatever their problem. However, providing more social housing is not going to solve the problem for thousands of people who cannot afford to live in a house. As a result, policies need to be implemented not just to take people off the streets, but to allow people to live in affordable and acceptable accommodation. Consequently, the main focus of this section is to attempt to find solutions for the whole of Dublin and not just the marginalised.

The “Rip-off” effect of private housing investors

Until 1995, the cost of a new house rose at the same rate as inflation as measured by the CPI. It also rose at the same rate as the average earnings of adult workers and house building costs. By 1998, building costs, wages and consumer prices had continued to increase at a similar rate; however, new house prices had increased at rates of more than 30% a year, compared to the 5% to 7% increases in the CPI.[10] As a result, it can only be concluded that supernormal profits are being made by incumbents. Supernormal profits imply market failure and it is for this reason that government intervention is justified. Supernormal profits also imply a degree of monopoly. Standard monopolistic theory reveals a welfare loss to society. This can easily be interpreted as larger proportions of income being spent on

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[10] Drudy, 1999: 4

housing as opposed to consumption, or savings, and as a result a loss to the economy. Therefore, not only are people being ripped off by these price rises, but they are also having a damaging effect on the economy. These prices are also having an effect on second hand homes, which are also being raised through the substitution effect. As a result, the government needs to try to encourage a degree of extra competition in the housing market.

The case for government intervention

Baumol's theory of contestable markets states that in order for there to be any type of competition, there must be the threat of a new entrant.[11] When such large barriers to entry have to be overcome, it is almost impossible to see any new entrants. This can be applied to the Dublin housing market, where to be a new entrant requires access to vast amounts of capital. As a result, land investors are able to form cartels in order to suppress supply and dictate prices. No private party has access to sufficient capital to restore equilibrium; therefore, the government should step in to the breach. It is not our belief that this should be done through the use of rent ceilings, as basic supply and demand theory dictate that this might cause a further fall in the supply or, more likely, a black market. Rent controls would necessarily cause prices to accordion proportional to old levels, which prospective tenants would be rational to supplement with "gifts" in a bid to buy the best property.

The solution, using the same basic theory, is to attempt to shift the supply curve to the right, by increasing supply. This supply should come from the government, who buy land and build apartments in the same way that the private investors do. The only difference is that the government charge rents in order to cover costs, and not to make profit. The government have the access to capital in order to build these apartments, and as a result is potentially the only actor with the means and the inclination who can overcome this significant barrier to entry. With an increase in supply, and competitive rents, the equilibrium price of rented property could be expected to decrease. The central argument of this project would be that it creates a competitive environment in the housing market, as the private rental firms are forced to lower prices in order to keep tenants. It will also force them, without regulation, to provide a greater quality of service, and more secure tenancy agreements.

People in glass houses …

It would be unrealistic to expect any government action of this sort. One of the principle reasons behind this is the power of the housing lobby. Their power was previously referred to in section two, where it was seen that they were even able to

[11] Baumol, 1982.

change government policy. This shows their rent seeking and lobbying abilities, perfectly demonstrating one of the key traits of monopolists or cartels. It is worth noting that the majority of TDs are home owners, if not land owners. A goodly proportion of them also work as, or in conjunction with, solicitors and developers. Government has in the past shown a willingness to face difficult and powerful opposition, as they did in the case of taxi drivers & Aer Lingus.

Another argument is that of efficiency. One of the key arguments to the expansion of the private sector is the increased efficiency that profit-seeking yields. Having established housing as a "need" and, therefore, categorised in the same light as health or education, we can use the U.S. health service as a stunning example of how privatisation exacerbates inefficiency in the market for necessities. The U.S. spends 14% of their GNP on healthcare every year. France spends 9% of their GNP on health every year, with a state-run health service. Simple arithmetic tells us that the U.S. spends 5% more of their GNP on healthcare than the French. As a result, people invest far more in the U.S. private health-care system (still leaving 40 million people uninsured) than in France on the State-run system. This wouldn't be quite so alarming, if the French didn't live longer than the Americans! Therefore, to use the argument of economic efficiency in this context is flawed.

Given our past experience in housing related corruption, it would be kept out of government hands. In Sweden, where this type of cost-rental system has operated for a number of years, housing is run by housing companies. These are tendered by the government, and put in charge of ensuring the upkeep of all the accommodation. Recently, the local authorities also gave them price-raising powers as well.[12] As a result, the scheme does not have to be subject to the reputations of extremely inefficient government departments.

Learning from our neighbours

Most continental European countries have a far more integrated housing policy than Ireland. Kemeny attributes this to political culture. Many continental countries enjoy more diverse input into policy formulation than do Britain and Ireland. Most continental governments are made up of coalitions dependent on post-materialist and special interest parties. In Ireland it has always been one of the larger parties which have dominated. As a result, Kemeny states that Ireland has a 'dualist' housing system, by which he means market oriented. This is evinced in the government's zeal to sell off local authority housing and ghettoisation of what little council housing remains and, more importantly, their inhabitants. He says that this is not the inevitable outcome, and that housing could be "socially constructed through

[12] Kemeny, 1985: 82

strategic policy making".[13] In the Netherlands, where land pressure is far greater than in Ireland, rent prices are half what they are in Dublin, and 40% of the accommodation is provided by the state, or through housing companies.[14] These housing companies have been able to continue to build more properties, as through the process of maturation, debts were paid off from previous buildings, and as a result, much of their older accommodation is now making an absolute rent. Here Kemeny asserts that the rental market starts to out-compete the owner-occupancy market. This happens because money is needed only once to pay for a housing company residence, whereas a second hand home can be sold three or four times over in a generation, which results in more debt being accrued. As a result, in many European countries, staying in rental accommodation for a lifetime can result in less money paid on accommodation than in the cost of a mortgage in Ireland.[15] Once the benefits are put forward in this way, especially in light of the current problems in Dublin, alternative policies such as these seem very tempting.

Home, James!

In conclusion, we have illustrated and elucidated an issue which affects everyone in society, insofar as housing is a need. The solutions to the problems of homelessness, unaffordable and inappropriate housing will come only when policymakers realise this fact. Current policies, by trying to guide the invisible hand, are themselves misguided. Only when the invisible hand is severed from the corpus of speculators that have corrupted the housing pool will a satisfactory level of housing provision be achieved. We consider government enterprise to be the best means of achieving this. As opposed to current piecemeal housing policies, public enterprise is a capital investment that will continue to have positive repercussions on into the future, and a state can do nothing more prudent than invest in its future.

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[13] *Ibid*. 38
[14] *Ibid.* 90
[15] *Ibid*. 42-49

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URBAN CHANGE IN DUBLIN

BY LAURA WATTS

In a sweet essay on Dublin's development, Laura Watts shows how our capital city has expanded "like a confectioner's waistband". Through a baker's dozen of causes, structural and policy induced, Dublin came to resemble a doughnut by the 1980s. The Haughey's administration attempted to fill the void at Dublin's centre by incentivising inner-city development. Ms. Watts compares two beneficiaries of the policy, the IFSC and Templebar areas, and asks if Dublin has received its just desserts.

Introduction

Dublin is the capital and primate city of Ireland. The ‘core’ area consists of the ‘inner-city’, located between the Royal Canal in the north of the city, and the Grand Canal in the south. The ‘periphery’ consists of the expanding suburban area of Dublin, which forms a ring around the inner-city. Population, demographic, employment and land-use changes have occurred in the inner-city and suburban areas in the past number of decades. I wish to examine the market- and policy-induced factors, which have prompted these changes, along with some of the policies adopted to deal with the problems created by such changes. I have paid particular attention to the policies and initiatives, introduced in the Custom House Docks and Templebar areas of the inner-city, to deal with the changes there. The problems faced by the residents of Cherry Orchard are examined and possible solutions are briefly explored.

Dublin – Background

A city with over one million inhabitants, Dublin is the largest urban centre in Ireland. Half of the total urban population in the country live in Dublin, which is about a third of the total national population. Its population is six times the size of

Cork, the next biggest urban area.[1] It is both the capital and primate city of Ireland. It is the locus of commercial, financial, administrative, cultural and social activities in the State. Yet, while acting in these capacities as a single metropolitan entity, it is also a collection of villages and neighbourhoods.[2] More and more towns are being subsumed into the fabric of Dublin. It now embraces at least seven local authorities and is constantly expanding '*like a confectioner's waistband*' [3]

Population Change

Migration or 'population dislocation'[4] is a common phenomenon in Irish life, with Census figures showing a consistent decline in aggregate rural population, with a consistent increase in aggregate urban population.[5] In Dublin over the past few decades there has been a trend of 'centrifugal'[6] growth, an ever-greater spread of urbanisation, or suburbanisation, with population growth occurring on the perimeter.[7] This has been facilitated by increased personal mobility due to the rise in car ownership, which has allowed people to commute from areas 'where they can enjoy the perceived amenities of essentially rural areas'.[8] This outward growth of population in the peripheries has, up until recently, been accompanied by a decrease in population in the core or inner city. This is a similar situation to the experience of British cities over the same timeframe.[9]

However, over the last several years, continued centrifugal growth has been accompanied by an increase in the population of the core, 'centripetal' growth.[10] The 1996 Census showed an increase in population in Dublin County Borough for

[1] Drudy, P.J. & MacLaran, A. (1994) *Dublin: Economic and Social Trends*. Vol. 1. Dublin: Centre for Urban and Regional Studies, TCD. p. 6.
[2] Bannon (1999) 'The Greater Dublin Region: Planning for its Transformation and Development' in Killen, J. & MacLaran, A. (Eds.) (1999) *Dublin: Contemporary Trends and Issues for the Twenty-first Century*. Dublin: GSI & CURS, TCD. p. 1
[3] Keirnan (1998) in Bannon (1999) *op. cit* p. 1
[4] Bannon et al (1982) *Urbanisation: Problems of Growth and Decline in Dublin*. Dublin: NESC Report No. 55. p. 39
[5] *Ibid*. p. 39
[6] Bannon (1999) *op. cit* p. 1
[7] Bannon (1982) *op. cit* p. 47
[8] *Ibid*. p. 49
[9] *Ibid*. p. 49
[10] Bannon (1999) op. cit pp1

the first time in several decades.[11] Until recently, the pressure of rural outmigration was taken off Dublin, as many emigrated out of the State. However, the phenomenon of net-immigration is now being felt.

