

THE ECONOMICS OF BOOM AND BUST: THE THATCHER MIRACLE RECONSIDERED

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Britain is in the verge of recession: this is the verdict of city economists in London, of Karl Otto Pohl, president of the German Bundesbank, of Sir Alan Walters, former economic guru of Prime Minister Thatcher, and of many more. The CBI (Confederation of British Industry) provides, in its latest monthly survey of industrial trends, further clear signs that the economy is moving into recession. Thatcher's Chancellor of the Exchequer said more euphemistically that the economy was in an essential "cooling-off period" during which there would be slower growth. This is the second time that Britain is facing recession under Thatcher policies (the first time being in 1981/82). Do these signs indicate that the so-called Thatcher economic miracle in Britain was merely a boom and bust phenomenon? In this brief essay it is argued that although the Thatcher revolution over the past eleven years has brought significant changes in the British economy, its policies have failed to lay the foundation for a lasting supply-side revolution. The plan of this brief essay is as follows. Section 1 outlines the economic reforms implemented by successive Thatcher governments. In section 2 we assess the performance of the British economy over the last decade, highlighting its weaknesses and examining the factors that underlie the current signs of recession. Finally section 3 provides a conclusion.

1. The Policy Reforms

The profound changes that Thatcher governments have brought about in the British economy can be categorized into three areas: (1) measures to increase competition in the private sector through

liberalization measures; (2) measures to reduce the role of the state in direct production sectors by privatization of public enterprises; and (3) measures to increase incentives to work and invest by reforming the tax and social welfare systems. Let us examine each of these supply-side measures in turn.

As soon as Thatcher came to power in 1979 all price and income controls which had been in force in one form or another since the early sixties were totally removed. Far-reaching legislative changes to liberalize the labour, capital, and commodity markets were implemented. In order to reform the labour market a series of employment acts was passed, which severely curbed the power of trade unions to pursue industrial action. For example, the assets of the once mighty national Union of Mineworkers (NUM) were seized, on its failure to comply with the new employment acts. A strike by the printers' union was ruthlessly crushed. And so it went on. The consequence of these rigid labour reforms was a reduction in trade union density from 58 per cent in 1979 to approximately 45 per cent in 1990. In the capital market, all direct banking controls for domestic and international transactions were phased out during 1979-81. In 1986 building societies were permitted to compete on an equal footing with banks in a range of services. In the commodity market, a number of statutory monopolies were legislated into history.

Privatization became the linch-pin of revival for the economy's supply-side. Almost half the stock of public assets has now been transferred to private

ownership. This includes British Telecommunications, British Gas, British Airways, Water distribution over one million public housing units, etc. Electricity is to follow suit shortly. The number of households with shares increased from 7 per cent in 1979 to nearly 25 per cent in 1989, and the owner-occupation of housing increased from 50 per cent in 1979 to nearly 65 per cent in 1989. On the tax front, the inherited structure of income tax rates spanning the range 25-98 per cent was trimmed to only two: a basic rate of 25 per cent and a top rate of 40 per cent. Personal tax allowances and thresholds were over-indexed to increase their real value and capital gains tax was amended to remove inflation gains from the net, while company taxation was completely revised to bring the marginal rate down from 53 per cent to 35 per cent.

There were extensive reforms of the social security system. In Thatcher's first term there was fierce financial control of local authorities. The second term saw the introduction of central control over the revenue that local authorities can raise - familiarly known as "rate-capping". In the third term numerous councils were forced to put many of their services out to tender, and domestic rates were replaced by the poll-tax system that put 75 per cent of local government revenue-raising under central control. Similar patterns were seen in state education (first there was new provision of "assisted places" in private schools; then insistence on a broader curriculum; then permission for schools to opt out of the local authority control). There was a reduction in the "replacement ratio" for the unemployment (defined as the ratio of unemployment benefit to expected post-tax income from work) and many more of the low paid were pushed into the "poverty trap" (defined as the disincentive to work by the withdrawal of unemployment benefit as income rises for the low paid).

2. Performance

What have been the results? The performance in certain areas of the economy appear, *prima facie*, encouraging. There was a temporary boom in the economy during the 1979-80 period followed by a recession in 1981-82. After 1982, labour productivity in manufacturing averaged 5.4 per cent per annum (p.a.) compared with 1.9 per cent p.a. during 1973-79. Overall labour productivity averaged 2.7 per cent p.a. during 1982-89; higher than in all OECD countries except Japan; and unemployment fell to 5.7 per cent in 1986, lower than in West Germany (7.4 per cent), France (9.4 per cent) and Italy (10.9 per cent). Real GDP grew at 3.3 per cent p.a. from 1982, vis-a-vis 2 per cent p.a. during 1973-79. However, in overall terms some of these statistics have to be interpreted with caution. For example, while economic growth was undoubtedly above trend since 1982, this trend is highly sensitive to the base year chosen. If 1979 is taken as the base year instead of 1982, the average rate of growth falls to 2.3 per cent p.a. which is only 0.3 per cent better than the growth recorded during 1973-79, but rather worse than 2.5 per cent p.a. of the 1960s.

