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The Political Economy of a British Stakeholder Society[♣]

Sabine Spangenberg[*]
School of Business, Richmond – The American International University in London,
Queens Road, Richmond, Surrey TW10 6JP, UK.

1. Introduction

Since the election in Britain of the Blair Government in 1997 the concept of the stakeholder economy has attracted plenty of comment and has been suggested as yet another "Third Way economic system". Post war system theory and analysis is characterized by a number of suggestions for Third Way economic systems which are traditionally supposed to combine the "good" elements of the dichotomously analyzed and juxtaposed systems of a free market economy with a centrally planned economy. Popular examples of Third Way economic systems are the systems of Germany (until recently West Germany), Sweden and The Netherlands. These economies are characterized by a combination of free market structures (such as decentralized economic planning and decision-making authority as well as private ownership rights) with elements of industrial democracy (or workplace co-determination) and a wide net and high level of social welfare provision. The term Third Way economic system has thus been used to describe a particular form of economic order that incorporates co-deterministic forms of participation. This characterization assumes neo-classical concepts of utility and profit maximization as goals of the economic units and accepts the employee-employer relationship within which the worker is hired for services. The employee is paid a wage or salary but is not entitled *per se* to appropriate the residual.

The stakeholder concept itself is a particular form of economic system and describes a new political economy of capitalism. The concept stresses that "…workers should be seen as members of firms" and that "…firms are social organizations" with ethical duties and obligations (Hutton, 1999, p. 80). It is however too simple and erroneous to portray the stakeholder economy as an Anglo-variant of German co-determination and it would at the same time reduce its potential to evolve new ideas and structural forms. The stakeholder concept provokes the creation of new ideas and enables the institutionalization of structures based on democratic principles of industrial democracy. Further, it provides scope for considering economics in ethical terms and facilitates the implementation of moral principles. The issue of morality called for little concern in liberal economic thought and the supposedly 'best outcome' is created if individual goals are pursued.

The stakeholder concept, as a societal form, considers those human beings affected by decisions taken by other members of society and accredits their interests – or 'stakes' - an increasing weight. Even though individuals might not have immediate decision-making authority, they hold a stake in the outcome of the economic process. The economic participants who are affected are employees, suppliers, consumers or local communities. Corporations are therefore understood not to be exclusively responsible to shareholders. Rather the economic unit 'firm' must adopt standards of accountability and responsibility more in tune with the communitarian manner. This proposition of increased accountability must be further defined in its extent and for its reasons, and the weight assigned to the affected individual's interests must be determined.

2. Economic System and Society

General system theory can be used to understand structural and subsequent functional relationships between the stakeholder economy and the stakeholder society. Here the economic system is identified as a partial social system. A multitude of social systems exists and each system consists of a number of elements which are interrelated. The entity of elements and characteristics defines the system itself. Further, the nature of this entity is, for a certain period of time, taken as given. However, systems do evolve so that at each point in time an accepted norm is assumed which defines partial objectives, methods and principles. This assumption is made because in most developed industrial societies the electorate defines the norm. Norm changes themselves can be expressed via alteration in behavioural patterns and political outcomes in those democratic states.

Structural elements of systems can thereby be identified as components serving to achieve the systems' objectives. Any behavioural possibility is shaped by norms and institutions, of which the latter form the interactions between the central subjects of any social system, that is, us human beings. Institutions and rules determine the opportunities of a society and any norm change must be followed by an institutional change (North, 1990).

The economic order of the economic system is defined as the evolved or consciously established legal and institutional regulations which influence the actions of economic units. Economic functions are served by organizational arrangements. This notion suggests that a system change, for example from the Anglo-Saxon style of capitalism to a stakeholder economy, implies structural organizational changes.

At every point in time the economic process takes place within a given institutional framework and the economic system - as a partial social system - is part of a broader behavioural function. The outcome of economic action is created by an interaction between the environment (or, outside elements), the economic system and the political system (Koopmans, Montias, 1970). It has been suggested that the improvement of the economic outcome as a result of structural change depends on *a)* the reaction flexibility of system elements following a normative change, and on *b)* the compatibility of changes within social systems (Spangenberg, 1998).

Let us take a closer look at the British case.

British Prime Minister Tony Blair described the creation of a stakeholder economy by referring to the following points in his ‘Singapore Speech’:

- creation of a welfare state which alleviates poverty effectively and results in a growth of independence,
- improvement of the education system that secures the opportunities of everybody,
- utilization of knowledge and new technologies to educate and liberate people,
- a relationship between business and government that assigns the government the “enabling role …to long term stability and growth”,
- institutionalization of the stakeholder company,
- extended relevance of self-employed and small businesses to support the stakeholder economy.

