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Failure followed by success or success followed by failure? A re-examination of British economic growth since 1949

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INTRODUCTION

Economic growth has perplexed economic theorists, economic historians and policy makers.¹ Much of the theory of economic growth effectively

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assumed away the issue by assuming that growth – like ‘manna from heaven’ – was not explicable by economic phenomena. Others believe that growth does respond to economic factors – but there is much disagreement about what these factors are and how big their impact may be (see Temple 1999 for a review of the vast literature).

Understanding economic growth may be difficult but it is important – not least because, if policy makers can create the right conditions to improve growth, then prosperity and welfare may increase. The goal of the current Labour government is to improve the UK’s long-term growth rate and the benchmark that it is using is whether the productivity gap between the UK and the leading countries, especially the USA, is closing (DTI 2002, Treasury 2000). In 1999, the average American worker produced 30 per cent more per hour than the average British worker. If the UK economy grew faster and closed this gap, this would allow some combination of higher consumption of goods and services (or more leisure time), more investment, a better trade balance and more resources for government to spend on public goods.²

The existence of the productivity gap – and policy makers’ preoccupation with it – suggests that the UK economy has underperformed or ‘failed’. This contention is, however, subject to debate and a wide variety of interpretations. First, there are those who argue that the issue of ‘decline’ is largely a misnomer and a pessimistic misinterpretation as the level of prosperity in the UK is much higher now than ever before (Supple 1994a and see also chapter 8 below). This argument often fails to address adequately the key issue of ‘relative decline’ – that the UK position compared to many other advanced countries has deteriorated. Second, there are those who acknowledge that the UK position has declined but suggest that this does not reflect ‘failure’ but is the outcome of the dynamics of growth (countries that were behind the UK in prosperity had the potential to catch up) or advantages that some other countries, such as the USA, had or have in terms of resources (Feinstein 1994). Although this argument can explain why the USA maintains its lead and why many countries have caught up with the UK, it is weaker in explaining why some of these countries have subsequently overtaken the UK. Third, there are those who believe that the UK economy did fail during the 1950s and 1960s, but that it has subsequently been successful in reversing relative decline or, at the very least, halting the decline (Crafts 2002). Finally, some argue that the UK performance has been consistently poor during the period since the Second World War, although the causes of such underperformance have changed over time (Coates 1994).

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² National income comprises consumption, investment, government spending and the trade balance (exports minus imports).

This chapter evaluates the evidence and analysis of the UK's growth performance. It does not address the issue that decline is a misnomer, because a wide variety of indicators show that the UK has a lower level of prosperity than many other countries. The first section of the chapter considers why economic growth is important. The second section evaluates the UK's relatively poor growth performance. The third section considers some of the insights from the economics of growth. The fourth section evaluates the various explanations for the growth performance of the UK economy.

WHY ECONOMIC GROWTH IS IMPORTANT BUT DIFFICULT TO MEASURE

Economic growth is important because it shows whether economic activity is expanding or contracting and it provides an indicator of the prosperity and well-being of a nation. But it is an imperfect indicator: there are empirical problems in measuring it accurately and difficulties in interpreting what it means for the standard of living.

Economic growth is normally conceived as the change in the real level of national output as measured by the percentage change in real Gross Domestic Product (GDP). Obtaining reliable measurements of GDP are problematic for a number of reasons. First, it is very difficult to measure the output of services (such as banking, health, education and so on) which are increasing in their contribution to GDP in the UK and in other advanced countries (see chapter 10 below). Second, it is increasingly difficult to measure the output of manufactured products because as they become more sophisticated their attributes are more difficult to quantify – e.g. the power of computers has changed so rapidly that many perceive that the statistics underestimate the contribution of Information and Communication Technology (ICT) to national output and growth. Third, there is the 'apples and pears' problem: how to combine the outputs of a variety of different goods and services (say, computer games and haircuts)? The answer is by creating index numbers of output and weighting the items together depending on the relative size of production, expenditure or income – but such weights change over time and this creates the problem of whether to use base-year weights or current-year weights – and there are strengths and weaknesses in either approach.