2.1 The Supply Side

The fundamental question, however, is whether supply-side reforms have laid the foundation for a high and sustainable growth path. The Thatcher government claims that these reforms have increased the profitability of British industry and have created a framework for sustainable growth, in a climate where managers are free to manage effectively and companies have both the funds (from retained profits) and the incentive (a dramatically higher rate on capital) to invest for the future with confidence. But a number of studies suggest that such an interpretation is unduly optimistic. It has been argued that high growth during 1982-89 owed much to the salutary effect of trade union reforms. During 1979-82 unemployment doubled as a result of labour market reforms and consequently broke the will of the unions to resist change. It has been estimated that 160,000 jobs have been lost in mining alone. And the number of apprentices working in manufacturing fell from

155,000 in 1979 to 53,000 in 1989. Thus it has been argued that productive gains were merely due to an intensification of work effort and the abolition of restrictive labour practices.

Recent macroeconomic indicators show that the economic growth achieved is unsustainable and they also reflect the shortcomings of the supply-side. The current account deficit reached 20 billion sterling or 4.3 per cent of GDP in 1989 (the deficit was 17 billion sterling in 1988 and 16 billion sterling in mid-1990, in comparison with an almost balance in the current account in 1979) as strong demand growth outstripped the capacity of the supply-side to deliver the goods, resulting in imports increasing to meet the demand. The implication is that, however efficient and profitable British industry may have become during the 1980s, the industrial base today is simply too small to meet the needs of the 57 million consumers in Britain. Inflation reached a double digit figure of 10.6 per cent in September 1990 (compared with the European average of 4 per cent), unemployment reached 1.6 million (compared with 1.2 million in 1979) or 12 per cent of work force in mid-1990. Moreover, economic progress over the last decade has been marked by massive regional disparities in the economy. Southern England prospered most, while Scotland and Wales were virtually left out from the development process. (It is worth mentioning that in the 1987 elections the Conservative party held just 10 out of 72 parliamentary seats in Scotland and 8 out of 38 in Wales).

Under Thatcher policies there is hardly any room for the Keynesian type of fiscal stimulus. (In fact, fiscal policies, as well shall show, were not even considered as effective demand-management tools.) Thus public investment did not occupy a significant place in economic policy formulation. The lack of public investment led to a further weakening of the supply-side as seen in the quality and the quantity of input to industries. There was a total lack of investment in: (1) Research and Development (R & D), (2) physical capital, and (3) human capital. Britain's record in R & D in 1979 was broadly in line with the USA, Japan, and West Germany - approximately 2.2

per cent of GDP. During the 1980s, while all industrialized nations increased the share of GDP allocated to R & D, in Britain the ratio declined over the years and remained around 1.7 per cent p.a. in the 1980s. Investment in physical capital was also relatively low during the 1980s. Overall, the capital stock in Britain rose by only 2 per cent p.a. in real terms between 1979 and 1988. Even so this figure conceals a great imbalance in investment, i.e. net investment in banking, finance, and business grew at 8.2 per cent p.a., while in manufacturing it grew only at 1 per cent p.a. Finally, investment in human capital was extremely disappointing. As a percentage of GNP, expenditure on education fell during the 1980s from 5.5 per cent in 1979 to 4.8 per cent in 1989. The proportion of manufacturing workers in training dropped from 4.5 per cent in 1979 to 2.1 per cent in 1988 for males and from 2.4 per cent to 1.1 per cent for females - reflecting underinvestment in training in particular and in education in general. During the 1980s Britain had the lowest proportion of 18-25 year olds in full-time education of any advanced country. There were substantial cuts in higher education and the Universities were alienated to such an extent that Oxford University refused to grant a honorary doctorate to Thatcher. The crisis of morale among the scientific community is such that brain drain has been a recurrent feature during the Thatcher years.

In the health sector the National Health Service (NHS) was so severely underfunded during the Thatcher years that waiting lists for minor operations etc. more than doubled. According to the British opinion polls, a majority of the British people believe that the NHS is not safe under Thatcher's government. As we have said, council house ownership increased under the Thatcher government. Homelessness however increased to alarming levels so that the number of people living in bed-and-breakfast accommodation, street corners, railway stations, and even in cardboard boxes increased dramatically. The deterioration of the social welfare side also reflects the lack of investment in the economy. Thatcher's image as an "uncaring" Prime Minister has increasingly taken root in British society over recent years.

At the centre of Thatcherism is the belief that a society whose individual members pursue wealth is likely to be a happy one, and that there is no reason why those who acquire wealth from their own efforts should not also enjoy power. In fact, Thatcher once said that there was no such thing as "society", but only "individuals". She strongly believes that the market mechanism functions very effectively, and even in times of difficulty, she believes that it is up to individuals or groups of individuals to make appropriate use of the market. For example, when the 1981 budget deflated in a recession, she told companies that their salvation lay in their own hands, not hers.