The last three points fall into the category of ‘elements of an economic system’. Of these the issue of the stakeholder company perhaps has the greatest potential influence as a catalyst for change toward the creation of stakeholder system. The increased relevance of self-employment describes the scope of a stakeholder company and its implications for the entire economy. The other points are structural elements of the environment or the political system.

The stakeholder company can be described as a particular form of the artificial economic unit ‘firm’. The firm follows an organizational structure of co-ordinative participation and is seen as a democratization of the traditional shareholder company. In this context the structural change has been described as:

> “… a change from the company being a mere vehicle for the capital market – to be traded, bought and sold as a commodity; towards a vision of the company as a community of partnership in which each employee has a stake, and where a company’s responsibilities are more clearly delineated”, (Blair, 1996).

This transformation implies an increased involvement and representation of workers. This paper aims to point to the principles of industrial democracy which can only support the stakeholder concept.

3. Industrial Democracy: Structures and Beliefs

3.1. Ethical Foundations

The theory of the democratic firm profoundly criticizes the conventional employment contract and conventional capital theory. The employment contract describes the employer-employee relationship and negates labour’s right to *a)* profit appropriation, and *b)* corporate control. Conventional capital theory assigns the whole product and its profits to capital. It interprets the residual as a return to capital, equating return with marginal efficiency to capital. Even if it was accepted that the whole product is to be owned by the firm, who then owns the production function? Further, is capital ownership then identical with production function ownership and ownership of the firm? The property-theoretic assumption of ownership of a corporation, being identical with ownership of a firm, must be rejected since the production function could exclusively consist of rented input factors. Of course one must take account of knowledge and know-how with regard to the production function but since labour can not be owned (and Norzick's voluntary self-enslavement is rejected) it must be accredited with marginal production responsibility. Labour as an input factor of the production function is partly responsible for the produced output. Its marginal productivity could be changed if changes were made to the production function. Since labour is denied any right to make such changes it is currently not legally, but factually, responsible. Labour cannot be owned or deprived of personal rights and therefore its responsibility cannot be disagreed on ethical and moral grounds. It must be assigned with legal responsibility and labour as part of the production function must own part of the production unit firm. It follows that people have an inalienable right to the output of their labour and an inalienable right to self-determination as a personal right.

The allocation of control rights in the conventional employment firm is criticized because it derives residual appropriation and control from the ownership of capital.

A democratization of the firm implies a reversal of the relationship between capital and labour. Ethical principles of the rights-based theory rather than utilitarian normative theory support this alteration. The rights-based theory touches on the Kantian principles of the Categoric Imperative (Kant, 1781) as well as on Rawls' concept of justice which is based on fairness (Rawls, 1973). These principles contribute to the creation of stable moral behaviour. They support the inalienability of personal rights, positive decision-making authority of the worker, as well as promoting the right to the residual. The general self-employment of individuals is supposed to form the organizational framework of the firm alongside system structures of private property rights and decentralized decision-making authority, that is, a market-based economy. The democratization of the firm would therefore imply a further decentralization of decision-making authority. It is responsibility that should legitimatize the decision-making authority instead of capital ownership. A stakeholder company would accept and follow these principles of industrial democracy. This implies that instead of focusing on the interest of the affected group, here the workers, I would like to go one step further and stress the idea of responsibility, which will be taken up again in section 4.

3.2. Co-deterministic Efficiency

The co-deterministic organization is ethically superior to traditional forms of organization and is able to create efficiency improvements. Here a positive behavioural relationship between non-pecuniary income and utility, as well as a utility and performance increasing - and thus less hierarchical - structure is given. The traditional shareholder company is characterized by the stockholders' utility function which generally aims at the maximization of profits and/or dividends. Sub-optimal efficiency can be asserted in the traditional employment firm because of the limited knowledge about workers' utility functions which causes positive information costs. The improved informational flow within the co-deterministic firm reduces transaction costs and increases efficiency. Not only is the informational flow improved but we also must expect a positive motivational effect because of the internalization of the workers' utility functions as a result of industrial democratization. This positive relationship between co-determination and information flow, motivation and incentives (due to the incorporation of employees into the decision-making process) increases efficiency. As Furubotn (1985, p.31) asserts "…industrial democracy may offer benefits that give the participatory firm some advantages the traditional (…) firm does not possess."

