

# Thinking in decades and centuries

## The decline in the incomes of workers in Europe and the USA

*Anthony Scholefield*

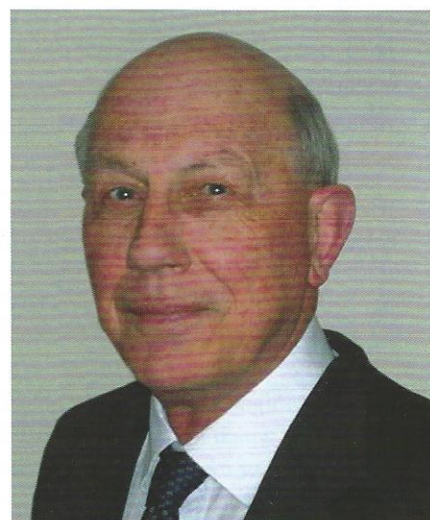
**B**leak economic forecasts are now commonplace. Officials and commentators speak of a decade at least of economic standstill or even economic contraction. From polling evidence, it seems these analyses are regarded as correct by the population as a whole.

This analysis considers that the pundits and the population are correct and seeks to examine the roots of the malaise. These roots are deep.

The relative decline of the median (average) British earner of labour income, which is a major constituent of national income, is one of the most important economic problems to be addressed by British governments. This decline is relative both to the earnings of the highest paid earners of labour income (the top 20 per cent) and the earnings of capital. The decline is also relative to the earnings of labour income in the world as a whole. The same problem faces the labour incomes of median workers in the US and Europe. The US median wage income has shown no increase for 30 years in real terms. Real hourly earnings in 2008 were actually 12 per cent below those in 1973, albeit these were partly a reflection of the participation of a greater number of low-earning female workers. Depending on the bases used, US household income, augmented by more female labour participation, has shown a small increase or no increase at all.

This trend has intensified in recent years. According to Neil Irwin in *The Washington Post* (2 January 2010): 'Middle-income households made less in 2008, when adjusted for inflation, than they did in 1999 – and the number is sure to have declined further during a difficult 2009.'

On September 16th 2011, the US Census Bureau reported that real median US household income was 7.1% less than in 1999. Male full-time worker real earnings were lower than in 1978.



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Median wages in the UK were stagnant from 2003 to 2008 despite GDP growth of 11 per cent in that period, according to The Resolution Foundation Commission on Living Standards' report of July 2011.

This relative decline has deep roots, as shown in this analysis.

The solution requires the establishment of profitable economic activity which will lead to increased labour demand and, therefore, higher wages. Profitable activity will attract and sustain capital investment. The critical steps are:

- To increase skills so that labour can compete with low-cost countries.
- To increase capital intensity per worker so that labour can compete with low-cost countries.
- To reduce the regulatory and tax wedge so that capital and labour both benefit from increased efficiency.
- These steps also require the activities of the welfare state to be reduced so that the tax and regulatory wedge can be reduced.
- Labour immigration which does not bring its own relevant capital, and which imposes net social costs, is a factor reducing labour income and capital per head and should be stopped.
- The return to currency which maintains its value. Depreciating the value of currency is not neutral in its effect; it transfers income and wealth from the average worker to the issuer of currency, that is, government, its beneficiaries and employees and to the first recipients, the financial sector. It also destabilises international trade.
- The establishment of true accounting for government and for the economy.

## Introduction

The famous economists of the past, with different philosophical approaches, rarely agreed on many things. However, it is interesting that Ludwig von Mises of the Austrian School and Friedrich Engels, Karl Marx's associate, from completely the opposite ends of the theoretical spectrum, both identified the

problem facing the income of labour in developed countries following globalisation.

There is a three-fold phenomenon.

First, the English working class, or earners of labour income, which is the largest component of national income and, later, the working class of Europe and the US, benefited from England's and, later, the US and Europe's early industrial monopoly, and then lost out as this monopoly was eroded.

Second, under globalisation, where there is ease of communication, safety and less restrictions on trade and factor movement, there is an ever-present tendency for capital to migrate to the most profitable centre, which is also where labour offers the most profitable combination of costs and skills, all things considered.