The main assumption behind Thatcher's radical economics is that price incentives *per se* will provide not only the supply-side factors needed for rapid industrial growth, but also services for the needy. Needless to say that these assumptions have not proved to be correct anywhere in the World. (The economic theory of 'market failures' and 'public goods' is well known and need not be repeated here.) Be that as it may, it is not only the weakness of the supply-side that explains the current signs of recession, but also the policies that were used to control the demand-side of the economy.

2.2 The Demand Side

Thatcherites like Monetarists believe that inflation everywhere and all the time is a monetary phenomenon. Thus they believe that a tight control of money supply would keep the demand-side on check. According to Thatcher's former Chancellor, Lawson, inflation is the "judge and the jury" of the Thatcher policies. If this is the case, the current verdict on Thatcher's policies is very clear. Let us examine why the British government suffers from high inflation. In fact inflation was brought down to a reasonably low level of about 6 per cent during the mid-eighties. But in the 1988 budget the then Chancellor (Lawson) decreased income and company taxes drastically with a view to avoiding a potential recession from the 1987 stock market crash. This policy immediately increased demand in the economy, particularly by increases in consumer

borrowings. This increase in demand which was not matched by an increase in supply resulted in inflation, an increase in imports, a trade deficit, and so on. In order to control inflation interest rates were raised. And this policy, as we shall argue, also contributed to pushing the British economy into recession.

The rationale behind the high interest rate policy (15 per cent — 65 per cent higher than in major competitor countries) is that it will reduce the money supply and maintain exchange rate stability, thus reducing the level of inflation. However, the Thatcher government does not pay any attention to the cost-push inflationary effects of a high interest rate policy. For example, increase in production costs feeds into price increases. Another effect is that high mortgages lead to wage increases thus leading to further inflation. Disregarding these cost-push features of a high interest rate policy the government continues to pursue it. The result is that not only has it not been very effective in bringing down inflation but it has also led to mortgage miseries, bankruptcies, unemployment, etc; in short, economic slowdown. The government categorically dismissed as "soft options" such policy tools as credit controls — to support a lower interest rate policy, and, until very recently (5 October 1990), joining the exchange rate mechanism (ERM) of the European Monetary System — to maintain exchange rate stability.

The main point is that high interest rate policy was used not only as a demand management policy but also as a measure to maintain exchange rate stability. In fact, Lawson dismissed fiscal policy as a demand management policy during the 1988-89 period and relied solely on the interest rate to achieve these dual objectives. Thus during 1988, 1989, and the first nine months of 1990 the government was torn between cutting interest rate to cushion the economy's slowdown and on the other hand keeping interest rate up to prevent sterling depreciation. It was only in early October 1990 that the government decided to enter the ERM and cut down interest rates by 1 per cent to reach 14 per cent.

In Britain, discipline in regard to currency had been lacking during the eight-

ies. Since the early eighties, when a rise in sterling squeezed inflation down, the pound was allowed to move erratically lower against the German D-mark. Many economists believe that if the sterling had been anchored to the ERM in 1987 there would have been a more stable exchange rate and thus less inflation today. During the 1988 - Oct. 1990 period, Thatcher considered that entry into the ERM would surrender British sterling to the powerful German mark and thereby allow the fluctuating German mark to dictate economic policy in Britain. However, the recent entry into the ERM shows that she has changed her mind and, *inter alia*, realized the political risks of using solely high interest rates to combat inflation. It must be noted here that credit controls too have proved to be an effective anti-inflationary policy in European countries such as Spain. But the government not only considers this as a "soft option" but also considers it to be contrary to the norms of market efficiency. The human cost of wide spread debt is characteristically discounted.

The cost-push effects of high interest rate makes it only a long-term policy tool in bringing down inflation. From the demand-side it was the sole reliance (to control demand) on high interest rates and the neglect of other demand management measures during the 1988, 1989, and the first nine months of 1990 that have led to the current high inflation rate and pushed Britain into the brink of recession.

3. Conclusion

In this brief essay we have discussed the shortcomings of the supply and demand side of the British economy and explained in turn the factors underlying the current recession in Britain. The important question however is whether eleven years of Thatcherism have laid the foundation for a lasting supply-side revolution or created a boom and bust economy. All the evidence clearly indicates that the latter is the case. The early 1990s will find Britain in a recession, with output declines, high unemployment, and all the other ills that recession brings. Even if the government manages to bring down inflation in 1991, by means of ERM entry and interest rate cuts, there will still be no rapid increase

27
Contd. from page 29

in supply responses. To bring such an increase substantial public investment in education and training would be necessary. Were there a firm commitment to such measures (which is unlikely under Thatcher) they would still, by their very nature, take some time to produce any widespread effect.

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