The extent to which efficiency gains can be expected depends on the scope of democratization that can be realistically achieved. Full democratization implies a complete identification of utility functions of all affected individuals and groups within the organization. This seems a rather difficult and costly objective. Another potential difficulty is the issue of how different stakes are to be weighed. The assignment of vote rights to outsiders such as consumers and suppliers is also highly dubious and would involve a governmental allocation.[1] Furthermore, this suggestion must be rejected because it would strongly impede the effects of competition and would undermine valued *creative destruction* in the Schumpeterian sense. It follows that the scope of democratization is to be limited to the affected group inside the firm. In particular an assignment of stakes to suppliers gives an immediate appeal to the creation of collusive behaviour which would certainly not be in the interests of the consumers. We should aim at the creation of a competitive market environment following the principles of industrial democracy inside the firm. Instead of actively involving everybody in the decision-making process only those with *de facto* responsibility are to be assigned with control and voting rights. The stakeholder society will take care of affected groups' interests (such as consumers and suppliers) on the basis of the principle that moral behaviour creates stable morality.

If a company were to follow the constitutional and democratic-ethical principles outlined above no control from customers and suppliers would be necessary. Moral behaviour inside the firm and competitive structures within the market are by themselves likely to create an efficient market.

4. Communitarianism and Free Choice of Participation

The democratic firm addresses the issue of responsibility on ethical and rights-based grounds. It follows that *de facto* responsibility must lead to the right of residual appropriation and to the right of corporate control. I would like to go one step further and extend this thought process.

Every individual, whether within a corporate or within any other social or political environment, possesses an obligatory responsibility, which leads to certain duties as a democratic member within a company or within society. It is misleading to only derive positive rights

[1] Exceptions must be made in the case of utility companies or markets which classify as natural monopolies. Here a decentralization following the stakeholder model could be suggested so that every individual demanding this service is thereby a stakeholder and is assigned with a share in the company.

from individual responsibility as this responsibility also imposes duties on individuals. Let us consider the plausible case of political responsibility. A democratic community consists of individuals. This 'democracy' will only persist if the voting process, through which candidates are chosen, continues to exist. Surely at no point in time will there be a situation where every citizen will feel himself fully represented by political parties. However, voters may abstain from participating in the process. Armchair democracy, with only a small number of individuals interested and involved in the community or society's affairs, must be sub-optimal. Every individual has a political responsibility to try their best and make an effort, think about issues, and participate in decision making.

Given all of this, can we expect that a stakeholder society can be implemented in today's Britain? Communitarianism has clearly suffered from the beliefs in individualism and liberal thought. So when we think 'individual and liberal' we also must take into account the duties we carry by being a member of society and by pursuing a liberal, free and individual life. An evolutionary creation of social capital and a more communitarian state of society can only be achieved if society as a whole moves into this direction. The huge inequalities in income and wealth must surely be decreased. Further, unequal opportunities ought to be eradicated and the prevailing restrictions on decision-making, at the corporate level as well as at other social and political levels, be widened to include directly affected members of society.

From these beliefs it follows that the degree of participation should be widened. A voluntary participatory structure leads to an internalization of the workers' utility functions and this will increase corporate efficiency.

At this point it might be useful to differentiate between departmental and corporate control rights. Departmental control and vote rights may be allocated to every worker. Corporate control rights should be obtainable by every worker who holds a share in the company. Vote rights should result from inside ownership, and inside ownership should be derived from responsibility. It follows that each member of the firm can individually decide whether s/he wants to get involved in corporate policy or not. Responsibilities and risk thereby result from rights and duties. This concept incorporates a duty and responsibility as a member of the firm and embodies a free choice of participation. This participatory structure is derived from the concept of responsibility and the inalienability of personal rights is guaranteed by this allocation of vote and control rights. Corporate policy rights coincide with the right to share in the profit appropriation. Vote rights and shares should be saleable within the firm and can be optionally allocated to the workers at the start of their involvement in the firm. Since the workers who own these corporate shares expect positive future income streams, the expected profits become part of their utility function and this carries a productivity increasing incentive. The issue of ownership and appropriation of the profit as a personal right follows the willingness to participate and the actual responsibility the workers choose to take on. The combined worker-stockholder status improves the information flow, internalizes the workers' utility variables and thereby reduces transaction costs. Instead of deriving the right to appropriate the firm's profit from ownership, the right is derived from responsibility and the personal right of participation inside the firm. This concept of a stockholder firm is derived from democratic thought and this implies that no vote and residual sharing rights are to be sold to individuals or corporations outside the firm.

5. The Stakeholder Society: The Big Picture

The degree to which any societal system achieves its set objectives is supposed to depend on the compatibility of elements inside and between partial social systems. The compatibility focuses on norms, rules and elements designed to describe partial objectives and behavioural functions. In the case of the stakeholder society this implies that some form of communitarianism, participation, responsibility, democracy and accountability must feature as variables of partial social systems. The stakeholder economic system can be described as an economic order with the following structural features.