Third, there was a new phenomenon, starting in the 1960s, which was the migration, to England, Europe and the US, of labour without appropriate capital from less developed countries. This increased the supply of labour in those countries in relation to capital and forced labour income down. Also, the amount of capital per head of the new combined immigrant/native population was less than the capital per head of the pre-existing native population.

So we have arrived at a situation where median US income has remained static in real terms for the last 30 years.

Real UK labour income followed a similar path, but was less emphatic. Over the period between 1977 and 2010, real UK labour income rose throughout the upper half of the income distribution and especially for the top ten per cent and one per cent. However, real wages between 1977 and 2010 in the bottom half remained virtually static.

The Resolution Foundation Commission on Living Standards report, entitled *Missing Out*, was published in July 2011.<sup>1</sup> It calculated that the share of gross value added received by the bottom 50 per cent of workers fell from 16 per cent to 10 per cent between 1977 and 2010. While the GDP of the economy increased by 93 per cent in real terms, the real wages of the bottom half barely increased. Wage gains were entirely captured by the top 50 per cent.

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The rise in mean US and UK real average labour income masks increased differentials. Highly-skilled workers (the top 20 per cent), especially those most protected from competition because of their knowledge of native culture, language and law, which is particularly useful for media professionals, lawyers and politicians, continued to make gains. But workers exposed to a market with increased labour supply lost substantial ground.

Awareness of these trends has become widespread. An Ipsos/MORI poll in December 2011 found that 23 per cent of people now think that their children will enjoy better living standards than their own generation, while 35 per cent think the next generation will be worse off.<sup>2</sup> This is a massive shift from a poll in 2003 when the comparative figures were 43 per cent and 12 per cent respectively.<sup>3</sup>

The result for English workers, as well as American and European workers, is that capital is flowing abroad and labour is flowing in. This is a recipe for, at least relative, impoverishment.

## Loss of industrial monopoly

Both Ludwig von Mises and Friedrich Engels foresaw how the loss of early industrial monopoly would reduce relatively the income of labour in England.

As put by Engels in the Preface to the English Edition of *The Condition of the Working Class in England*:

The free trade theory was based upon one assumption: that England was to be the one great manufacturing centre of an agricultural world. And the actual fact is that this assumption has turned out to be a pure delusion. The conditions of modern industry, steam power and machinery can be established wherever there is fuel, especially coal... The truth is this: during the period of England's industrial monopoly, the English working class have, to a certain extent, shared in the benefits of the monopoly... With the breakdown of that monopoly, the English working class will lose that privileged position; it will find itself generally ... on a level with its fellow workers abroad.<sup>4</sup>

The relatively highly-capitalised English industry of the mid-nineteenth century meant English workers got high wages because of labour's relative scarcity in England vis-à-vis the capital/labour ratio in the rest of the world and shared in the benefits of this relatively high capitalisation. Engels envisaged that the industrialization of other countries with the same capital intensity would reduce English wages to the same level as workers abroad.

## World equalisation of labour income

Von Mises in *Human Action* stated that labour incomes in industrial countries would fall under the influence of globalisation.

If we assume that there are no institutional barriers preventing or penalising the transfer of capital goods, workers and commodities from one place or area to another and that the workers are indifferent with regard to their dwelling and working places ... [t]here is, if we disregard the cost component, a tendency towards an equalisation of wage rates for the same type of work all over the earth.<sup>5</sup>

## Misinterpretation of globalisation

There is a great difference between globalisation in the nineteenth century and the globalisation since 1960. Much of the movement of factors of production in the nineteenth century was a joint movement of capital and labour together from England to the US and the British dominions. Generally, globalisation from 1960 has seen a movement of capital out of England but a net movement of labour into England. These trends in England have been followed in Europe and the US.

In all cases of capital exports from the UK, labour loses as the following analysis shows:

**Table 1: Calculation of gains and losses when capital leaves the UK**

Categories of capital	Changes to income of			
	British Capital	British Labour	British Consumer	Summary
UK-based foreign owned capital moves abroad				
a) Previously supplied foreign market	No change	Losses	No change	-1
b) Previously supplied British market continues to supply same markets	No change	Losses	Gains	0
UK-based British owned capital moves abroad				
a) Previously supplied foreign market	Gains	Losses	No change	0
b) Previously supplied British market continues to supply same markets	Gains	Losses	Gains	+1
British owned capital previously supplying British consumers from the UK now moves abroad to supply foreign consumers with foreign production	Gains	Losses	Losses	-1

a) It is assumed that capital moving to another country always gains or rather avoids a lower return as otherwise there would be no motive to move.

b) It is also assumed that capital's extra profits are competed away when supplying the British consumer. Thus, in two scenarios the British consumer gains. In these two cases, capital moves to retain its return (a gain) or to avoid losses.