From 1991 to 1996, the population of the core increased by 10,000.[12]. The Dublin Sub Region, as a whole, increased its population and proportion of the national total. In 1961, Dublin accounted 25.5% for the national population; by 1991 this figure had risen to 29.1%.[13]

Land Use Changes

Market Factors

There are many market factors that brought about the outward growth and increased suburbanisation of the region. High land prices and high return on investment in core areas encouraged the development of 'high value' land uses, such as office functions. Housing and industry are considered to be 'low value' uses. Industrial decline in the inner city encouraged outmigration, as workers moved to live near industrial zones in the periphery. The lack of space, coupled with the high land prices, meant that expansion of industrial firms in the inner city was often not feasible, therefore influencing the outmigration of industry to the suburbs. Technical change, which is best exemplified in the inner-city by the Docklands where containerisation and mechanisation of goods handling were introduced, reduced local labour requirements. Traffic congestion too caused problems for firms, as it increased the cost and time of production. Firms were not the only actors to see the benefits of a peripheral location; individuals too wanted to leave the inner city due to the high levels of pollution, traffic congestion, and the perception of high crime rates.[14]

Policies

Policies adopted at various levels of government, too, promoted the growth of the periphery. The zoning policies of Dublin County Council led to private residential development on greenfield sites. This, coupled with the deterrent of high land prices in the city centre, encouraged the construction of housing in suburbs. Local authority housing developments occurred mostly on greenfield sites, in order

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[11] Drudy & Walker (1996) 'Dublin in a Regional Context' in Drudy, P.J. & MacLaran, A. (1996) *Dublin: Economic and Social Trends.* Vol.2. Dublin: Centre for Urban and Regional Studies, TCD. p. 11

[12] Bannon (1999) *op. cit* p. 5

[13] Drudy & MacLaran (1994) *op. cit* p. 7

[14] *Ibid* p. 10

to its achieve low density policy. Central government policies too induced suburbanisation on greenfield sites. The remission of stamp duty on new houses, the abolition of rates in 1977 and the mortgage interest tax-relief which encouraged owner-occupation all contributed to the outward growth of the region.[15] The policies of the Industrial Development Authority (IDA) tended to attract firms and industrial developers to suburban areas, where the industrial estates they built were located.

There was an increased problem of dilapidated and derelict buildings in the city as buildings in the core were abandoned. In a 1986 survey, there were 600 cleared sites or derelict buildings, which accounted for 65 hectares of inner-city land. This dereliction prompted a visiting architect from the Finnish Ministry for the Environment to comment, in a letter to The Irish Times, that it seemed that the "*historic core was left to rot*".[16]

Changes in Employment

From its very beginnings Dublin has always been a centre for trade and commerce. Its primary industries tended to be distilling, brewing, and some food and textiles.[17] However, over the last number of decades changes in the nature and composition of employment in the region have occurred. This is due to the suburbanisation of industry and the decline of some of the city's traditional service employers, such as the Docklands, along with an increase in the number of office-based activities.[18] As a region, Dublin's share in the total national employment has risen from 32.7% in 1961 to 41.7% in 1997.[19] This is due to agricultural decline, industrial stagnation and restructuring, coupled with the rapid growth within the high-tech and services sectors.[20] However, the growth in employment was not shared by all in the region. The inner-city became increasingly subject to the evils of unemployment. For example, in the north inner-city in 1986, 26% of the labour force was unemployed. For the Dublin sub-region as a whole, this figure was 19

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[15] *Ibid*. p. 11
[16] MacLaran, A. (1999) 'Inner Dublin Change & Development' in Killen, J. & MacLaran, A. (Eds.) (1999) *Dublin: Contemporary Trends and Issues for the Twenty-first Century*. Dublin: GSI & CURS, TCD. p. 22
[17] Bannon (1982) *op. cit* p. 54
[18] *Ibid*. p. 55
[19] Bannon (1999) *op. cit* p. 6
[20] *Ibid*. p. 6

percent.[21] Some inner-city areas had long-term unemployment accounting for 60% of unemployment.[22] The reason for this is linked to the 'surburbanisation' of industry, and structural and technical change I have outlined previously.

'Peripheral' Problems

The continued outward growth of Dublin means a widening of commuting fields, which in the mid 1990s already encompassed towns within a 50km radius of the city-centre.[23] Bannon (1999) feels this is due to a lack of planning, leading to '*urban scatter which is unsustainable, a misuse of resources, and a visual intrusion into the rural environment*'.[24] Traffic congestion, due to commuting and a lack of a public transport infrastructure in the periphery, had become an increasingly serious problem.

There are a number of issues which have arisen with the growth in the population of the periphery, and the establishment of new towns. As they have yet to be recognised as separate entities. Tallaght, for example, had a population of over seventy thousand in 1993, making it the third largest urban population in the State. Yet, up until recently, it was without any separate local authority.[25]

Cherry Orchard: Case study of a suburban area

Despite rapid economic growth in recent years, in particular in the Dublin region, there exist 'pockets' of deprivation in certain areas.[26] Cherry Orchard, a local authority housing development in the suburbs of Dublin, is one such area. Its inhabitants are semi-skilled and unskilled workers. 65% of the population of the area are under 25 years old. It is described as an unemployment 'black-spot', as it has 64-70% unemployment. There are very low levels of educational attainment in the area, with more than 70% leaving school by 15 years of age, and only 1%

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[21] McKeown, K. (1991) *The North Inner City of Dublin: An Overview.* Dublin: Daughters of Charity. p. 19

[22] MacLaran, A. (1999) *op. cit*. p. 22

[23] MacLaran, A. (1993) *op. cit Dublin: the Shaping of a Capital* Dublin: Belhaven Press. p. 50

[24] Bannon (1999) *op. cit* pp6

[25] MacLaran (1993) *op. cit* p.72.

[26] Bartley & Saris (1999) 'Social Exclusion & Cherry Orchard: A Hidden Side of Suburban Dublin' in Killen, J. & MacLaran, A. (Eds.) (1999) *Dublin: Contemporary Trends and Issues for the Twenty-first Century.* Dublin: GSI & CURS, TCD. p. 81

remaining in education beyond their twentieth birthday.[27] It is a low-rise, low-density development. However, there is very poor infrastructure *in situ* for the residents. For example, there is no primary or post-primary school in the area, no post-office, post-box, public telephone, shopping centre, playground, or public house.[28] This lack of service-provision in the area is exacerbated by the low level of mobility in the area, due to low car-ownership and a limited public transport system.[29]

This is indicative of the situation faced by many suburban low-income groups, whose physical isolation is a manifestation of their social and economic marginalisation.[30] This hinders continuance in the education system, especially considering the lack of schools in the area. The lack of meeting-places in the area both decreases the opportunities for interaction and limits the establishment of local neighbourhood networks.[31] This is a serious problem in 'new' areas.

The social marginalisation, lack of opportunities and lack of activities have been responsible for high drug usage in the area. Drug abuse has created a downward spiral, as it stigmatises the area, further limiting its development.

Unfortunately, such areas in the periphery have had limited focus from local and central governments. In the last few years, however, 38 independent local partnership companies have been established under the Local Development Programme in order to tackle the issues of long-term unemployment and social exclusion that have afflicted such areas. These companies have representatives from the community, from statutory agencies and from the social partners. They represent a grass-roots, bottom-up approach to the development of these areas.[32] However, such talk-shops will have little fruition if there is not a massive injection of investment into the physical infrastructure of such areas.

Urban Renewal: Outline

Until the mid 1980s there had been piecemeal and uncoordinated approaches to the problems encountered in the inner-city.[33] The new integrated approach coincided with a sustained and rapid economic growth in the State.

[27] *Ibid*. p. 83
[28] *Ibid*. p. 86
[29] *Ibid*. p. 86
[30] *Ibid*. p. 82
[31] *Ibid*. p. 88
[32] *Ibid*. p. 83
[33] MacLaran (1999) *op. cit* p. 23

Changes in lifestyle and attitudes meant that the inner-city took on a new importance in the residential arena. There existed an increased preference among young adults to move out of the parental home; this was aided by the growing economy. Large-scale private sector residential development gentrified the inner-city,[34] so that young white-collar workers were willing to live in hitherto undesirable inner-city locations. This was accompanied by property-based renewal polices adopted by central government to encourage the construction of apartments for rental, in the form of tax-incentives.[35] [36]

Up until 1985, Dublin had the 'advanced symptoms of a doughnut city', with a total loss of a middle-income population in the inner-city and with large areas of dereliction. In response to industrial decline in Dublin, the government granted Designated Area status to the inner-city in 1982, which was a limited incentive based initiative. However, this was a failure due to high land prices, congestion and lack of space, the same reasons which had contributed to industrial decline in the core initially.[37] However, the Urban Renewal Act (1986) was the first major step in which the government took active responsibility for the capital city.[38] Up until this point, the IDA focused mostly on the western seaboard; Dublin was left to its own devices and consequently suffering a massive loss in its industrial sector. Between 1971 and 1991, there was a 29.7% decrease in industrial activity in the Dublin sub-region, while there was a 15.5% increase in the rest of the country. IF There was an increase of 36.1% in service activities in the region, the rest of Ireland had an increase of 47.1%.[39] Central government was disaffected with local government policy and their ability to deal with these issues; thus, independent agencies were established in order to avoid "bureaucratic inertia"[40]. Area-specific authorities were established in order both to create long-term plans for the areas in question and to administer the investment incentives. Most notable among these are the Custom House Docks Development Authority (CHDDA) and Templebar Renewal Ltd.