The motivational structure describes the degree to which decisions are carried out and characterizes the means of control and incentives. The degree to which decisions by agents are carried out depends on the homogeneity of the economic agents' objectives. In the Weberian sense agents behave rationally and in the decentralized market economy this behaviour can be described as instrumental-rational (Weber, 1968). The action of the *economic agent* is determined by the construction of the means towards the achievement of certain objectives, leading to the materialization of purposes. In this context this is based on profit and utility maximization (in the neo-classical sense of behaviour), but additional focus is placed on co-operative and participation-integrated incentive structures. It is not expected, or surmised, that radical changes in these structures are taking place since no dramatic changes of norms and values has preceded the discussion about the stakeholder concept. However, increased interest in the subject and recent publications - as by Fukuyama (1999) - show a growing concern for moral values whose structural integration might make the system more stable in the long-run.

Intra-firm motivational efficiency, as well as external and non-market input efficiency describe *X*-efficiency, here improved by participation and incorporation of co-operative aspects (Leibenstein, 1966). The decision-making and informational structure in a stakeholder corporation is decentralized. Informational decentralization allows the dispersion of information between a number of economic agents and indicates choice allocation to the individual. Horizontal transmission of information and co-deterministic decision-making structures outline the stakeholder firm.

The political system can again be portrayed by the actual decision making process and the information flow. Each member of a society is to be assigned with increasing social responsibility also involving duties as described. The government is attributed with the role of supporting industrial democracy by, for example, setting up democratic development agencies. Steps have been taken, such as the announcement of fiscal political instruments in British Chancellor Gordon Brown's pre-budget declaration on November 10th, 1999. As of April 2000 employees in Britain will be able to receive company shares worth up to £3000, exempt from income tax.

The environment, as a further essential parameter within the broader behavioural function, must be brought within the remit of stakeholder principles. These could be described by an increase in social capital, a reduction of inequalities, decrease in the proportion of long-term unemployed as a fraction of the labour force, and an improvement of the inner-societal information flow. Information technology and education can be used to render this stakeholder aspect operational. Social capital has been described in its economic character by Szreter (1999) in the following way as:

> "…the additional productive benefit to the society or economy as a whole that results from the synergy of a set of mutually-trusting social relationships."[2]

6. Conclusions

The stakeholder concept must redefine the utilitarian-normative theory and accept some aspects of the rights-based theory for a new order to be formed and created. The stakeholder system can only succeed if some structures of the complete societal-behavioural function are altered. Prime Minister Tony Blair correctly targeted elements of the economic system in the form of the stakeholder government and the stakeholder company. Elements of the political system such as the alleviation of poverty and the re-establishment of individual independence were targeted by altering the welfare system; the environmental aspects of social capital were addressed in the form of a dispersion of information and the promotion of the notion of opportunities for all. It may be concluded that, in the interests of progress, the compatibility of these structural changes has to be taken as a given.

The stakeholder company can be the first step on the path towards a society that places increased weight on justice and the pursuit of a properly defined moral code. However, we ought not get carried away. The election of the Labour Government in 1997 does not represent a strong norm change in societal values. The change from the British variant of capitalism - deriving its essence from the belief in liberal thought - and the traditional emphasis on individualism towards a more communitarian state of society must be expected to be gradual.

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* **Dr Sabine Spangenberg** lectures in the economics programme at Richmond. She has previously taught at Lancaster and London Universities. In 1998 she published *The Institutionalised Transformation of the East German Economy* with Springer Verlag.

♣ *The views expressed here are personal to the author(s) and do not necessarily reflect those of the other staff, faculty or students of this or any other institution.*

Book Review:

Robert J. Shiller. (2000) Irrational Exuberance. Published by Princeton University Press. PP 312. ISBN 0 691 05062 7.

Comedians like to invent a catch-phrase. It both identifies them and lives on after they have ceased to be funny. Similarly, politicians and other key decision-makers are often saddled with a key phrase, one which is thrown back at them in derisory manner even after they have ceased to be powerful. British Prime Minister Harold Wilson was saddled with “the pound in your pocket”, a phrase he never uttered! And Alan Greenspan is saddled with “irrational exuberance”, a phrase he did use in a speech on 5th December 1996.

In his speech the chairman of the Federal Reserve was trying to convey his fears over a stock market that many analysts felt had become “overvalued”. By indicating that the Federal Reserve shared this view, Greenspan was signalling to the markets that the Federal Reserve would be called upon to take action unless the markets took corrective action themselves. The markets reacted swiftly with almost all key stock markets declining over the next day or so. However, since that time the markets have continued to climb almost inexorably.

