

The Macroeconomic Impact of Liberal Economic Policies in the UK

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April 2015

EXECUTIVE SUMMARY

A sea-change occurred in the early 1980s in the way the UK economy was organised. From then on, until the present day, openness to trade, light-touch regulation of commerce and free competition have been the watchwords, alongside low income tax rates and constraints on trade union action. Most importantly, the removal of a raft of restrictions on banks and building societies, combined with the abolition of controls on the international movement of capital, allowed a huge expansion in household borrowing. These liberalisation measures extended an earlier trend including the bonfire of war-time restrictions, international trade agreements to reduce tariffs, the move to floating exchange rates between 1971 and 1973, and the switch from direct to indirect controls on bank lending in 1971. However, even by the late 1970s the UK economy was still strongly managed by government. Controls were still in place on capital movements, investment, prices and incomes. Trade unions remained powerful and the basic rate of income tax was at 30% with the top rate at 83%. Most lending to households was still undertaken by heavily controlled building societies. Government economic policies prior to the late 1970s still aimed to maintain full employment although the practice had become more difficult to achieve. After 1979 policy switched decisively towards controlling inflation, firstly through monetarism and later by using interest rates to meet inflation targets.

It is often taken for granted in media and policy making circles that more structural economic reforms, involving greater labour market flexibility, will increase the efficiency of the economy. This assumption may arise because liberal markets are linked to a political philosophy of individual freedom and responsibility. It may also be because many economists in business and academia have a presumption that private sector organisation of economic activity is superior to any state intervention. We make no such assumption. Instead, the purpose of this report is to assess the factual evidence on the macro-economic impact of liberal policies on the UK economy. In particular it is to assess their impact on the growth of GDP, productivity, employment, unemployment and inflation. The report shows that GDP and productivity have grown *more slowly* since 1979 than over previous decades, contrary to widespread belief. Although inflation and industrial disruption were reduced after 1980, unemployment and inequality have been higher. The volatility of the economic growth has also been much greater. The fluctuations in GDP have come in large waves in contrast to the ripples of the 1950s and 1960s.

Any support for the conventional wisdom that the liberal market regime since 1979 has had a favourable impact on growth of the UK economy thus depends on a view that economic performance would have been worse after 1979 even if the previous 'corporatist' regime had been maintained. One view is that the high inflation of the 1970s would have continued as a problem if a liberal market regime had not been adopted from 1979, leading to slower growth. However price inflation fell sharply from 1980 in all advanced economies irrespective of the economic policy regime.

An important post-1979 change that should be taken into account is the slowdown in growth in the volume of world trade in goods from the mid-1970s. A likely cause of the slowdown was the ending of the long recovery in the war-torn economies of Europe and Asia, but the switch to floating exchange rates may have played a role. We estimate that the growth in real per capita GDP in the UK would have slowed from 2.6% per annum to 2.2% per annum due solely to the impact of slower growth in the volume of world trade. Assessed against this more slowly growing benchmark trend, per capita GDP in the UK exceeded the trend in the late 1980s and in all years from 1994 to 2008. It then fell well below the trend and now looks unlikely to regain it for many years, if ever.

We argue that per capita GDP was maintained at levels above this trend after 1979 only by the build-up of high household debt levels. Once debt, and the rising property prices supported by rising debt, reached unsustainable levels, as it did by 2007, the banking system crashed and the level of GDP fell much further below previous trends than in any period since the Great Depression. The UK economy now appears to be developing permanently on a

lower and slower long-term trajectory than for any period in the last 80 years. Our view is that the Labour Government was misled into believing that the economic growth rates of 1997-2007 could be sustained, and hence kept up a growth in public spending higher than might otherwise have been the case. A belief that the trend growth of the economy had increased during this period was held by the Treasury and by many academic economists. The politicians can hardly be blamed for accepting this professional advice.