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[34] *Ibid*. p. 21
[35] *Ibid*. p. 24
[36] MacLaran (1996) 'Private Residentrial Development in Central Dublin' in Drudy, P.J. & MacLaran, A. (1996) *Dublin: Economic and Social Trends.* Vol.2. Dublin: Centre for Urban and Regional Studies, TCD. p. 20
[37] Drudy & MacLaran (1994) *op. cit.* p. 19
[38] Gleeson (1999) 'Changing Approaches to Planning in Dublin's Inner City' in Killen, J. & MacLaran, A. (Eds.) (1999) *Dublin: Contemporary Trends and Issues for the Twenty-first Century.* Dublin: GSI & CURS, TCD. p. 49
[39] Drudy and MacLaran (1994) *op. cit* p. 15
[40] MacLaran, (1993) *op. cit* pp 72/73

Custom House Docks

The Custom House Docks Development Authority was set up in November 1986 under Section Eight of the Urban Renewal Act, after the failure of attempts to interest private developers. CHDDA was the planning and development authority for the area. Financial incentives were established in order to attract investors. These took the form of tax allowances, rate remissions and rent allowances. A central part of the plan was to develop an International Financial Services Centre (IFSC).[41] High specification offices were mandatory under the CHDDA Planning Schemes. Between 1986 and 1995, the area received 24% of designated area investment, in order to encourage the lucrative financial services information-based industry.[42] However, the main beneficiaries have been the large-scale investors and financiers, whose incomes are already quite high.[43] There was high level of relocation of firms to avail of the incentives, which resulted in no more than a moderate gain in employment. In general, the scheme did little to give employment to the existing local community to lessen the problem of local unemployment.

The area is inanimate after business hours. The overall impression is one of "an introverted office precinct which dies after the working day."[44]

> "The ambience is muted in contrast to the bustling vibrant mixed use development mooted in the 1987 Planning Scheme. Its links to the rest of the city are weak both by virtue of its introverted urban layout and boundary environmental conditions."[45]

This does little to foster of a sense of community between the existing residents and the incoming population.

The Dublin Docklands Development Authority (DDDA) was created in 1997 and encompassed the role of the CHDDA. Its aim was social and economic regeneration on a sustainable basis.[46] It recognised the need to place more emphasis on education and training opportunities for residents of the area and to create a mix of housing, in an attempt to redress the lack of integration which has occurred thus far.

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41 Drudy (1999) 'Dublin Docklands: the Way Forward' in Killen, J. & MacLaran, A. (Eds.) (1999) *Dublin: Contemporary Trends and Issues for the Twenty-first Century.* Dublin: GSI & CURS, TCD. p. 37
42 KPMG (1996), *Study on Urban Renewal Schemes* Dublin: Dept. of the Environment. p. (ii)
43 *Ibid*. p. (v)
44 Gleeson (1999) *op. cit* p.51
45 KPMG (1996) *op. cit* p. (viii)
46 Drudy (1999) *op. cit* p. 39

Significant increases in house prices in recent years have been aggravated by investors purchasing in the area for rental purposes. This further marginalises existing residents and directly contradicts a central tenet of the new housing strategy; owner-occupation was to be encouraged in order to create a sense of community and provide stability in the area.[47] Blackwell and Connery (1991) estimated that about half of the recent investment in designated areas would not have taken place without incentives.[48] This, of course, implies that half of the investment would have occurred anyway; due to the economies of scale generated by agglomeration, this investment may have even attracted more. Therefore, we cannot be certain how beneficial incentive schemes have been to urban renewal.

Templebar

Templebar is an area just south of the River Liffey. In the mid-1970s, Córas Iompar Éireann began acquiring the core of the area, with the intention of putting in place a central bus depot. However, the area began to take on a 'bohemian' and cultural aura. The plans for the depot were abandoned when, in May 1991, the then Taoiseach Charles Haughey told the Dáil that the objective of the development of Templebar

"is to build on what has been already taking place spontaneously in the area and to create a lovely bustling cultural and tourist quarter which people will visit in significant numbers and which many more will work and live."

Has this vision been achieved? The figures speak for themselves. Within the 24 acre area, there are now at least 44 restaurants, 28 licensed premises, 15 nightclubs, 12 hotels or hostels, 12 cultural centres, 1,200 employees, 1,500 residents, and an average of 100,000 visitors per day. When the project began there were 17 cultural organisations; now there are 65. Architecturally, it has been a massive success, as the area has won many awards in recent years. The existing local authority housing in the area have added to fostering a sense of community within the area. This community has, to a certain extent, been incorporated into the projects of the area, including the 'Greening of Templebar' project. Crampton Buildings for example has a 'wormery' to provide organic feed for the trees and shrubs in the courtyard.

However, the area has not been without its problems. Residences are now very expensive, even allowing for the increase in housing prices over the last several years. The bustling and vibrant nature of the area brings with it its own set of

[47] *Ibid*. p. 44

[48] Drudy and MacLaran (1994) *op. cit* p. 35

difficulties. Clearly a huge number of licensed premises in such a small area has led to annoyance for those living in the area. One resident of the area has commented that "*I'm sick to death of all the vomit and urine*".[49] However, this issue is being dealt with. Publicans, who have benefited from the tax incentives, now contribute towards the cost of street cleaning, and 'stag-party tourism' is no longer encouraged officially.

Templebar is not just a tax-driven development, as direct public sector funding and co-funding under a number of EU projects and programmes have also provided for its redevelopment.[50] The development of the area under the auspices of Templebar Renewal Ltd. has not simply been a function of the tax-incentives introduced, as many business in the area are too small to avail of these incentives. In a survey to establish the factors of attraction and retention in the area tax-incentives ranked fourth, behind improvements in infrastructure and environment. Perhaps the unique control that Templebar Renewal Ltd. exerts means that a certain type of business is attracted to the area, which allows it to live up to Haughey's mission statement. Thus, while still having teething difficulties, Templebar is perhaps an exemplar of urban renewal in that it has reverse the damage of dereliction and, indeed, continues to do so. It has achieved what the IFSC has not, in creating an open and accessible urban space, providing the 'missing-link' between the north and south of the city.

Conclusion

In summation, Dublin has undergone a consistent expansion of its suburban areas, which in the last number of years has been accompanied by an increase in the population of the inner-city. The increase in the peripheral population and previous decline in the core population were caused by inter-related factors. The out-movement of industry, caused by market and policy-based factors, led to changes in employment and housing demands, which continue to encroach further into the peripheral greenfield sites. The ensuing difficulties with urban stagnation and decline have been addressed by central government with the establishment of a number of area-specific schemes, backed up by legislation for tax-based investment incentives. The Designated Area policy coincided with the upturn in the Irish economy, and a shortage of office space in the Dublin area. The extent to which these policies are responsible for the turnaround in these areas, or indeed for causing the upturn, are unknown.

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[49] McDonald, F. 'Work in Progress' in The Irish Times 5/8/00

[50] KPMG (1996) *op. cit* p. (vi)

Designated Areas programmes with adjacent inner-city communities have not addressed the issues that are central to the regeneration and sustainability of these areas. Unemployment is still a problem, in particular long-term unemployment. There remains a lack of adequate public amenities. The issue of education, training and youth development continues to be ignored for the most part. Inner-city communities are generally impeded from benefiting from development led by tax incentives, as firms and individuals do not have sufficient tax liability or capital to partake in such schemes. Escalating land prices in these areas, fuelled by the economic regeneration, further compounds the social exclusion that is already in action. There are a number of suburban communities which are immobile both physically and socially; due to a lack of co-ordinated planning, they fail to provide the necessary infrastructure to meet the transport, commercial, industrial and educational needs of these communities. There is a need for an intermediate level of public consultation, whereby local community involvement could become being more proactive rather than reactive.[51] These problems have been recognised by those in power and, while there have been attempts to solve them, it is clear that more needs to be done.

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[51] Ibid., pp (x-xi)

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"TO FRANCHISE OR NOT TO FRANCHISE" – IS IT EVEN A QUESTION?

BY MICHAEL COSTELLO & STEPHEN TEELING

Senior Sophister

Typical, you wait all year for a bus related essay and then three come along at once. Seamus Brennan proposed franchising Dublin bus routes from 2004. This essay takes a critical look at this suggestion. Solving the congestion problem in Dublin has led to a number of policy proposals. Oliver Fegan investigates the benefits of the Luas and Foster et al have looked into congestion charging in the city. Here, Michael Costello and Stephen Teeling investigate ways of improving the existing transport structure, by examining proposals to introduce franchising into the Dublin bus service.