In this book, Robert J. Shiller examines a number of factors which contribute to irrational exuberance in the financial marketplace. The major categories are structural factors, cultural factors, and psychological factors. His book is a broad study of what brings about the behaviour that moves financial markets, drawing upon a wide variety of sources and expert knowledge, as well as a (highly) selective series of statistics which are used to illustrate the author’s argument. Shiller is not concerned with examining the proposition that the market is overvalued—which occasioned the Greenspan phrase—as he takes this as a given. Rather he is concerned with examining the factors which explain how the market came to be overvalued. One result of Shiller's thinking is that the stock market will come to pay far lower returns over the next ten years than it has over the past ten. This should give pension and other investment fund managers pause for thought!

That Shiller is an innovative thinker in the field of finance—itself a branch of applied economics—is incontrovertible. His contributions speak very much for themselves, especially his studies on market volatility. And it is in this vein that he tries to bring his ideas to a broader audience—an educated lay audience-for the first time.

However, to my mind this book falls between two stools. It lacks the depth necessary to be a truly innovative academic study, and yet it does not entirely succeed in its attempts to convey Shiller's argument to the educated layman. In an earlier era of economics, it was commonplace for economists to bring their ideas to an educated audience outside of the economics profession. Keynes' regular contributions to the *Manchester Guardian* are a perfect example. And Marshall felt that economics ought to afford practical solutions to the economic issues of the day. Yet this is a skill which is largely lost among contemporary economists. Some would argue that the field has become so specialised and complex that it is difficult to explain to those outside the profession. I do not hold this view, regarding it as academic snobbery of the worst order, a piece of humbug designed to deflect criticism from those who try to blind with science, yet really have no insight into the world they seek to explain.

This latter criticism is not aimed at Shiller's book, for it is a valiant attempt to bridge the chasm between the academic world and that of the educated layman. And in finance, given the high-level educational background of many practitioners, this gap *should* be almost minimal. Yet I feel that Shiller is trying too hard, making something of a mountain out of a molehill in order to convince his reader that there is something more substantive behind Greenspan's phrase "irrational exuberance" than a short, sharp signal to the marketplace. Indeed, I would argue that the ideas which he develops have already been explored in a simple fashion is Burton Malkiel's *A Random Walk Down Wall Street*, while the empirical aspects of financial bubbles is better dealt with in Charles Kindleberger's *Manias, Panics and Crashes*.

Put simply, when markets are in a bull run which is expected to continue, participants will mostly apply technical analysis to determine their investment strategies; when the market is bearish, then participants will prefer to adopt fundamental analysis to determine their investment strategies. Greenspan's phrase was designed to get investors to switch from looking at trends in the marketplace to looking at the underlying fundamentals. Shiller's structural, cultural and psychological factors are little more than an elaboration upon this theme. Nonetheless, they are an elaboration worth reading, for they force the reader to think about more than what drives prices in the financial markets, or whether or not such markets are efficient.

Ivan K. Cohen

Forthcoming Conferences:

April 6-7, 2001: Annual conference of the Agricultural Economics Society to be held at Harper Adams University College, Shropshire, UK. Theme: Papers on the rural environment, rural development, the food sector, etc. Contact: Steve Wiggins at the Department of Agricultural and Food Economics, University of Reading, Box 237, Reading RG6 6AR, UK. E-mail: s.l.wiggins@reading.ac.uk

June 14-16, 2001: Fifteenth annual conference of the European Association of Population Economics to be held at Athens University of Economics and Business in Athens, Greece. Theme: household issues, public economics, demography, etc. Contact: Professor Robert Wright, Department of Economics, University of Stirling, Stirling FK9 4LA, Scotland. E-mail: r.e.wright@stir.ac.uk

Recently published papers:

- The September 2000 issue of the Journal of Economic Literature has a paper by E.J Bartelsman and M. Doms on *Understanding Productivity: Lessons from Longitudinal Microdata*.
- Journal of Economic Perspectives (Summer 2000) publishes 4 papers in the form of a symposium on *Fiscal Policy*. There are other articles by Charles Manski on *Economic Analysis of Social Interactions*; and by Ernst Fehr and Simon Gächter on *Fairness and Retaliation: The Economics of Reciprocity*.
- Economic Journal *(October 2000)* includes papers on *Happiness, Economy and Institutions* by B.S. Frey and A. Stutzer; and *The Economics of Tenancy Rent Control* by K. Basu and P.M. Emerson.

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