Growth in per capita GDP is the arithmetic sum of growth in productivity (GDP per hour), hours worked per employee, employment rates and the ratio of working-age to total population. It is clear that productivity has grown at a slower rate in the post-1979 liberal market period than previously. This is associated with the decline of manufacturing, a casualty of free market policies and globalisation. Manufacturing had, and has, consistently faster productivity growth than service sectors. The conversion of the UK economy to one based overwhelmingly on services has reduced the rate of productivity growth from around 2% per annum thirty years ago to less than 1.5% per annum today. For many years from 1982 to 2005 the falling rate of productivity growth was offset by a rising employment rate to generate a growth in per capita GDP not far below the pre-1980 trend. Even with employment rates recovering between 1982 and 2007, rates were however generally lower after 1979 than before this date and unemployment much higher. Other factors helping to maintain the growth of per capita GDP were a slower annual decline in average hours worked, and generally favourable changes in the proportion of the population who were of working age. Without these offsetting changes in employment rates, hours worked and dependency ratios, per capita GDP in the UK would have grown by 1.6% per annum on average since 1980.

Inflation, de-regulation and privatisation

The main improvements in the liberal market era have been lower inflation and a greatly reduced rate of industrial disruption. More than anything else it was the huge rise in inflation during the 1970s and associated industrial disruption that stimulated the change in economic policies from 1979 onwards. UK inflation was generally a little higher than in the USA or G7 average over the 1950s and 1960s and again in the 1980s. It was in the period 1971-77 that inflation rose well above the US or G7 average levels, averaging seven percentage points above the level of inflation in the USA, and peaking at just below 25% in 1975. However UK inflation had returned to a level close to the US and G7 averages by 1978, although the subsequent breakdown of wage controls, a new oil price hike and a near doubling in the rate of VAT led to an increase in inflation in 1979 and 1980.

The main improvement relative to the G7 average came not with the Thatcher Government's monetarist policies over the 1980s but following the UK's ejection from the European exchange rate mechanism (ERM) in 1992. After 1992 UK price inflation was generally below the G7 average, due initially to high unemployment and after 1996 to a large appreciation in the Sterling exchange rate. However UK price inflation has returned to its traditional position, a little above the G7 average, since the large depreciation of Sterling in 2008. It was only in the exceptional 1993-2007 period that the UK had lower inflation than the G7 average. Otherwise inflation relative to other major economies in the post 1979 period has been similar to the 1950s and 1960s.

While the high inflation of the 1970s is often viewed as the culmination of earlier corporatist policies, it can just as easily be treated as a temporary aberration that was on its way out by the time the Thatcher government took office in 1979. Inflation was high in all major economies in the 1970s due to high deficit spending in the USA, the resulting collapse of the Bretton-Woods exchange rate system and the associated quadrupling of world oil prices in 1973. The corporatist era's policy regime of wage and price controls in a context of strong unionisation was unable to deal well with this disruptive situation and policy mistakes were made. The threshold wage agreements introduced by the Heath Government in 1973, caused prices to soar in 1974 following the oil price increase, but rises in unemployment were kept smaller than would otherwise have been the case. Inflation is likely to have been somewhat higher after 1980 than it actually was if corporatist policies had continued, but unemployment would have been much lower.

Other projected gains from liberal market policies have not been realised or not sustained. Total taxation is no lower now relative to GDP than in the 1970s. The enterprise boom in new firm formation did not outlast the 1980s and new firm formation rates are now only a little higher than in the decades prior to 1980. If business investment was expected to have risen from its low rates in the pre-1980 period, then the expectation was not realised. Nor has the record of research and development spending improved. Indeed it has worsened. Again this is likely to reflect the loss of manufacturing with the UK experiencing the largest proportional loss of any industrial nation.