Introduction

The past twenty years has seen many state-owned monopolies around the globe crumble in favour of private sector participation in an attempt to rid the transport sector of numerous inefficiencies. Consequently, the Minister for Transport's plans to end Dublin Bus's age old monopoly in favour of a fully franchised Dublin bus sector by the year 2007 has been received with much enthusiasm by both consumers and regulatory bodies such as the competition authority alike. In this paper, we discuss how such a monopoly came to prominence, referring to the 1932 Transport Act and the interventionist nature of Irish governments in the transport sector. The essence of the franchise model and the format which has been proposed for the greater Dublin area will be outlined, followed by an argument supporting the rationale of 'limited competition'.

The franchise model has been the recipient of much criticism by those who view it as a watered down version of competition. Faults both theoretical and practical can be found within the franchise model and these have been analysed thoroughly. In the course of our research for this paper we obtained the opposing views of John Lynch, the Chairman of the state incumbent Bus Ath Cliath and John O'Sullivan, founder of Aircoach. Consequently, we formulated a more rounded and practical perspective of the issues surrounding the proposed franchise model. We shall conclude by offering recommendations specific to the greater Dublin area.

Overview of Restrictive Practices in the Urban Bus Sector

In August 2000 the New Institutional framework for Public Transport was published. This set the wheels in motion for the end of Dublin bus's strangle hold on the bus sector in the Greater Dublin area. The ramifications of this report are being felt today in the transport sector but how in essence did this era of anti-competitive behaviour begin and what was the rationale behind it?

The restriction of competition between bus operators in Ireland began under the Road Transport act in 1932. In this act, the operation of scheduled passenger transport services except under license from the Minister for Industry and Commerce was prohibited. The objective was to protect the railways, which had lost market share because of road competition. The pressures on the government to curtail the independent bus sector increased steadily from the late 1920s. "Road transport should be merely used as a complement for rail transport, not as a substitute for it"(Conroy, 1928;37). There was a belief in the 1930s, that the market was prone to bouts of "wasteful competition". According to John Lynch of C.I.E, "unfettered competition had led to chaos on the streets", citing this as the main reason behind the 1932 Act and not the protection of the railways.

S. Barrett (2000), felt there were four main factors behind the Irish government rationale for prohibiting bus competition.1.) Successful lobbying of the railways resulting in regulatory capture of the regulatory arm of the government by the railway lobby.2). The interventionist tradition in economic affairs of Irish nationalism. "one major legacy of the thirties was the institutionalisation of an Irish dependence on the state"(M.Daly;1982). 3). The interventions induced by the recession in 1929. 4.) The lack of economic knowledge of the consequences of regulation. The economic case given for government intervention was based on a market failure in this sector but in reality it was legislative rather than economic.

The Road Transport Act of 1932 requires the Minister for Public Enterprise, in considering an application for a license to consider if this proposed bus service is required in the public interest having regard to the passenger road services and other forms of passenger transport available to the public. The Act does not prohibit the Minister from granting other licenses to transport operators other than Dublin Bus in the Greater Dublin area. But "To get the license under the 1932 Act you had to prove that the demand was there for the service" (J. O'Sullivan, 2003)

However until July 2000, only 7 private transport operators held licenses for routes in Dublin. Eleven new licenses in the Dublin Bus zone were granted in July 2000. There were various licenses awarded but Dublin bus monopoly was retained. Unlike private operators Dublin Bus was exempted from the requirement to hold a license to carry passengers under the 1932 Act. Dublin Bus monopoly was held in check by a drastically anti-competitive licensing application process. A "one operator per route" policy was applied and the Department's policy was to refuse an application for a license where the route sought was similar to an existing Dublin Bus route. Route licenses were given to private operators for routes not directly served by Dublin bus, like "feeder services" or "orbital services'

The legacy of the 1932 Act imposes not only legislative barriers to entry but also financial. In the Act, C.I.E companies can all self-insure but any private operator hoping to compete must get full cover insurance if it wants to participate in the market. In today's economic climate this poses a massive financial barrier to entry into the bus sector as insurance coverage has jumped to extreme levels in recent years! John O' Sullivan of Aircoach informed us that in the year ending 2002 that his insurance costs had sky rocketed to five hundred thousand euro from two hundred thousand in 2001. He felt that " this posed a massive financial barrier to competing in the Dublin market". Contrary to this John Lynch of C.I.E. maintained that the state body did not self insure, but revealed that the organisation's insurance bill of a mere five million euro provided cover for the entire company. When compared to Aircoach's insurance bill of five hundred thousand euro for one route, the amount C.I.E is required to pay appears minute and the level playing field referred to by Lynch seems to be non existent.

Over the past number of years, there has been an increase in the financial resources allocated by the government and the EU for greater investment in public transport. With state subsidies in 1999 £13.2 million was channelled through the C.I.E Group to Dublin Bus. There is no transparency in how the subsidies were allocated to the different routes and C.I.E has never identified which routes are loss-making!

Over the past few years the National Development Plan (NDP) has become a point of contention in the transport industry. Various Economists and private transport operators cite the possibility of EU funds being handed out to a state run monopoly, while there are private competitors in the same industry. Critics have stated that EU funds had been used for various capital expenditure in C.I.E and some have felt that this may be illegal. "This is certainly not in the spirit of the EU understanding and it is definitely open to challenge." (J.O'Sullivan, 2003)

Since the bus market in the UK was fully deregulated in the 1980s, the Irish government has issued various regulatory reviews. In 1985 'The Green Paper' was issued on the bus sector in Ireland. The Green Paper on transport policy presented numerous proposals for regulatory reform. It evaluated for and against liberalisation of the bus industry. However no white paper followed the review, due to the proponents against liberalisation winning out. But it wasn't long before the issue was once again under review. In 1989-1993 the National Development Plan promised to replace the outdated Road Transport Act of 1932. But the usual bureaucracies and interest groups delayed this review. The process of bringing liberalisation into the bus industry to provide greater competition was not however pursued until the publication of the New Institutional Regulatory Framework (NIRF) in the Summer of 2000

On the 7th of November 2002 the Minister for Transport Seamus Brennan delivered a statement on Public Transport reform where he set out the recommendations from the NIRF in his proposals for the bus sector in the Greater Dublin Area. The main feature of his proposal was the introduction of "Controlled competition" in the form of a franchising model for the regulating of the bus services in Dublin. He proposed *"that the first phase of franchising be introduced at the beginning of 2004, with up to 25% of the market becoming available in that year and with annual progress thereafter."* (Brennan, 2002)

The Franchising Model

The introduction of full competition into the market can sometimes lead to problems such as market power, externalities or information problems. An example of this in the bus sector might be where competition in bus services would lead to needless pollution, congestion and a lack of service integration.

Franchising, as a term in the transport industry is understood as "*an arrangement whereby firms tender for the right to undertake certain activities under conditions of limited competition"* (Competition Authority, 2001). This competitive tendering involves a synthesis of public and private roles. The public sector thus decides what services should be competitively tendered and what specifications should apply. The competitive market responds to the invitation of the government and one or more producers are selected to provide a specific period of time.

A new entrant under the franchising model does not face the usual risk associated with entering a market with a dominant incumbent. "*By winning the franchise competition, the new entrant can take on that part of the market immediately rather than trying to do battle for market share with an incumbent"* (Competition Authority, 2001). The competitive tendering rules out the possibility of predatory pricing by the incumbent and the presence of this competitive environment helps to ensure the incumbent is efficient.

For a franchising scheme to be effective service specification levels should be kept very clear and concise. These would include frequency, capacity, availability and the specific route being tendered for. Typically, franchise licenses are between 3-5 years in length, with this being decided by the regulatory board. It is imperative that the specifications be kept concise but not overly restrictive as this might hamper innovation. Some freedom must be left to the franchisee to make judgements about elements in their own sector or the worth of the model is called into question.

Various different franchise structures are used, varying on the basis of the allocation of risk between operator and contracting authority. There are 7 variations of the franchising model**:-**horizontal franchising**,** vertical franchising**,** investment franchising**,** gross cost franchising**,** net cost franchising**,** progressive franchising and big bang franchising**.** But in the Urban bus transport sector, there are 2 basic franchising options that apply. 1.)*The Gross Cost contract*: where operators take no revenue risk and receive a fixed income from the government. 2.) *Net Cost Contracts*: where operators take both revenue and cost risk.

Under gross cost contracting, competition is based on the cost at which bidders offer to supply the required service. The payment for the contract period is determined by the bid cost. Gross cost contracting has been used successfully for procuring bus services in a number of developed cities. It has the advantage of facilitating integration and enlarging the pool of competition. Cost savings over public monopolies are in the range of 20-30% with this form of franchising. But one of the limitations of the gross cost approach is that the operation has little incentive either to generate or to secure revenue!

Net cost contracting is also known as minimum or net subsidy. The incentive to generate traffic can be increased by requiring franchisees to be responsible for both costs and revenues. This makes the basis of competition the best offer for the subsidy requirement. The authorities carry no risk, except operator default or failure. The operator carries the costs and revenue risks though he/she has a guaranteed income. There is an increased incentive to generate traffic but with this comes a high incentive to engage in predatory practices against operators on parallel or overlapping routes.

The increased incentive to attract revenue may imply less need for monitoring the quality of the service provided. There will be an opposing need to monitor street behaviour. Coupled with this, the process makes integration more difficult to achieve and requires safeguards to ensure that any loss making service that is required is not being neglected. Even the allocation of compensation for reduced fares such as those for pensioners and school children is more difficult because it requires information on who is carrying the passengers.