The movement of capital to the most profitable centres means capital holders tend to maintain their incomes in western countries while earners of labour income see their incomes fall.



From the 1980s there was a growth in inward investment in the UK. The surge of outward investment following globalisation may be being balanced to some extent by inward flows of capital.

## Capital intensity

Data provided in the CIA World Factbook on gross fixed investment as a percentage of GDP in 2010 includes the following:

**Table 2: Capital intensity ratio**

	%
China	45.50
India	29.50
Spain	22.50
Japan	20.60
Germany	18.10
UK	14.70
US	11.90 <sup>6</sup>

Source: CIA World Factbook, 2010

However, in considering the relative changes in capital intensity, the developed countries have to allocate a considerable portion of gross investment to replace existing depreciated capital. For example, in 2008 the US's capital consumption was 12.4 per cent of GDP<sup>7</sup> and its gross investment was 18 per cent of GDP<sup>8</sup> according to the World Bank, so its net new capital formation was 5.6 per cent of GDP. The UK had a similarly very low rate of net new fixed capital formation. According to the Office for National Statistics publication, *Capital Stocks, Capital Consumption and Non-Financial Balance Sheets, 2010*, net new fixed capital formation in the UK was £91 billion in 2008 and £49 billion in 2009, being respectively 6.30 per cent and 3.52 per cent of GDP.<sup>9</sup> When we take account of population growth, the US and the UK are nearly static in capital intensity. Contrariwise, depreciation on existing limited capital in India and China is very low so net new capital formation is very high. One can also note that in a country like Spain, high rates of gross capital formation were also leading to a massive malinvestment in property.

Finally, demographic factors play a role. In India and China, a considerable part of capital investment is spread among a still rapidly increasing population, making the figures per head less spectacular. Contrariwise, capital intensity growth in Japan, with a falling population, is remarkable.

Overall, it is quite clear that net new capital investments in China, India and Japan are outpacing European and US rates at a remarkable rate. Von Mises' forecast of the 'equalisation of wage rates' is thus becoming a reality.

## Engels and Von Mises on labour migration

Engels had already pointed out that the influx of Irish workers into nineteenth century England reduced English wages. From the original text of the English edition of *The Condition of the Working Class in England*:

The rapid extension of English industry could not have taken place if England had not possessed, in the numerous and impoverished population of Ireland, a reserve at command... The worst quarters of all the large towns are inhabited by Irishmen... With such a competitor the English working man has to struggle, with a competitor upon the lowest plane possible in a civilized country, who, for this reason, requires less wages than any other. Nothing else, therefore, is possible other than that, as Carlyle says, the wages of English working men should be forced down further and further in every branch in which the Irish compete with him... it is easy to understand how the degrading position of the English workers, engendered by our modern history, and its immediate consequences, have been still more degraded by the presence of Irish competition.<sup>10</sup>

Von Mises analysed the process from his theoretical point of view and introduced the movement of labour as a further tendency to reduce wage rates to the same level worldwide: 'if we disregard the cost component'.

In a section of *Human Action*, justifying the abolition of the American tariff and calling for free trade, von Mises pointed out that barriers to out-migration of capital and in-migration of labour benefited the worker in mid-twentieth century America:

Now it is true that under perfect mobility of capital and labor there would prevail all over the world a tendency towards an equalization of the price paid for labor of the same kind and quality. Yet, even if there were free trade for products, this tendency is absent in our real world of migration barriers and institutions hindering foreign investment of capital. The marginal productivity of labor is higher in the United States than it is in India because capital invested per head of the working population is greater, and because Indian workers are prevented from moving to America and competing in the American labor market. There is no need, in dealing with the explanation of this difference, to investigate whether natural resources are or are not more abundant in America than in India and whether or not the Indian worker is racially inferior to the American worker. However this may be, these facts, namely the institutional checks upon the mobility of capital and labor, suffice to account for the absence of the equalization tendency. As the abolition of the American tariff could not affect these two facts, it could not impair the standard of living of the American worker in an adverse sense.