To use GDP as an indicator of the standard of living some account has to be taken of the size of the economy in terms of its population or workforce – in 2001 the GDP of China was more than 10 times greater than that of Ireland but the average income of a citizen of the latter was 33 times greater than the former. One of the most common measures of growth – although strictly it is a productivity measure – is the change in output per worker. And a variant, to take into account the difference in

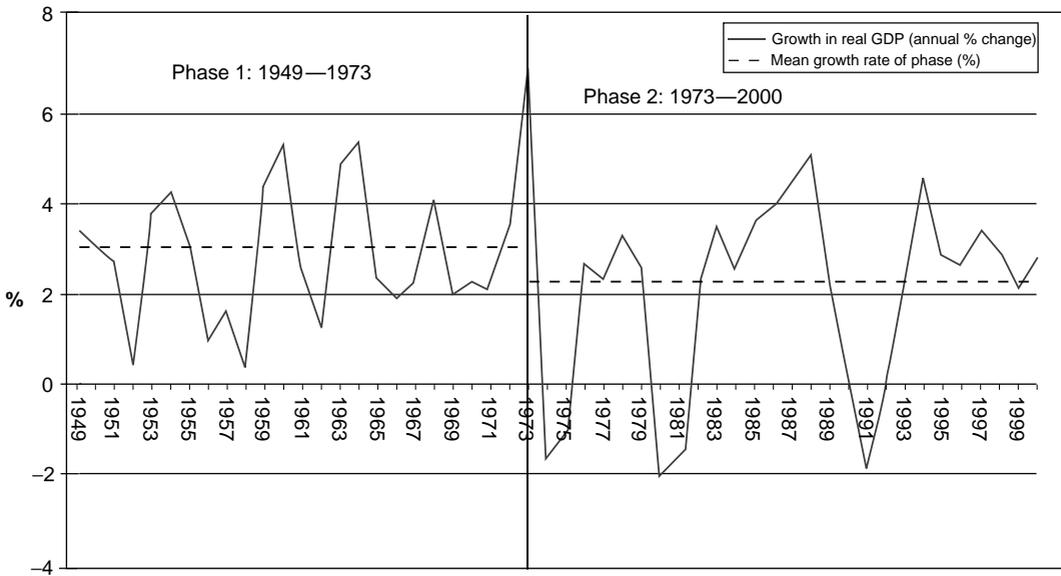
hours worked across sectors and, more importantly, between countries, is changes in output per hour worked.

GDP and its various derivatives are the most commonly used measures of growth and they are, in many ways, the best and most comparable – but care is required in their interpretation as GDP may not adequately reflect the standard of living when the latter is broadly defined. First, some components of GDP (investment and some parts of expenditure by government and on imports) are postponed consumption which will (hopefully) benefit future generations but do not have a direct impact on the current standard of living although they will indirectly benefit those who earn income through such expenditures. Second, having the financial power to purchase more goods and services may improve well-being but other factors may be more important (health, education and so on). An alternative measure of growth and development that helps to capture such factors is the Human Development Index (HDI) which combines GDP per capita with life expectancy and literacy levels.³ Third, GDP and related measures do not take into account economic activity that does not involve a legitimate financial transaction – so they ignore the black economy but also many other forms of legitimate activity such as home improvement and some child-care. Distortions may arise over time when types of activity move from the informal economy (where they are not recorded) to the formal economy (where they are). For instance, if parents decided not to look after their child themselves but to employ a nanny or child-minder, measured national output would increase even if there were no real change in the level of activity. Such changes may be important in the UK, especially since the 1970s, due to increased female participation in the workforce and because of changes to lifestyle. Fourth, GDP includes many items that may not be good indicators of the standard of living. For instance, deteriorating health that is treated may be shown as higher output of health care, and a high crime rate may lead to a high output of policing and legal services. Fifth, GDP takes no account of the environmental impact of economic activity. Sixth, there is no account taken of the distribution of income.