Even so, since the net cost constraint allows operators to increase revenues by operating a service which attracts new customers it would be expected that the number of potential bidders for a tendered net cost route would be greater than that of a route under gross cost. But due to uncertainty, people who are unfamiliar with a particular market prefer at least at the beginning to go with gross cost contracts. White and Tough in 1995, found this to be true in the Urban Bus sector in London. It demonstrated that there was much higher competition for gross cost contracts than the net cost contracts. It was found that small operators, who do not have the ability to diversify risk across their operations, favoured the net cost approach less.

N Shaw in 1996 found that despite the fact that net cost contracts transfer a greater proportion of the risks to the operator, gross cost contracts have several major advantages. These are namely: lower cost to franchising authority, greater compatibility with integrated multimodal system planning, greater compatibility with complex subsidy mechanisms and lack of incentives for predatory operating practices. However, they do depend on stronger measures to monitor performance, secure revenue collection and transfer mechanism.

One approach might be to begin with gross cost contracts and move toward net cost franchises as uncertainty surrounding the newly competitive market dies down. This is what was done in London in 1997. But it created some problems with the integrated ticketing system in the city. To try and rectify this particular problem there was a move toward a system-wide smart card ticketing.

The Proposed Franchise Model for the Greater Dublin Area

The NIRF model for franchising is derived from the work of Demsetz "Why Regulate Utilities" in 1968. The Demsetz model seeks the benefits of competition by tendering for the market where there are obstacles to competition in the market. It is proposed that an independent public transport regulatory function will be established which will : regulate the bus market through franchising and licensing, negotiate public service constraints and award public transport franchises and allocate state financial support for non-commercial bus routes. This is imperative to separate government from the operation of the franchising.

Much of the regulatory framework proposed is based on the Copenhagen experience. In the franchising model, the state will define the bus service and will invite tenders for its provision. The winning tender will have exclusive rights to operate services on particular routes for a specified amount of time (normally 5 years). The winning operator will either pay to operate the service exclusively, or will receive subvention. The type of franchising model used will depend on whether the route in question is profitable or not.

The independent regulatory function will ensure a quality of service and keep the integration of the public transport network. Its main objective will be to ensure a level playing field for all operations and maintaining contestability and competitiveness in the market place. The framework proposes a 3-phase transitional period to a fully franchised bus market. But it is envisaged that the regulatory body will begin franchising the core network in late 2003 or early 2004. With a process of 25% being franchised each year, probably leading to franchising of the entire network by 2006/2007, John Lynch is of the firm belief that it is pending union support and is not by any means guaranteed. It follows that the progressive process of franchising, which experience in other countries suggests is the best incremental approach.

The Rationale Behind the Proposal for "Limited Competition"

In Britain in the 1980s, full deregulation was introduced to the bus sector with the exception of the Greater London area where the franchising model was introduced. In 1984, an Act of Parliament was passed which required competitive tendering of bus services to begin in London. In 1985 the tendering for bus routes began.

Cox, Love and Newton in 1995, found in a study on the "Expansion of Competitive Tendering in International Urban Transport" that since the introduction of the franchising model to London in 1985 bus services had increased by 26%, while the total cost of bus services declined by 27%. With a 42% reduction in cost per vehicle kilometre, the operating margin for all bus services had climbed from 60% in 1985 to 89% in 1995. A hard hitting figure of £3.4 billion was saved from 1985 to 1995 in bus operating costs from the combined effects of competitive tendering and competitive pressures. In Copenhagen, positive results of the franchising model were found. Since its introduction in 1989 there had been a 20% reduction in inflation adjusted costs per mile of bus services.

But in their report it was found that not just in London but throughout the developed world competitive tendering has saved money for governments, kept fares affordable and expanded services. Competitive tendered services have been less costly, with virtually no reduction in service levels or service quality. Urban transport operator costs have been reduced in response to competition. The results have been significant with system-wide cost per vehicle kilometre reduction from 19% in Perth to 33% in San Diego and other cities around the world experiencing approximately a 25% reduction. The best results were achieved where there is a separation of politics from operations.

These figures are supported by the Irish Competition Authority Report in 2001, which found that there had been a 30% reduction in operating costs in the last decade in the London Bus market. With fares not increasing in real terms and service level improving, it was also found that there had been an increase in patronage and a marked decrease in subsidy levels. The report found that service levels in London were superior under the franchising model than under the model of full deregulation that had been applied to the rest of the UK. It was felt the reason behind this was due to the franchising model maintaining the degree of co-ordination and integration between competing operator's services since the acceptance of the tender is made under strict guidelines. The very nature of

London’s tendering system led to better operations by maintaining the overall ticketing system, which allowed co-operation between different operators.

In contrast, it was found that the most negative of outcomes under liberalisation was a decrease in patronage. This was attributed to some extent to the loss of integration and co-ordination since competing operators are reluctant to enter into agreements with competitors. In recent years however, this problem has been overcome with the establishment of “Quality Partnerships” in the UK due to the co-operation between local authorities and bus operators on issues of integration. This agreement has led to increased productivity and quality in the deregulated market. The report though poses a very interesting question: *“It is possible that the management of the transition to a deregulated market is what failed in the UK and not the deregulation itself”.* (Competition Authority ,2001)

The Report concludes with the recommendation that the franchising model seems appropriate for the bulk of services in the Greater Dublin area. However, other models may be appropriate for outer suburban routes and that the independent regulatory function should have the flexibility to develop alternative approaches to different markets. Transparency seems to be the key in its recommendations and the design of the tendering system is of utmost importance.

The Isotope Report in 2000, which carried out a survey of authorities and bus operators from 109 European cities found that deregulated markets have theoretical and empirical advantages. In terms of efficiency in production, regulated markets have efficiency in terms of consumption. But, limited competition through franchising may have advantages overall. It was felt that if the political will and technical competence were present then the limited competition regime was the best choice because stability of the system can be maintained at lower cost with the prospect for further improvements.

It seems even advocates of full deregulation such as J. O’ Sullivan of AirCoach, see the advantages behind the franchise proposal. He feels that total deregulation in an environment like Dublin will only further the chaos in Dublin, with the infrastructure problems, road space and gridlock issue. He also feels that the franchising model has all the efficiencies of a competitive deregulated market without the negative issues associated with full liberalisation and that “*it was absolutely the right way to go.”*(J.O’Sullivan, 2003).

Criticisms of the Franchise Model

Although the proposed Franchise Model, based on competitive tendering, has been widely adopted recently, both in other EU states and elsewhere, it has not been without valid criticism and even staunch opposition from many economists. The model has been deemed both theoretically unsound and practically flawed and we shall now evaluate such claims.

It is a maxim of economics that the market works best for the increase in efficiency if it is left alone. Any argument for intervention must be made against that assumption. Franchising does intervene in the market process to a certain extent, and therefore the Franchising Model must be open to the risk of doing more harm than good.

The N.I.R.F maintains that "Franchising can push a market towards being perfectly contestable, by winning the Franchise competition, the new entrant can take on that part of the market immediately rather than trying to battle for market share with an incumbent". Thus by obtaining the Franchise the new entrant therefore becomes the sole incumbent, for a period of five years no less. However even basic economic theory asserts that a contestable market is one in which the positions of the incumbent firms are easily contested by entrants.

Indeed Barrett (2001) observes that "the policy implications of contestable markets are that governments should not ban new entrants and should remove obstacles to competition". In reference to the Franchise Model, John Hibbs of the University of Birmingham was of the opinion that "*conventional wisdom has it that this (franchising) means 'competing for the market' instead of 'competing in the market': an aphorism that makes no sense in economics, since the market is where competition takes place. It would be better expressed as 'competing for a monopoly*"(1997). If the Franchise Model is simply a mechanism to rid the state of its inefficient monopoly, and to subsequently replace it with a private monopoly of sorts, how then can the consumer benefit from the effects of market competition?

The "battle for market share" usually results in short term gains for the consumer, followed by the provision of competitive service by a producer who is wary of further competition around the corner. However, the NIRF report takes pride in mentioning that this "battle for market share" will not occur, a point highlighted by Barrett(2001) "*The failure to permit market forces in Irish public transport involves excess costs to users, creates economic rents for producers and signifies regulatory capture of the government as regulator by the protected company*".

The extent to which the franchise model can benefit the producer rather than the consumer is also established by Hibbs, "*Management is free to operate for the set period of years in the knowledge that there will be no threat of competition* *over the route. From the investor's point of view the degree of certainty that the system provides is an attraction*"(1999;14). This school of thought contradicts the conclusions of the Isotope report which suggested that although a fully deregulated market would have theoretical and empirical advantages in terms of efficiency of production, regulated markets had theoretical and empirical advantages in terms of efficiency of consumption.

Not a Franchise Model in the Traditional Sense

One must also consider the context of this 'franchise' model, which is very different from the high street version. In a traditional sense, the term 'franchise' relates to an outlet where the franchisee sells goods or services to a guaranteed standard, paying for the use of the franchisor's reputation and style, in a highly competitive market. In this instance the 'franchise' is not as much a threat to competition as the proposed franchise model for the bus sector would be.

McDonald's still have to compete with local chip shops for their custom If consumers are unhappy with the service provided by McDonald's or if the rival chip shops provide a cheaper service, then as in any competitive market the consumer is entitled to make an informed decision.