On the contrary, given a state of affairs in which the mobility of capital and labor is restricted, the transition to free trade for products must necessarily raise the American standard of life.<sup>11</sup>

## Labour immigration

If the conditions restricting inward movement of labour into England, Europe and the US, which prevailed before 1960, still continued to exist, labour incomes in those countries would still face erosion because of the loss of early monopoly wages and the movement of capital to the most profitable or low-wage countries.

However, since about 1960, labour income in England, Europe and the US has been put under additional pressure by a substantial labour inflow from less developed countries.

Immigration of labour in the present time has the same effect as the arrival of Irish labour in the mid-nineteenth century. It raises the supply of labour vis-à-vis capital and reduces wages. In Mises' words, it reduces 'the marginal productivity of labour'.

So, English and American workers today face a world of reasonably free mobility of capital and, if still quite restricted, a much freer inward movement of labour than existed in England since 1860 and the US between 1920 and before 1960. Von Mises's analysis, tracing the American worker's standard of living to the fact that 'capital invested per head of the working population is greater', is being put under threat. There is a capital outflow and a labour inflow.

Further, as von Mises pointed out, freedom of movement of labour is normally restricted by 'cost components' in wages; that is, the cost of migration, of acquiring skills, housing and earning sufficient wages to pay for education, housing and medicine in higher-cost countries. The establishment of welfare states, especially since 1945, has the effect of socializing these costs. Immigrants do not require the human and financial capital to work in more expensive countries but can obtain a great deal of the costs of migration from the socialising of costs via the welfare state.

As put by Professor Borjas, the Harvard expert on the economics of migration:

There's also been a lot of fake fog thrown into the question of whether immigrants pay their way in the welfare state. It's time for some sanity in this matter as well. The welfare state is specifically designed to transfer resources from higher-income to lower-income persons. Immigrants fall disproportionately into the bottom half of the income distribution. It is downright ridiculous to claim that low-skill immigrants somehow end up being net contributors into the public treasury.<sup>12</sup>

## Capital cost of immigration

But it goes beyond this. With little capital being brought in by migrants and a high outflow of remittances, a migrant requires capital to work and to function in society (including roads, schools, hospitals and offices). Most of this capital has to be provided by natives.

He also requires his share of the 'tools of production'. The acquisition of a proportion of capital stock for free is correctly perceived by immigrants as making immigration attractive. After all, immigrants are not building a society and an economy with their bare hands on a deserted island in the Outer Hebrides; they are crowding in and using the capital stock of an already functioning economy.

One of the reasons why immigrant labour is so costly is that it requires the full supply of capital stock, including the appropriate share of dwellings, structures, schools and hospitals. By definition, existing natives not in the workforce, but transferring to the workforce, only need the 'tools of production' since they already have their share of the rest of capital stocks.

From the point of view of the national 'cost', imported labour is incredibly expensive compared to employing existing native labour from outside the current workforce.

The basic economic effect of immigration was set out in a study entitled *The New Americans* by the National Research Council, commissioned by the US Congress in 1997:

If immigrants have exactly the same skill distribution as domestic workers ... and if they have brought sufficient capital with them to maintain the US capital/labor ratio, then natives will neither benefit nor lose from immigration. In this case, all inputs and national output will increase by the same amount and the wages of all workers will remain constant.<sup>13</sup>

Despite this common-sense conclusion, some 'free market' economists seek to prove that the arrival of immigrants, without appropriate skills or capital, benefits natives. These economists draw attention to the increased GDP created by extra workers, but neglect to consider the provision of capital 'to maintain the US capital/labour ratio'.

In calculating the capital that has to be provided to immigrants by natives, it is assumed below that immigrants bring in no capital. Clearly, this is an 'upper bound' assumption. However, most immigrants do, in fact, have negligible capital.