UK GROWTH PERFORMANCE

The UK has been in relative economic decline since the latter part of the nineteenth century. Since the 1970s, the UK growth rate has been consistently less than that achieved by the other major capitalist countries. The norm has been for the UK growth rate to be approximately two-thirds of that achieved by the other industrialised economies and only during

³ The United Nations measures the HDI by combining life expectancy, educational attainment (adult literacy and combined primary, secondary and tertiary enrolment) and adjusted income per capita in purchasing power parity (PPP) US dollars.



the 1930s was this norm disrupted. The UK's fastest period of sustained growth was from the end of the Second World War up until the early 1970s. This period has often been described as the 'golden age of capitalism' as growth rates were much higher than previous or subsequent periods. Yet, even during the golden age, the UK's growth rate of 3.0 per cent compares with an average growth rate of 4.6 per cent achieved by the other leading capitalist countries (Kitson 1997).

The path of UK economic growth is shown in Figure 2.1. During the first major phase, from 1949 to 1973, the UK economy grew at an average of 3.0 per cent per annum with regular and (with hindsight) mild cycles. In the subsequent phase from 1973 to 2000 – following the collapse of Bretton Woods and the rise of free-market economics and policies – the growth rate slowed to 2.3 per cent per annum with more pronounced and irregular cycles. The post-1973 phase was characterised by a number of external and internal shocks which generated deep recessions, including the 1973 oil shock, the 1979 shock following the introduction of a new policy regime by Prime Minister Thatcher, and a 1989 shock which followed the collapse in the price of houses (which influenced householders' wealth) and problems of exchange rate management.

An analysis of the growth of key variables in various (peak-to-peak) sub-phases is shown in Table 2.1. Since 1964, the growth of GDP had fallen in each sub-phase – from 3.1 per cent in 1964–73 to 2.2 per cent in 1990–2000. This slowdown in growth reflected both a lower utilisation of resources – reflected in high and mass unemployment during much of the latter period – and a slowdown in productivity. As shown in Table 2.1 the growth in output per worker was significantly lower in

Figure 2.1 UK GDP growth, 1949–2000 (annual % change)

Source: ONS, *Economic Trends*.

Table 2.1 Growth of key variables in various phases

	Phase 1: 1949–1973		Phase 2: 1973–2000		
	1949–64	1964–73	1973–9	1979–90	1990–2000
Average annual growth in real GDP (%)	3.0	3.1	2.3	2.3	2.2
Average annual growth in consumption (%)	2.5	3.0	1.9	3.2	2.5
Average annual growth in output per worker (%)	na	3.1	1.5	1.6	2.1
Average annual growth in total factor productivity (%)	na	1.8	1.2	1.3	1.3
Average annual ratio of current account surplus to GDP (% of GDP, current prices)	0.5	0.2	–1.2	–1.1	–1.7
Average annual ratio of balance of trade in goods and services to GDP (% of GDP, constant (1995) prices)	–0.1	–0.8	1.0	–0.3	–2.5

Sources: Office of National Statistics and National Institute of Economic and Social Research.

the post-1973 phases than it was in the earlier period although the rate of growth in the 1990–2000 phase was higher than that achieved in the 1970s and 1980s. Output per worker may increase because workers use new technologies or because they have more capital to work with. A measure that seeks to take account of this is total factor productivity (TFP) which attempts to quantify the productivity of both capital and labour. As shown in Table 2.1 there has also been a fall in TFP growth since the 1964–73 period, although the lowest growth rate was during the 1973–9 period. The growth of TFP tends to be lower than labour productivity as some of the latter is driven by investment and the growth of the capital stock and this difference is most noticeable during the 1964–73 period. There are limitations to the TFP concept. First, TFP is particularly difficult to measure and estimates are prone to error. Second, it is difficult to know what it is measuring: technological progress, entrepreneurship, managerial abilities or something else?