Competition for the market has proved to be a success in some areas as previously documented. However, the model does seem to be most adept in ensuring competition occurs in areas where a competitive market is difficult or impossible to obtain and where few economists have any objection to its use. Barrett identifies areas such as the air traffic control sector where competitive tendering "*brings competition to a sector whereas airlines shopping around between competing control towers is impracticle*". (2001;10)

Stifling Innovation

Another bone of contention among detractors of the franchise model is that it accommodates bureaucracy and stifles innovation. One of the positive externalities of competition is that inefficient bureaucracies are consigned to the scrap-heap. Unfortunately the franchise model provides sufficient scope for such bureaucratic tendencies in the sense that it may give power to people who are "at more than one" removed from the market, thus creating extra layers of communication which can result in time wasting. John Lynch cites the Copenhagen regulatory body as a prime example of how the franchise model can promote bureaucracy. He states that the body " *was vastly over staffed with 300 people which lead to bureaucracy and in turn low levels of productivity."*

The franchise model will inhibit managers who wish to increase the frequency of service or attempt slight alterations of routes as demand sees fit, due to restrictions which are expected to be rigid in terms of route deviation. Professor

Hibbs observed of the London experience that "*franchising can only limit the freedom of managers to innovate and to do so at their own risk. For franchise means bureaucracy. And bureaucrats, administering public funds, must not go into the risk business* (Hibbs and Bradley, 1997). Those who are to administer public funds to the franchisees in Dublin have yet to be established of yet, but there is a demand that this body be independent of political influence as to minimise the potential of bureaucracy or indeed corruption.

The franchise model will also "in effect" create private monopoly's on routes, and in general monopolies tend to be inefficient according to John O' Sullivan of Aircoach "*Any monopoly tends not to be lean and efficient, it tends to be overburdened with extra layers of management which don't really add any value….consequently decision making can take a long time and therefore is expensive".*

Problems in The Competitive Tendering Process

The franchise model is not without fault at a practical level either, and many of these faults could be exacerbated by certain factors present in the Irish economy. Primarily, one of the main practical concerns is regarding the possibility that the bidding process for the franchise of certain routes will not be competitive. If few firms put forward applications during the tendering process, then the firms involved may decide it is in their best interest to behave in a oligopolistic manner through collusion and signalling. This would involve the firms engaging in private consultation on prices and attempting to carve up the market to best suit each other's needs and not necessarily to suit the best need of the consumer. What could follow competitive tendering in this instance? A market where the competitors refuse to compete and collude with each other to their mutual benefit. Although the Competition Authority has produced a paper on "Detection and Prevention of Collusive Tendering in Public Service Contracts", this possible drawback of the franchise model needs to be addressed in far greater detail. The regulatory body may need to reserve the right to abandon a tendering process if it has evidence indicating that collusion has occurred.

Another assumption in which confidence may have been misplaced by the department is that *"the more competition there is in the bidding process the greater the expected efficiency of the winning firm*" (Competition Authority, 2001;62) However, the uncertainty which will no doubt accompany the first round of competitive tendering may induce some eager firms to price themselves so competitively that they may not be able to provide an acceptable standard of service. Thus they themselves may eventually go out of business, while the consumer is left with an inadequate service. Conversely, many services currently provided by Dublin Bus are not profitable because of the inefficient manner in which they are run, therefore some firms who obtain the franchises on these routes may be able to achieve supernormal profits.

The False Legacy of London?

With all of the above in mind, one must question how the N.I.R.F came to the following conclusion that "*it is clear that the franchising model is the optimal regulatory solution to manage the development of the core urban bus network*". (N.I.R.F, 2000) Indeed Barrett (2001), ponders why they were so quick to dismiss on road competition. It appears, at least to these authors that the N.I.R.F proposals were predominantly based on findings derived from the franchising experience of London compared to the deregulation of cities and areas outside of the greater London area. Recently, whilst the number of people using buses in London has been increasing, the number in the rest of the country has slightly declined. This conundrum has led to the simplistic conclusion that the 'London franchise system' works better than the deregulated market which exists in the rest of the country. This could be a red herring according to Professor Hibbs (2000) who believes that "*London is not comparable with provincial cities, central London is large enough to have bus and tube services that cater for the demand of the central areas alone. In London there is an established market for such travel: people do not, to any significant exten,t use buses to travel within the centre of cities like Birmingham or Manchester*". Hibbs estimates adult commuting in central London at 80% and 40% for the city on a whole, compared to a National figure of just 7%, leaving us in no doubt as to attractiveness of the London market to bus companies.

Jakee and Allen contradict the Isotope Report which outlines that full deregulation causes problems of integration, instability of supply and greater inequity in the levels of service. They suggest that much of this evidence in the UK is anecdotal "*But the substantiation of numerous claims of ill-conduct, such as hazardous driving, is practically non-existent even by* contemporary economists". Ms Anne Nolan of Trinity College Dublin found that the level of service within the cities outside London has not declined and in some cases had improved in the routes where mini-buses had been introduced. The final question the N.I.R.F should ask themselves is 'Can we compare Dublin, a city with a population of roughly a million people with that of greater London with a population of roughly seven and a half million people?"

Conclusions

The franchise model has emerged as many people's favourite option to replace the state monopoly Dublin Bus. The model has some positive attributes, not least the fact that it appears to provide a compromise between a state monopoly and outright deregulation. However, economic theory would suggest that rather than push a market towards being perfectly contestable, the franchise model restricts entry to the market preventing the consumer from obtaining the benefits of competition and the improvements in technology which might occur within the window period of five years.

The Competition Report's acknowledgement that " *it is possible that the management of the transition to a deregulated market is what failed in the UK, not deregulation itself*" (Competition Authority, 2001) has many implications. First and foremost, the market had not necessarily failed and that it was the poor implementation of the theory rather than the theory itself which failed. The loss of patronage evident in the deregulated bus market in areas outside London was attributed to a loss in integration and co-ordination since competing operators were reluctant to enter into agreements with each other. No doubt this may also prove a big problem if Dublin were to enter into a predominantly deregulated market.

However, it is not beyond the bounds of possibility that adequate integration cannot be achieved by a regulatory body within a deregulated system. The level of integration required would have to be high as Dublin's streets are notorious for their narrow congestion, and the confusion which may accompany deregulation would need to be kept to a minimum. According to John Lynch, this can be attributed to Dublin's medieval street structure which has traditionally caused problems for Dublin's infrastructure.

The establishment of an independent regulatory body would be of primary importance, and it is imperative that this body would be transparent in every facet of the organisation. This organisation would have to be strictly independent of government intervention and its main role should be to as a watchdog and co-ordinator over the industry. The success of the proposed model may hinge on the government's ability to learn from other countries' mistakes, such as the bureaucracy encountered in Copenhagen and the lack of co-ordination in the London model.

The proposed franchising model represents an attack on the inefficient structure of the Dublin Bus market without what we feel is an appropriate strategy to tackle the infrastructure problems that plague Dublin. The apparent lack of any National transport policy is a major concern and renders the introduction of full competition into the Dublin Bus market highly improbable. In conclusion, we feel that the proposed model can be made to work if it sticks rigidly to its two primary objectives of providing a better service for the consumer and reducing costs for the operators. The franchising model will be an improvement from the current situation. However monumental efforts should be made to tackle Dublin's congestion problems thereby paving the way for the possible introduction of full competition, so consumers can reap the same benefits from the bus services as they have in the airline and taxi industries.

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COST-BENEFIT ANALYSIS OF THE DUBLIN LUAS LIGHT RAIL PROJECT

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The Luas is due to cut journey times from some Dublin locations in half. Planners are telling us that light rail is the solution to the increasingly congested Dublin Streets during peak times. 800million euro will have been spent on the Luas by the time it is opened in early 2004. Oliver Fegan investigates how the benefits of Luas will pay back this huge investment.

Introduction

Dublin has come to a halt in recent decades due to an overwhelming increase in annual car purchases. In some periods, 1,000 new car registrations were granted a week. Numbers travelling during peak travel hours have increased from 172,000 in 1991 to 428,000 in 2002 (Keegan, 2003). Journey times in this period have increased by over 50%. To add to this woe, public transport has undergone minor adjustments in this time frame, leading to serious questions being asked and significant answers being sought. Although various alternative means of public transport were looked at, few were studied in-depth, so viable solutions were slow to present themselves. After so-called "intense research", policy makers came to the following conclusion: the Luas Project is the answer to our problems, the golden solution or our "White Elephant". This great hope met problems in both planning and construction, which have put in doubt the viability of further lines due to cost constraints and productivity limits.

With these factors at the fore of current Infrastructure planning debates, I sought to examine the initial Cost Benefit Analysis (CBA henceforth) undertaken on behalf of the Dublin Transport Initiative, using their conclusive figures, and analyse them against current cost and benefit estimates. In doing so I hope to shed a light for further public transport planning projects. I shall conclude my essay by looking at the alternatives we should examine in tackling the dire mess that is Dublin Public Transport.

Foundation of Luas Plan

The need to form a plan was evident from all corners. 32% of the Irish workforce are based in Dublin. Travel demand in the Dublin area is projected to grow by 72% by 2016, reflecting a growth of population, employment, economic activity and households. (Sunday Business Post, 16/09/2001) The government has pledged over 17 billion-euro to the radical transformation of public transport services within this timeframe reflected in the NDP. This substantial figure reflects the urgency and necessity of action. The Luas Project can be traced back to 1988, when the minister for the environment established the Dublin Transportation Review Group. It had representatives from the relevant government departments, local authorities and CIE. Its aim was to review transportation policy for the Greater Dublin Area (DTI, 1994;1). In September 1991 the DTI completed a 20-year study of Dublin transport, highlighting historical trends. The second phase began in February 1992 and had three objectives:

- Creation of a LRT strategy until 2011 for the Greater Dublin Area.
- Preparation for a medium term investment and implementation programme for the period 1994-1999, drawn from the DTI Strategy.
- Putting in place a continuous transportation planning process.