Only five out of 582,000 new arrivals in Britain in 2004 came under permits issued to persons of 'independent means'.<sup>14</sup> As for the USA, according to *The New Americans*, in 1995, 10,465 visas were available for allocation to investors and their families but only 540 were taken up – within the immigration total of 720,461.<sup>15</sup>



Moreover, the calculations below make no allowances for capitalising the value of remittances, transitional costs, fiscal costs or cultural costs. These capital costs will be enormous.

The impact of what appears to be a relatively small amount of added population can have enormous implications for capital intensity. For example, in the United Kingdom in 2008, there was approximately £80,000 in existing gross fixed capital per head of population (or £50,000 per head in existing net fixed capital stock after taking account of depreciation). Every year, net savings are generating £60 billion of capital additions (additional to the amounts required for capital replacement), or £1,000 per head, in an average year [2006 figures]. The arrival of 250,000 migrants means that an estimated 'upper bound' of capital to the sum of £20 billion ( $250,000 \times £80,000$ ) must be found every year if capital per head is to be maintained, so 33 per cent of net investment goes to providing the capital requirements of migrants. The appendix describes the basis for the calculations.

To put it another way, 33 per cent of net new capital formation is expended on equipping a population increase of 0.4 per cent. The increase in capital intensity of the native population is substantially reduced, with consequent implications for competitiveness and labour income. (All figures to do with capital per head should be treated with some caution and should only be regarded as approximate.)

It is worth mentioning that each new worker not only needs capital stock in the form of fixed investment but also a slice of working capital in the form of stocks, work-in-progress inventory and cash. These figures have not been calculated and are not included in the Office for National Statistics figures.

The Appendix tabulates the statistical inter-relationship between population, GDP and capital stock. Taking the average of 2008 and 2009, net fixed capital formation, after immigration provision, was less than one per cent of existing fixed capital stock and much of this was swallowed up by growth in the existing population, so capital intensity was static while India and China were showing enormous gains.

The present system of National Accounts records the income gains from increased labour but does not record the capital costs. Theoretically, increased labour supply could spread the government's liabilities over a greater population. In this scenario, the new immigrant walking out of Heathrow immediately assumes £65,000 per head of the national debt (£260,000 for a family of four) based on the reasonable calculations of capital liabilities carried out by Nick Silver of the IEA which totalled these liabilities at £4 trillion.<sup>16</sup>

A more comprehensive study by the National Institute of Economic and Social Research entitled *Generational Accounts for the United Kingdom* put the total intergenerational budget imbalance, including public debt, at £7,612 billion.<sup>17</sup>

Do immigrants also take on a share of pre-existent government liabilities?

The correct accounting for such liabilities is that immigrants take on immediately a share of pre-existent government liabilities. However, immigrants also acquire rights to claim income in the form of pensions and intergenerational transfers at a later date. In other words, immigrants join the various government Ponzi schemes. A young immigrant worker does make a contribution to paying for pre-existent government liabilities but later he becomes a beneficiary of entitlements to pensions and intergenerational transfers.

If the government froze its liabilities on the day an immigrant arrived and then steadily paid them off, he would indeed be burdened by a share of pre-existent liabilities. However, these liabilities are not being frozen and then paid off, they are being constantly replenished and, indeed, augmented by fresh and growing liabilities.

The increasing augmentation of the Ponzi promises in debt and intergenerational transfers means that an immigrant acquires greater future income than the immediate pre-existent liabilities he takes on. Whether this income will ever be paid in full is doubtful.

There have been numerous studies that showed immigration would not of itself reduce the intergenerational and Ponzi-type scheme liabilities, usually put popularly as 'migrants are needed to pay for our pensions'. A 2001 Home Office report, 'International Migration and the United Kingdom: Patterns and Trends', stated:

The impact of immigration in mitigating population ageing is widely acknowledged to be small because immigrants also age. For a substantial effect, net inflows of migrants would not only need to occur on an annual basis but they would have to rise continuously... Despite this and other findings, debate about the link between changing demography and a migration 'fix' refuses to go away.<sup>18</sup>

Thus the capital available to support workers is not only draining away abroad as capital moves to obtain best returns, reducing capital invested per head of the population and, therefore, reducing wages but, further, a large slice of the capital that remains has to be allocated to the capital funding of immigrants.