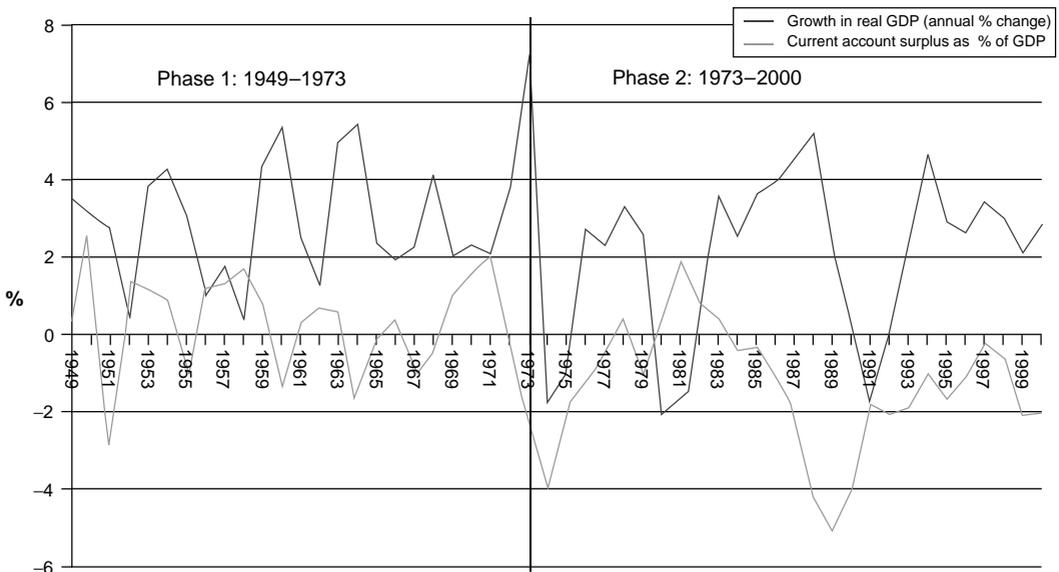
The consumption component of national income has increased its growth rate since 1973 – rising from 2.7 per cent in the 1949–73 phase to 2.9 per cent in the 1973–2000 period. As shown in Table 2.1, however, there have been variations with sub-phases with the fastest growth of consumption being in the 1979–90 period. Overall, there has been a shift from the economy growing at a faster rate than consumption, to consumption growth outstripping the growth of the overall economy. This may not be a problem if the economy grows more rapidly in the future but if it does not then consumers may have to save more in the future in order to service and repay their accumulated debt.

Table 2.2 shows the variability (using the standard deviation (SD) as a measure) of the key indicators. The issue of whether there are advantages or disadvantages to economic variability is subject to debate (see below) although the aim of the New Labour government is to reduce ‘boom and bust’ as it believes that such variability can harm the economy. During the 1949–73 phase the economy was relatively stable with low levels of

Table 2.2 Variability of key variables in various sub-phases
(standard deviations)

	Phase 1: 1949–1973		Phase 2: 1973–2000		
	1949–64	1964–73	1973–79	1979–90	1990–2000
SD of annual growth in real GDP (%)	1.7	1.8	2.9	2.3	1.7
SD of annual growth in consumption (%)	1.7	1.8	3.1	2.5	1.9
SD of annual growth in output per filled job (%)	n.a.	1.1	2.0	1.8	1.1
SD of annual ratio of current account surplus to GDP (% of GDP, current prices)	1.2	1.1	1.4	2.2	1.0
SD of annual ratio of balance of trade in goods and services to GDP (% of GDP, constant (1995) prices)	0.7	0.7	1.3	2.0	1.5

Sources: Office of National Statistics and National Institute of Economic and Social Research.



variability of the key indicators. This changed from 1973 when variability increased – with significant increases in variability during the 1973–9 and the 1979–90 sub-periods. In the most recent period (1990–2000) there is evidence that variability has fallen back to the levels prevailing during the 1950s and 1960s although the sources of this relative stability and whether it will continue are subject to debate.

As shown in Table 2.1, during the 1964–73 sub-phase the average current account balance was in surplus – this changed in the subsequent phase when the average balance was in deficit. The path of the current account is shown in Figure 2.2; during the first phase there were periodic but relatively small deficits, but since the early 1970s the current account has been in almost persistent deficit with the exception of the

Figure 2.2 Growth and the balance of payments, 1949–2000

Source: ONS *Economic Trends*, various years.