Any consideration of the changes in business regulation in the post-1979 period is complex. The prices and incomes controls of the pre-1980 period did not work well and arguably had a limited impact on inflation. Such controls would in any case have become redundant as global inflation came down over the 1980s and 1990s. Regional development controls on manufacturing investment did help regions with high unemployment but were in abeyance by 1979. Although such controls were abandoned, a regime of grant-based incentives has continued up to the present albeit one regulated through EU state aids rules. The huge success of a low business tax regime in attracting multi-national firms to the Republic of Ireland shows that regional attraction measures can be very effective.

The growth of new regulations over recent decades, many EU-wide, in health and safety and other areas are part and parcel of a higher standard of living. Countries with more controls, including Germany, Austria and Sweden, do not appear to suffer a significant overall productivity penalty. OECD studies suggest that, among deregulation measures, it is free trade that has most impact. We argue that most of the tariff reductions on trade in goods had already been introduced by 1979. Nevertheless it remains true that, on average, the post 1979 period experienced much freer trade than the preceding decades. Other regulations, including labour market rules, appear to have had a limited impact. UK attempts to derogate from EU labour regulations are likely to have done little to increase economic growth or productivity over recent decades. We conclude that the regulatory regime before 1980 had little negative impact, and the fact that the UK has had a somewhat lighter regulatory regime than other EU countries since has done little to increase economic growth or productivity.

It was the de-regulation of bank lending which had most impact after 1979. Financial de-regulation, undertaken initially in 1971 and more determinedly after 1979, led to faster growth in GDP up to 2007 but eventually left a highly indebted household sector and a devastated banking sector. Since the financial crash of 2008 the UK economy has languished further and further below the pre-2008 trend and seems most unlikely ever to regain that trend.

The impact of privatisation on industrial efficiency has been judged in most studies to have been limited. This was surprising because privatisation improved corporate governance, and freed companies from political interference and from Treasury financial controls which were likely to have constrained investment. Commercial objectives including profitability became more dominant and firms improved efficiency in marketing, innovation and finance, and were able to diversify into overseas markets, becoming large multinational companies. Even so, studies across privatised companies have concluded that either there were no long run effects on UK output or that it was tough regulation rather than privatisation per se that gave rise to welfare gains for consumers. Studies of individual privatisations show mixed results. Only some studies detected clear performance gains and a number confirmed that the main gains occurred in the run up to privatisation. In general however efficiency gains were, as expected, more likely when accompanied by competitive markets or effective regulation.

The official historian of UK privatisation concludes that *'the strident claims of ministers during the 1980s and 1990s about the benefits of privatisation were exaggerated and the true picture is more of a mixed one'*. It should also be borne in mind again that any efficiency gains at company or sector level only lead to macro-economic gains if redundant labour is re-employed in productive activity. The persistently high unemployment of the 1980s and 1990s indicates that there was insufficient re-employment to growing sectors and fits our observation above that, far from improving, the trend growth in GDP per hour deteriorated substantially from the early 1980s.

It is true that the retreat of state involvement in the UK has avoided repetitions of some of the commercial failures of the corporate age including nuclear power (AGRs), Concorde and launch rockets. However other countries, and notably France, persevered longer with these technologies and now have more successful firms in these areas than does the UK. Nor was it the case that government commercial failures were confined to the corporate period. Commercial blunders were equally possible in a regime of liberal markets, as shown by the mis-selling scandal over privatising pension provision as personal pensions in 1985, and the attempt to privatise vocational training as individual learning accounts in 2000.

Relative productivity performance

Much of the support for the liberal market reforms comes from a belief that the UK's economic performance improved relative to Western European competitors although not, it should be noted, relative to the USA. Other than the support of what we regard as inappropriate theories currently dominant in much of university economics, and in some quarters a philosophy of individual freedom, it has been the UK's improved performance *relative* to major European competitors that has underpinned the consensus around the economic benefits of market liberalisation.