## Hard currency

Whether or not the creation of credit by the increase in the volume of paper currency and entitlements is beneficial to economic activity, the abandonment of hard currency has also impacted on the relative incomes of median workers. There are two effects. The first is to transfer income from the average worker to government and the financial sector. The second is to create vast amounts of credit which destabilise the international trade economy. This meant that workers in deficit countries were losing jobs and incomes because of supplies from more efficient competitors – which were paid for in debt. In its most extreme form, this debt becomes unpayable. This benefits no-one.



Prices remained stable in the nineteenth century. Since the breakdown in the gold standard in 1914 and especially since the abandonment of the gold exchange standard in 1971, central banks in the western world have continually expanded the supply of money, transmitting inflation through the fractional-reserve banking system.

The effect of this expansion of money has been a transfer of income and wealth from the bulk of workers to those closest to the issuance of this money; that is the government, its beneficiaries and employees and the financial sector. In 2011, for example, the Greater Washington area had the highest income per head in the US, having overtaken Silicon Valley in that year.<sup>19</sup>

The process was summed up by John Maynard Keynes in one of his most famous remarks:

By a continuing process of inflation governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens. By this method they not only confiscate but confiscate arbitrarily and, while the process impoverishes many, it actually enriches some.<sup>20</sup>

Of course, there had been many monetary expansions and breakdowns throughout history. Richard Cantillon, in his famous essay in the eighteenth century,<sup>21</sup> showed that money and the expansion of the money supply was not neutral. In his example of a newly discovered gold mine, he showed how the proprietors and workers benefit from the discovery by using the proceeds of the mine before the extra supply of gold raises prices throughout the economy. The effects of monetary expansion since 1914, and especially since 1971, had similar effects, benefiting government, its beneficiaries and employees, and those investing in or working in finance, at the expense of ordinary workers. These transfer effects are known as Cantillon effects.

A further effect of the non-neutrality of money expansion in nearly all countries was to create vast amounts of credit which prevented the working of the traditional gold-based international trade economy. Instead of a trade imbalance being automatically corrected by gold outflows, as in the classical system, surplus countries were enabled to run enormous fiat money credit balances in debtor countries without any adjustments to the trading currencies. This created a false economy in which the surplus countries will be the ultimate losers as they will have supplied goods for which they will not be paid. In the interim, workers in the deficit countries were put out of work by the availability of goods which did not have to be paid for. Trade financed by debt is a system far removed from the comparative advantage trade theory of traditional free traders.

A return to hard currency will mean that trade surpluses will immediately trigger the changes in values which the gold-backed financial system automatically imposed. The prevention of liability bubbles would mean incomes are immediately adjusted to reality. This, in turn, will motivate policy makers to reduce the welfare state, taxation, regulation and immigration and

restore the only source of labour income, which is profitable economic activity.

At present, the lack of true accounting and the existence of expandable fiat currencies mean that policy makers seek remedies in yet further expansion of liabilities.

A return to hard money will benefit the median worker.

## Conclusion

Thus, English and, later, European and American labour have lost relatively due to the erosion of their participation in their countries' relative monopoly of early industrialisation.

Second, the outflow of capital, as part of recent globalisation but not the nineteenth century model of globalisation, exerts a further downward pressure on labour wages.

Third, the existence of subsidised living costs in the shape of a welfare state open to all attract never-ending low-income migration without appropriate capital, reducing native labour income.

Fourth, the existence of high levels of previously built-up economic and social capital means that migrating labour without capital requires capital to be appropriated from natives to immigrants, reducing further the net additions to capital which would increase labour income.

Fifth, the abandonment of hard currency has the effect noted by Keynes – the impoverishment of the many. Those who are enriched are those who first receive newly created money: government, its beneficiaries and employees, and the financial sector.

## Proposed action

Increasing labour income can only be achieved by a combination of increasing profitable economic activity and increasing capital intensity, and by increasing skills and reducing the overhead of labour costs, such as taxation and regulation. Additionally, immigration of labour should cease unless that labour brings its own relevant capital and imposes no net social costs.

These proposals for action are not new. Indeed they represent the consensus among many policy theorists. However, while lip service has been paid to the need for better skills, higher capital intensity, low taxes and less regulation, these objectives have not been realised. On the contrary, there has been considerable backward movement.