Table 2.3 The relative productivity performance of the UK – total economy output per hour (UK = 100)

	USA	France	Japan
1953	195.7	75.5	39.5
1960	200.1	91.5	47.0
1970	180.7	112.6	70.1
1980	158.8	134.5	83.8
1990	137.6	139.6	92.0
1999	130.3	129.4	88.7

Source: O'Mahony and de Boer 2002.

early 1980s. The irony is that during the first period the balance of payments did 'matter' – both economically and politically. As Feinstein (1994) observed: 'The recurrent fear of actual and progressive deficits, together with speculation against the pound meant that there were repeated sterling crises, during which the currency was sold heavily by foreign holders and – if they could – by British residents.' Since the 1970s, the balance of payments apparently no longer matters:

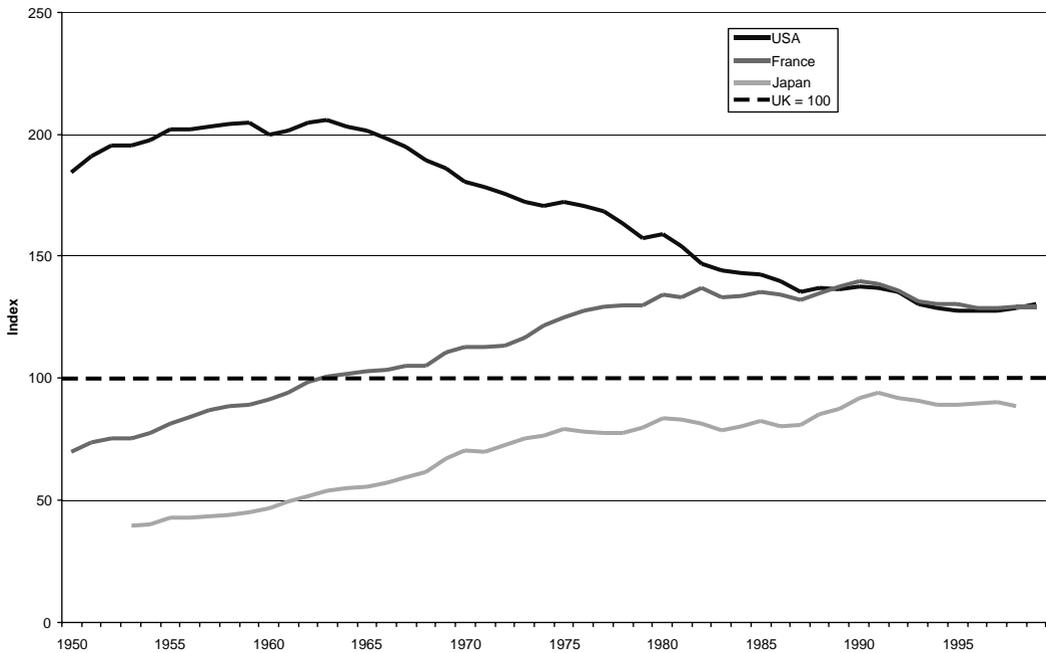
'history offers no real precedent as to how long a country with good access to capital markets can run a balance of payments deficit before it starts to matter' (Pain, Riley and Weale 2001; see also chapter 8 below).

The UK's relatively poor growth rate has been associated with many industrialised countries catching up with the UK level of GDP and with some countries overtaking that level. For the past 180 years the UK has been slipping down the GDP league table. In 1820 the UK was the richest of the capitalist countries as measured by GDP per head (Maddison 2001). By 1870, per capita output of the UK remained greater than that of the USA and that of all the European countries and was only exceeded by Australia's. By 1913, the UK had also been overtaken by the USA and New Zealand, and by 1950 two European countries – Switzerland and Denmark – had also overtaken the UK. During the next twenty years the UK position continued to fall as it was overtaken by other European countries: by 1973 the UK had slipped to twelfth and five of the six countries that formed the European Economic Community had higher levels of output per capita. By 1999, the UK had been also overtaken by more European countries (Austria and Ireland) and by the leading Asian countries – Singapore, Hong Kong and Japan (rankings taken from Crafts 2002⁴). Although prosperity in the UK had been transformed in the period since the end of the Second World War – output per person in 1999 was 176 per cent greater than it was in 1950 – the UK's relative position had significantly deteriorated indicating that other countries had higher living standards and suggesting that the UK may have failed to realise its full growth potential.