In the immediate post-war years, levels of productivity and per capita GDP in the UK were well above those of most of Western Europe. The advantage had disappeared by 1979 as productivity in other EU countries improved faster than in the UK, but after 1979 the UK matched or bettered growth in per capita GDP in the original EEC members. There is however little evidence, as we have argued, that this improvement in relative growth was caused by any improvement in the actual growth of UK GDP. Rather, the improved *relative* performance was caused by a dramatic slowing in the growth of continental EU economies from the early 1970s onwards. GDP in the EU6 countries grew rapidly at an annual rate of 4.5% per annum from 1950-73, slowing to 2.5% per annum in 1973-79 and only 1.6% per annum from 1979-2007.

By 1980 French and German labour productivity levels were approaching 90% of US levels and had little further room to converge, while their hours worked per employee continued to fall. Moreover there was no compensating rise in employment rates, including in Germany until the Hartz labour market reforms of a decade ago. As a result, growth in per capita GDP slowed within the EU6. These conditions did not apply to the UK, where labour productivity was only 75% of the US level in 1979 and has never subsequently reached 90%. With less globalisation and hence a slower decline in manufacturing we believe that productivity growth would have slowed down less after 1979 than it actually did. On the other hand a more unionised UK is likely to have continued to reduce hours worked per employee as in the EU6 countries.

One of the proximate causes of slow productivity growth in the UK has been the low rate of investment both by businesses and government. Data from the IMF show that the UK has consistently had the lowest rate of total investment of any major economy. The investment rate in the liberal market era has been even lower than in the previous corporatist decades, but both were low. OECD data shows that business investment has been the lowest of any major economy since 1980.

Our conclusion is that UK growth in per capita GDP did not improve after 1979 and even the achievement of keeping close to pre-1980 growth rates was attained by keeping working hours from falling further. Labour productivity has remained below that of France and Germany and has fallen further behind the USA. There is little to suggest that liberal market policies in the UK contributed to convergence with other European economies.

One confidence-sapping characteristic of the pre-1980 decades was the continuous decline in the UK share of world trade in goods. This decline appeared to cease after 1980 initially due to the growing production of North Sea oil and gas combined with high oil prices. The longer trend has been a continued decline in the UK share of world trade at much the same rate as before 1980. Once again there is little to suggest a sustained improvement in performance due to liberal policies. Instead the UK current account on the balance of payments has been continually in deficit since 1983 in sharp contrast with earlier decades. This has occurred despite a growing surplus in trade in services.

Slow Growth in Future

The future implications of the analysis in this paper are serious. The trend in productivity growth in a UK economy heavily denuded of manufacturing by decades of globalisation is unlikely to be much above 1.4% per annum. Growth in the employment rates did offset declining productivity growth from the early 1980s, but this offset cannot be sustained in future. With the employment rate in 2014 once again close to a peak, there will be little or no future secular growth in employment rates. Even worse, a projected decline in the proportion of working-age people, due to an aging population, will reduce the long-term trend in growth of per capita GDP by a further 0.5% per annum. If the average number of hours worked per employee continues to decline, even at the slow rate of recent decades, a further 0.3% per annum will be subtracted from the growth rate of per capita GDP. The trend growth rate of per capita GDP would then be only 0.6% per annum. If this sounds alarmist, we should note that observed growth over the decade to 2014 has been only 0.4% per annum. We thus expect the UK to experience the secular stagnation that Lawrence Summers projects for the USA, but the reasoning involves fundamental trends in sectoral productivity and demographics rather than the demand-side factors invoked by Summers.

Discussion

The main contention of this paper is that financial liberalisation was the sole aspect of the liberal market reforms introduced into the UK, initially in 1971-73 and more consistently from 1979, which materially increased the rate of economic growth. The freeing up of finance led to a huge, and eventually unsustainable, expansion of household borrowing. This temporarily accelerated the growth of consumer spending and hence GDP and of house prices, but in 2008 contributed to a banking crisis and the longest recession for over a century. Other than this unsustainable boost to demand from *financial* liberalisation there is little evidence that other liberal market policies taken together improved the trend rate of economic growth in the UK even temporarily, although they may have been advantageous in other ways. Evidence that the growth rate was poor in the post-1979 liberal period also lies in the consistently high level of unemployment which has averaged 8% since 1979, (not including the concealed unemployed on sickness benefits), compared with 3% in the three previous decades.