The activities of the welfare state supported by taxation have increased. Regulations have multiplied with the EU, and other international institutions, being extra and very active sources of regulation. Capital-less immigration has greatly increased. Skills in the widest sense, including a diligent and flexible workforce, have declined.



While all levels of skill have seen a narrowing between gross incomes and financial rewards after all taxes, this process has borne most heavily on median and below-median workers. After all, the top 50 per cent, and especially the top 20 per cent, were enjoying substantial rises in gross incomes. Median and below median workers were seeing virtually no gains in gross income while they had to support a greater burden in taxes.

However, in South and East Asia, skills have greatly increased. Regulations and taxes have not increased at Western rates. There is little welfare state in India or China nor are huge entitlements being built up in government Ponzi schemes. In the more distant future, the evolution of China's demography and increased welfare entitlement does pose similar problems as in western countries.

So, there is backward movement in all these objectives, both absolutely and relatively, despite the policy consensus.

## True accounting

One long-lasting weakness was the failure of the British government (as well as other countries in Europe and the US) to establish true accounting records. While true accounting records would have always been useful, they were not so critical before 1914 when government took a small share of economic activity; where there were few long-term liabilities; and when the economy was self-regulated by a gold-standard currency. The UK and most other Western countries did not have accounts; that is, a statement of income and expenditure and a balance sheet, either for the government or for the economy as a whole, prepared according to GAAP [Generally Accepted Accounting Principles]. Proper double-entry book-keeping has been around since the work of Fra. Luca Pacioli in the fifteenth century. These types of accounts have existed in commercial and other entities since the Middle Ages and have been required by law for many of them since the nineteenth century.

Such true accounting has imposed the discipline of closing defined benefit schemes in company pensions but there was no such discipline in government accounting, where enormous pension and other liabilities continue to accumulate. Steering fiscal and economic policy with a pre-medieval system of cash accounting inevitably leads to financial shipwreck.

The existence since 1997 of the Financial Report of the United States government, prepared on GAAP but not integrated into proper financial accounts, has gradually made the enormous off-balance-sheet liabilities of the US government quantified and known to policymakers. After an interval, it is accurate to say that from about 2006 these more accurate accounts began to affect US policymaking or, at least, were referred to in statements by policymakers such as Ben Bernanke and politicians such as Rick Perry.

There has been a revolution in British government accounting with the publication of the first annual Whole of Government

Accounts (WGA) on 29th November 2011 which covers the accounting year to 31st March 2010.<sup>22</sup>

This revolution has been many years in gestation. The concept of WGA was promoted in parliamentary debates in the 1990s and an Act of Parliament in 2000.

WGA is a considerable achievement and its architects need congratulating.

There are weaknesses in the WGA. A full critique of WGA is itself a major task but some reference needs to be made to this revolution which at present does not appear to have impinged on the financial and economic media or the political world.

To start with, WGA immediately revealed that, even including some doubtful credits, the current deficit of the British government in 2010 was £165 billion and not the £107 billion referred to in the National Accounts. The current deficit, plus net capital investment of £49.5 billion, actually totals £214.5 billion and not the £156.5 billion usually referred to by political and economic commentators. The £156.5 billion is correctly defined as the public sector borrowing figure but is £58 billion less than the WGA totals of the current deficit and net capital expenditure. A useful reconciliation of the deficit according to National Accounts and the WGA figures is included on page 26 of the WGA.

WGA also shows that the government has total liabilities of £2,419 billion and mostly unsaleable assets of £1,208 billion with a net deficiency of £1,211 billion. This is entitled 'Total Liabilities to be funded by future revenues' – that is, £80,000 for a family of four.

A further revealing fact is that the government's liabilities for its own employees' pensions at £1,132 billion exceed the total value (built up over centuries) of the government's fixed assets: all its roads, railways, offices, hospitals, schools, investment in banks and so forth.

Old age pensions and health expenditure commitments are not included in WGA. Generally, the total deficit and liabilities shown in WGA are in line with estimates made by independent observers in past years.

It can be hoped that critics and policymakers make use of the fact-based WGA in addition to the system of National Accounts. National Accounts are not true accounts but simply the statistics of economic activity.

For the future, WGA needs to include the liabilities for old age pensions and health care commitments.