With these objectives in mind, the Irish Marketing Surveys Ltd conducted both qualitative and quantitive research to ascertain public opinions and attitudes, to various forms of current and prospective transport. These public opinions were and still are important in transport planning.

Table 1. Project Approval Ratings

Project	M50 Motorway	Quality Bus Corridors	Expanded Dart Service	Luas LRT	Other
Approval Rating	92%	89%	85%	85%	76%

Source: *DTI Public Consultation 1994*

The approval ratings for the various modes of transport draw attention to the fact Dubliners in general see any potential project as a step in the right direction, hence they all score high approval ratings. When LRT project was given the go ahead, the public in general were satisfied something was at last being done to tackle the situation. In October 1994, the government requested that CIE should begin preliminary work on the establishment of the system. £200 million was allocated for this purpose. The McHugh Transport consultants undertook the preliminary work for the project. They began to develop an environmental impact statement, on behalf of the CIE in December 1995. These were the foundations of the current Luas project, obtaining support from business and general public, but to obtain funding and political viability, the project had to illustrate its overall feasibility through a Cost Benefit Analysis.

Cost-Benefit Analysis

Cost-Benefit Analysis (CBA) is a "practical way of assessing the desirability of projects, where it is important to take a long view and a wide view… i.e. it implies the enumeration and evaluation of all relevant costs and benefits" (Georgi, 1973;3). The reason why CBA is used for this type of capital-intensive project is that it is good for organising expenditure according to function and performance. When undertaking a project estimated at £200 million, where operating costs will not reap profits to pay back construction costs, other benefits are relied on to balance or justify the cost. We are all aware, that we have limited economic resources to improve our infrastructure. So it is economically desirable to allocate them efficiently, in order to gain a maximum overall rate of return.

The broad range of issues, dealt with, in the CBA include 'land-use, social impacts, environmental factors, public attitudes and technical feasibility in the assessment of different modes of transport' (LRTVol6: 1995;12). Issues involving the cost include whether funding is sourced from, EU, national or private investment. In order for any project to get the go-ahead, it had to meet certain criteria. It had to:

- encourage economic development, regeneration and employment.
- Improve reliability and quality of travel
- Improve access in an international and national context.
- Be coherent with development plans of the city and outlying regions.
- Meet financial and time-scale goals efficiently.

According to the DTI Technical Volume 6 of the Light Rail Project, the Luas Plan exhibited these critical factors. Thus it passed the planning phase and finally entered the construction phase.

Costs of the Luas Project

Proposed Costs

'The actual project costs are the value of goods & services, that are required to establish, maintain and operate a project.'(Georgi, 1973;18) The Luas planning office estimated their actual cost would be £220 million in 1994. This figure was arrived at when a sensitivity test on capital cost of the LRT project was carried out. However this figure was quickly revised to £260 million due to additional costs. The initial cost estimate per kilometre, for the 39.3 km project was £6.6m. This is more expensive than Manchester. Sheffield cost £8.1m per km, Nantes and Grenoble both cost approximately £11.8m/km. Therefore the cost estimate was below the average of most Light rail projects. The cost figure includes diversionary public utility works, which must take place well in advance of the track laying contract, the cost of the actual track-laying contract, purchasing of land and other unavoidable costs. For many reasons the figure of cost is grossly undervalued. The £40 million rise indicated that certain elements were unaccounted for, in the initial summation, which could possibly inflate the actual cost even higher. In an article 'Light Rail – Pricing itself beyond cost-effectiveness', examples of British projects, which were abandoned due to the funding realities, depicted a bleak picture for British light rail. The Dublin-Luas project started escalating in price once governmental contracts were signed. San Diego, the site of the first modern US light rail project, is regarded as the model for others to follow. It followed a strategy of lowest possible cost by eliminating unnecessary frills. This £260 million figure represents the 'no frills' policy. However in reality, Dublin's narrow roads would not be able to accommodate new lanes as in San Diego, hence costs began to inflate, as some frills were necessary for construction to begin (complicated diversionary works).

Connex a French firm will be operating the Luas. Therefore if operating losses are incurred they will lose money. This will relieve the government or CIE, of the task of operating the Luas, so no operating losses will affect the state.

Actual Costs

The actual costs of the Luas, paint a different picture to that of the surreal planning optimists who said costs would be £260m. Cost estimates have escalated to €800m or £630m. This equates to just over £16m/km. This figure is nearly 300% more than expected and marks a massive failure on the part of planners. According to Ger Hannon (Strategic Planning and PR) of the Luas Office, they defend this figure, by stating 'property acquisition prices were responsible for the hike in cost'. The main additional cost comes from city centre property acquisitions such as those on Benburb St, Mary's Street and Capel Street corner. Inflation has been extremely high in the Irish property market, but to account for most of the 300% is unbelievable considering some sites were purchased in the late 1990's. Due to the time delays, workers on the line were employed longer than required, with constantly increasing wages, this pushed up the wage bills, thus increasing costs. It will be 10 years from when the CBA was taken in 1994 until it is operational in 2004. In that time, the Irish Economy has progressed like never before and as such costs have increased exponentially due to the delays in construction.

On the 11th January 2002 the Rail procurement agency was set up. It took over the responsibilities of the CIE light rail project office. It was reformed in order to improve the possibilities of public private partnerships (PPP's) in order to minimise future cost. Although PPP's do not play a significant part in the first phase of the Luas project, they are increasingly more important. The European Regional development fund (EDRF) contributed 82.5m-euro per line to the Luas project through the national development plan (NDP). The Luas plan seemed attractive early on, when this 165m-euro was half the estimate of the time. But now it is only 15% of the total cost.

It has been generally assumed that the operators Connex will break even or make a small profit from their venture into management of the Luas. However historical evidence shows us a different conclusion. Cities with both Bus and LRT services had a direct correlation between the two fare boxes. Cities with low fare box to operating cost ratios for buses, tend to have a similar relationship for light rail. Dublin Bus has experienced heavy losses, therefore allowing the possibility for Luas to do likewise (however it should be pointed out Luas will be operated in private hands, unlike Dublin Bus).

Table 2. Operating Costs covered by fare box revenue as a %

City	LRT	Bus
San Diego	89	40
Geneva	130	69
Portland	53	30
Nantes	113	48

Source: Steer Davies Gleave DTI Tech Vol. 6

Benefits of the Luas

Proposed Benefits

"The proposed LRT network is forecast to achieve significant transfers (in excess of 8,000 trips in the 2011 morning peak) from car to public transport and will bring considerable gains to public transport users". (DTI, 1995) By comparison QBC's will only attract 2,000 over 9 new bus lanes.

In order for the benefits to outweigh the costs, the monetary value of the costs (£260 million) must be outweighed by the perceived benefits. In many cases the benefits do not have monetary values, so we must ascertain what their likely value would be. Although I could not locate how the DTI office calculated their proposed benefits in the CBA (in monetary terms) and this project is not large enough to work them out for myself, I have used examples from the rail industry case study in Ireland. This provides a similar comparison to the Luas, as both aim to take market share off bus and car transportation elements of Irish society.

The government had decided they would invest the necessary funds, to tackle the congestion problem. They realised LRT would be cheaper than a metro system and provide a better service than the bus only alternative. In environmental terms, the Luas was the most-friendly mode of transport. It would greatly reduce emissions at street level, which would significantly improve city life for everyone. In a 1974 study, the cost per mile of a bus in terms of air pollution was 2.78p (Barrett, 61). In real terms it would have risen exponentially due to the recent environmental problems. Hence the Luas would reduce this negative effect of the bus. Similarly, LRT has proven to be a far safer mode of transport. In 1979, a fatality was given a value of £70,000, with the Luas reducing accidents; further benefits can be achieved here. At the least, reducing traffic on the roads might make travel safer for cyclists and pedestrians. Travel times will be reduced because of the Luas's segregated tracks. This will result in large timesavings by commuters, where they would have increased leisure or work hours, increasing their utility. The Dublin Transport Office declares the main benefit of LRT is that it is 'affordable'. They state it is the 'cheapest and best value form of mass transit' (DTO web-site, 2002). Cost estimates contradict this benefit. It has been argued that it rivals the car for convenience, offering seamless journeys and it is accessible to all disabled groupings.

Light Rail has rejuvenated its surrounding areas across the world, increasing property values and general prosperity. The Dockland in Portland Oregon has been completely revitalised due to light rail, so too has the docklands area of London in the 1980's. In Manchester and Sheffield, light rail has been particularly successful in restoring commercial prosperity in decaying towns. (LRTA Fact Sheet No.62, 1998) Tallaght and Dundrum areas of Dublin have seen progress already due to the Luas. Two new town centres have begun construction, which will lead to economic growth in their vicinity.

In an article by the Light Rail Association, an argument put forward stated, 'only rail borne modes can in practice get people out of the car'. In Manchester after the 'Metrolink' was inaugurated, 13% of passengers transferred from car travel and

55% of people on shopping excursions also switched from the car. From the experience of other cities, such as Nantes, Montpellier and Sacramento, expected levels of patronage have been greatly exceeded, once the service was put in place. This proves that the Luas should reduce car travel on its routes. However in the short run, with only 2 lines, congestion should not decrease significantly in the city centre and due to the cost, further lines may not be constructed. In saying this a technical paper published by the Australian assembly pointed out that between 1986 and 1996, 25 European cities with mixed tram and bus systems but no underground or metro increased their transit trips by an average of 20.3%. This compares with 22 bus-only cities, which during the same period lost an average of 5.6% (LRTA 2001). This reiterates the need for light rail as it will rejuvenate the Irish public transit market.