The liberal market reforms were one attempt to stem the rate of decline in the UK share of world trade. Joining the EEC in 1973 in the expectation of tying the UK economy to fast growing markets had been another. While post-1979 liberal reforms may have had some success in improving management and industrial relations, they have also allowed UK firms to relocate production to emerging economies, helping the extreme de-industrialisation of the UK economy. As far as EU membership is concerned, the UK actually joined one of the world's slower growing trade blocs, as growth slowed permanently in France, West Germany and other EEC nations just as the UK acceded.

Margaret Thatcher regarded the British in 1979 as "a brave people who were stifled and controlled by a bureaucratic state that penalised the good and rewarded the bad, stifled innovation, while generating feckless welfare dependency". The policies designed to reduce bureaucracy, promote innovation and reduce welfare dependency clearly did not succeed in raising rates of economic growth. Even in 2007 government current spending was higher as a percentage of GDP than it had been in 1979. Welfare dependency rose by 50% during the Thatcher-Major years and remains at this level today. Attempts to reduce taxation through lower public spending were also only temporarily effective and did not survive the first post-Thatcher recession in 1990/91. Levels of business investment in the UK have remained low compared with all major competitors. Company formation rates rose only briefly and are now not much higher than before 1980. Expenditure on R&D has also remained lower than competitors and indeed the UK is the only major country in which R&D expenditure has been trending downwards relative to GDP. The erosion of manufacturing has left the UK with a permanently lower rate of productivity growth. OECD research shows that less regulated labour markets do not lead to a better economic performance. Even trade restrictions like the 11% cap placed on car imports since 1977 have served the UK well as Japanese car manufacturers subsequently set up production plants in the UK.

What was achieved by liberal economic policy was a reduced level of industrial disruption and weaker trades unions, although in part this was due to higher unemployment. It is difficult to estimate the direct economic impact of improved labour relations and lower level of industrial disputes. Common sense indicates that less disruption should be a good thing in itself but not necessarily if the result has been a weakening of wage bargaining power that has allowed a resurgence of extreme income inequality. We note that the UK economy grew consistently and well through the 1950s and 1960s even with poor industrial relations, as it did in the USA with extra-ordinarily high strike levels by British standards. Moreover, the idea that high inequality is necessary for enterprise and innovation also receives little support from the data. Recent research from the IMF suggests that increasing inequality is not associated with faster growth in GDP or higher productivity.

This report attempts to lay out the facts of UK macro-economic performance under contrasting policy regimes. It does not attempt to say much in detail about alternatives to the current liberal market regime. We can say that while we believe a framework of competition between companies and organisations promotes productivity growth, the evidence appears to show that this is not necessarily sufficient to generate adequate growth in productivity. In complex economies like the UK, in which governments are inevitably involved in supporting the economy, the extreme assumption that free markets will generate optimal outputs is shown to be untrue. The evidence suggests that policies aimed at maintaining full employment generated better growth outcomes than policies that instead targetted inflation. The main reason is likely to be the greater certainty engendered when governments maintain demand at a high level. This encourages company investment and skill formation. Persistent tightness in labour markets also promotes rapid sectoral change as low productivity sectors run short of labour which is attracted to higher paying sectors. The problem with liberal market regimes is that they leave demand management to an unco-ordinated private sector. Bank lending, chiefly to households fills the gap vacated by governments and has negative impacts on house prices and ultimately on bank viability. Aggregate demand is usually too low, resulting in high unemployment which while depressing inflation has permanently unfavourable social effects. Our conclusion is that a wider range of varieties of capitalism are available to policy-makers than is commonly assumed.