For policymakers, WGA is extremely helpful but it is not enough. There also needs to be a similar set of accounts for the nation as a whole prepared on GAAP. Unfortunately, WGA uses the inferior International Financial Reporting Standards [IFRS] system which is not so prudential. Some preliminary 'national' GAAP accounts have been prepared in Australia.



These accounts would show asset values, such as reserves of oil and gas, and liabilities, such as imported capital, borrowings abroad and population growth. The result would be true income per head, true capital intensity per head and true liabilities.

Knowledge of these realities would motivate policymakers to reduce welfare-state entitlements, immigration, regulations and taxation.

## Finally

With capital stock static and increased labour immigration, the prospects for median labour income in England are bleak.

Fundamental change is needed.

## APPENDIX A

### Inter-relationship of Population, GDP and Capital in the UK

		2008	2009
GDP at market prices	(billion)	£1,445	£1,392
Population	(000's)	61,398	61,792
GDP per head		£23,544	£22,538
Gross fixed capital stock	(billion)	£4,985	£5,199
Net fixed capital stock	(billion)	3,061	£3,181
Gross fixed capital formation	(billion)	£240	£205
Depreciation	(billion)	£149	£156
Net fixed capital formation	(billion)	£91	£49
Net international immigration of foreign citizens	(000's)	251	242
Existing fixed capital stock per head		£81,191	£84,137
Capital requirements of immigrants per head	(rounded)	£80,000	£84,000
Total capital requirements of immigrants	(billion)	£20	£20
Net new fixed capital formation after immigration provision	(billion)	£71	£29
Percentage of net new fixed capital formation to existing capital stock		1.42%	0.55%

Figures sourced from the ONS Blue Book and Capital Stocks, Capital Consumption and Non-Financial Balance Sheets, 2010.

**Note:** Capital stock in the ONS publication is valued on the depreciated replacement cost basis, not on a true accounting basis of the lower of cost, less depreciation, or net realizable value. This depreciated replacement cost basis results in capital stock values increasing by more than the actual net additions.

## APPENDIX B

### Gross or net?

While the capital stock present in a country should be valued at its net value, cost less depreciation, it is patently obvious that it is impossible to add extra part-used assets when new workers or immigrants join the economy. They have to be equipped with brand new equipment so the figure to employ for estimating additional capital per immigrant is the existent gross capital stock figure per head.

It is suggested that as brand new equipment has to be added to the capital stock, this equipment will be more modern than part-depreciated existing capital stock and, therefore, less equipment per head will be needed.

This argument may have some validity when considering office or factory equipment. But, where capital stock items are discrete, this argument does not apply. Where discrete capital stock is required per individual, such as houses, train seats, car seats, office square feet, road space, classroom space, hospital beds, etc. (these are the prevailing mass of capital stock), new equipment may be superior to old equipment but the number of individual pieces of equipment required per head remains the same. Thus, unlike factory equipment, these are not subject to the argument that less equipment per head is needed as more modern equipment is introduced.

For the sake of clarity, the requirement for new workers' capital is, therefore, calculated at gross valuation figures.

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(continued overleaf)



# Beyond the EU's Emissions Trading System

*David Merlin-Jones*



The EU's flagship environmental policy is a disaster on a titanic scale. Not only is it adding to energy bills, aggravating fuel poverty and leading to international trade wars, it has also had no real environmental benefit and is unlikely to provide any until 2016, over ten years since its inception. Indeed, the only beneficiaries of the EU's Emissions Trading System (EU ETS), the jewel in the crown of European climate change legislation, are big banks and businesses making windfall profits.

The EU ETS is a cap-and-trade scheme, meaning there is an upper limit to the emissions allowed in EU countries. This quantity is represented by transferable credits dished out to the ten thousand or so installations covered by the ETS across Europe, comprising a mix of factories and power stations that emit the most CO<sub>2</sub>. Installations are given a set level for free and must buy extra credits if they emit more CO<sub>2</sub> than their allowance permits, or they can sell their spare credits. The theory goes that, as the cap falls, the price of credits rises and companies are forced to invest in reducing their emissions. The scheme was set up in 2005 and is promised to run until at least 2020, with the cap getting increasingly tough from 2013.

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