Actual Benefits

'The benefits of a project comprise of all the positive effects, less the negative effects, resulting from the realisation of the project regardless of whom they fall to. This is known as the 'with or without' principle. (Georgi, 1995;19) In the case of the Luas project, it is not operational so the actual benefits will not be completely in play for another year. However this theory indicates the 2,280 people, who can travel on the line in any hour, will benefit us all. According to the DTI report, the Luas will increase rush hour capacity by 19%. So travel times on these routes will improve by a similar figure, as other modes of transport should be less congested, due to the extra capacity.

Since this plans induction, positive actual benefits include the boost to social and economic prospects of the surrounding area. The Luas plan has coincided with the Harp project, to revitalise the north inner city, including Smithfield, the fruit & vegetable market and Abbey/O'Connell St area. I contacted the Inchicore/ Kilmainham County Council, asking 'how the Luas has effected their district?' I was told the area has improved since the mid 1990's due to the Luas. A new affordable housing scheme has been initiated. Apartment complexes and new amenities are planned for the Mount Brown and Richmond park areas as well as the infamous St Michael's Estate area. The county council put these increases down to increased demand for the locality due to the marketability of a house near the Luas line. Between 1994 and 2001, over 16,000 new houses and apartment facilities were built in the vicinity of the Luas track in South County Dublin.

While this has served to revitalise these areas, the dramatic increases in population all along the route, could create over-congestion on the Luas in the beginning. This could result in negative press and long-term problems for the Luas. The Chartered Institute of Transport (CIT) cited in a report that the most cost-effective capacity range of light rail is between 5,000 and 15,000 passengers per direction per hour. (CIT 1991;1) The Luas, with an hourly capacity of 2,280, on a route with increasing population, will neither be cost effective nor have large enough capacity to meet demand. Hence the proposed benefit that the Luas will soak up extra demand will not ring true. This highlights that whilst the Luas has revitalised areas, it might not induce long-term growth due to under capacity.

LRT has been most successful when it has been part of an integrated public transport network. Luas does act to integrate the services available by linking Heuston and Connolly stations. However despite claims by CIE, DTO and the Luas Office, it is not and will not be fully integrated with Dublin bus services. The use of feeder buses will not be exploited by current plans. Connex CEO Mr Antoine Frerot confirmed that if Dublin Bus was to be privatised or liberalised, they would tender a bid to operate the service. He stated they would use an 'integrated ticketing system enabling passengers to transfer onto other modes of public transport'. (Irish Times 02/12/2002)

Finally British Deputy Prime Minister, Mr John Prescott stated in 1999 that trams were too expensive and offer no solution to traffic problems. He claimed an upgraded urban bus system can do as good a job as light rail (LRTA Fact Sheet No 83, 1999). This would leave a more favourable balance for the CBA.

Cost-Benefit Analysis of Luas

The Cost-Benefit ratio of the project at the time of the initial calculations was 1:1.76. In monetary terms this meant that for the £220m investment, the benefits are equal to a monetary value of £387m. By this analysis, conducted by Semaly Ewbank on behalf of the DTI, the benefits far outweigh the costs. Even a 70% increase in costs would still maintain an overall benefit. For any project to rise 70% in costs, either the cost projections were flawed in the first place or the economy is entirely unstable. The first explanation seems most likely here. Eoin Keegan of the Dublin planning office put this point forward by highlighting that most capital intensive projects in Ireland both lower cost prediction to ensure funding and are flawed by not setting rigid targets, which if not met will result in penalising the firm that is delayed. This would ensure the targets are met. The Luas project is now estimated to cost 800m euro (£630m app.), a far cry from the original estimate. This has spiralled the initial CBA estimate upwards, where the cost benefit ratio is now 1:0.35. Therefore if the cost estimates figure was the current 800m-euro figure. Costs outweigh benefits nearly 3 to 1, rendering the project obsolete. To explain why the project should not have gone ahead with these data tables, the DTI report puts it best. "A citywide Dart network with tunnels and underground would cost £600m and as such would be prohibitively expensive. The high cost of the city cost £600m and as such would be prohibitively expensive. The high cost of the city wide Dart extensions outweigh all quantifiable benefits…such as demonstrated by the results of the CBA undertaken by the DTI'. (DTI Tech Vol6, 1994;34)

Finally due to the fact that Dublin in a low-density city, it is most suitable for buses to serve the mass transit needs. They can reach more people on a wider scale, for less cost than the light rail engineering solutions. Contrary to the DTI report findings, the modal share of Dublin Bus has increased recently (to 21% in 2002) whilst the share of travel by car has decreased slightly to 70%. During this time heavy rail has decreased its patronage with large investment, whilst Dublin Bus has experienced low levels of investment.

Alternatives to the Luas project

When the DTI undertook its study of Dublin public transport, 3 options were studied.

- A comprehensive bus based option.
- An extended citywide DART infrastructure.
- Combined LRT and Quality Bus Corridor Option.

Since then the minister for public enterprise Mary O'Rourke TD has launched the initial process for the development of a Dublin Metro Project phase one.

The comprehensive bus option was turned down because it would not have sufficient capacity to cater for the demand forecasts. It would not relieve city centre congestion. Finally it would not be as successful as either the Dart or Luas in attracting car users or aiding economic regeneration or social cohesion.

The Dart based option in contrast would attract cars and aid economic revitalisation. Journey times would significantly improve citywide accessibility. However this option would be prohibitively expensive and have an extremely long construction period.

The proposed Metro project, which was ignored in the preliminary DTI report, was left out because the benefits of its existence do not outweigh the costs. The costs continue to rise whilst the benefits will not. In fact, across Europe and the USA, public and political support for metro projects are dwindling due to the cost and negative social benefits including crime and safety issues.

Solution

In my opinion, there is no golden solution to the Dublin congestion crisis. No one service will cure the chronic state of Dublin public transport. In reality a combination of factors only can relieve the pressure put on our city streets. I believe the Luas, although it has become an overly expensive project is a step in the right direction. But by itself will not greatly improve the situation. The Port Tunnel will alleviate many trucks from the city centre and legislation needs to be passed to provide set hours for city centre delivery, so as not to coincide with peak hour traffic. QBC's are a relatively cheap alternative to the Luas. Eoin Keegan stated that bus lanes will be given greater priority in the future. In my opinion continuity is their problem. On the north and south quays in Dublin, they stop and start too often to effectively tackle traffic. If QBC's were given dedicated lanes like the Luas will have, they would be just as efficient, without public work diversions needed. In time if they are not working adequately, it would be possible to change them into tramways.

When planning the Luas, a provision should have been made on their routes, to allow for a segregated bicycle lane. Public opinion in Dublin favours bicycle use (as demonstrated in the DTI Public Consultation Report), if provisions were put in place, making it safe to travel by bike, I believe the lanes would be utilised. This would be achieved at a low cost, whilst also being a healthy option. Congestion charging in the city centre would not be possible now, as no viable transport alternatives are available for the mass transit needs, but when there are alternative modes of transport, London's lead could be followed. In Mannheim Germany, they have an area of integrated transit lanes covering 1km. This is where buses share the tram's segregated track, in effect sharing the cost of the project, thus increasing their benefits for the same cost. This should be done along the Quays in Dublin, to utilise the tram tracks more effectively (LRTA, 1999)

Finally, the Chartered Institute of Transport states that due to the cost of Light rail, "buses will still provide the principal solution to the majority of urban transport needs. Accordingly they need to be assisted through priority measures and integrated with light rail" (CIT, 1991;120). Therefore we should continue implementing schemes to improve bus services such as QBC's and priority traffic light systems, to enable the mass public to avail of a efficient and rapid transport system.

Conclusion

In conclusion, the Luas has evidently gone over budget and outside the CBA ratio. This deemed the project unworthy of the investment it received and as such a failure. The main reason why the project was delayed and went over budget, was because the original plan literally only stated where the tracks would be laid. Inexperienced contractors undertook this project, with the wool over their eyes, hence they met difficulties as they were operating on a 'trial and error' basis. Both Manchester and Sheffield can be regarded as pioneers and despite hiccups in the early stages are now very successful. Planned new systems can now be spared from going through that expensive learning curve thus bringing down the cost of light rail (LRTA 09/2000). Lines A, B and C in Dublin represent our Manchester and Sheffield experience. Therefore new light rail lines, if constructed, will inevitably cost less than the first 3 sections. I believe the biggest problem we could have, is that we neglect further investment in order to avoid a similar failure. We must begin a new project sooner rather than later but make sure we keep a watchful eye on the CBA.

The main use of this project is that it is a valuable learning lesson for Irish planning. By 2016, vast improvements still can be made but we must consider the cost element of projects more rigorously, The Luas LRT projects still represent sound transport initiatives, this is evident from LRT abroad. I think we must be both more realistic about their cost and time scale to construct. Finally we must point out the overwhelming evidence, which states that opinions on LRT before construction and after, always tend to favour it with the passing of time (Evidence includes the cities of Buffalo and Manchester among others). If this is the case in Dublin, few people will remember the cost element of the project and all will focus on the benefits.

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