Further evidence of the UK's relative performance is shown in Tables 2.3 and 2.4 and Figures 2.3 and 2.4 which provide data on labour productivity for the UK relative to the USA, France and Japan.⁵ From 1960 the UK economy partially closed the productivity gap with the USA – whereas the US economy was twice as productive as the UK in 1960 it

⁴ The UK has had a similar (although not identical) relative decline in terms of GDP per hour worked (see Crafts 2002: tab. 2.4).

⁵ Germany has been excluded due to the empirical problems of adjusting for unification.



was only 30 per cent more productive by 1999 (measured by output per hour worked). In manufacturing, the gap narrowed from 121 per cent in 1960 to 38 per cent in 1990 – although the gap then widened to 55 per cent mainly due to the strong growth in US manufacturing productivity in the latter part of the 1990s. Despite the narrowing of the gap there are a number of issues of concern. First, other advanced countries have been much more successful in improving their position relative to the USA and have had much higher rates of growth. Thus, as shown in Figures 2.3 and 2.4, by 1999 France had achieved similar levels of output per person hour to the USA in the whole economy and in manufacturing. Output per person remains higher in the USA, because American workers work longer whereas the French take advantage of economic growth in terms of increased leisure time. Second, for many sectors in the UK, productivity has been associated with stagnant output and falling employment and this is most apparent in manufacturing. Since the 1960s the UK productivity level in manufacturing has remained significantly lower than that of the USA and manufacturing output growth in the UK has been very low and employment shedding has been

Figure 2.3 Total economy productivity, 1950–1999 (Output per hour, UK = 100)

Source: O'Mahony and de Boer (2002).

Table 2.4 The relative productivity performance of the UK – manufacturing output per hour (UK = 100)

	USA	France	Japan
1953	267.5	86.3	55.9
1960	221.1	93.8	63.2
1970	185.8	116.9	115.2
1980	174.0	147.5	158.0
1990	137.5	125.9	148.1
1999	155.0	132.4	147.1

Source: O'Mahony and de Boer 2002.

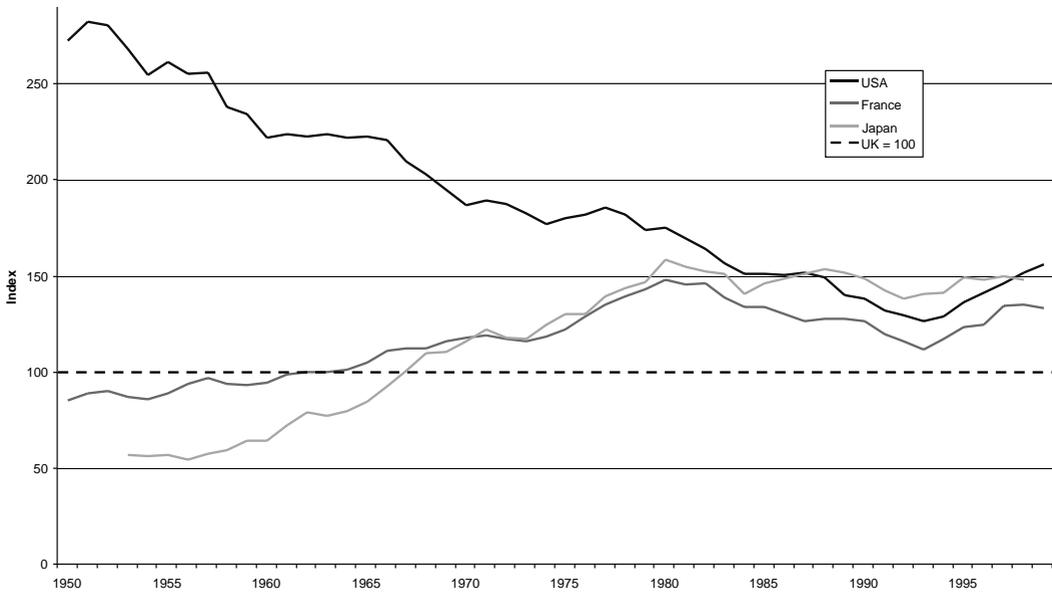


Figure 2.4

Productivity in manufacturing, 1950–1999 (Output per hour, UK = 100)

Source: O'Mahony and de Boer (2002).

rapid (Rowthorn 2001; see also chapter 3 below). During the 1964–99 period UK manufacturing only grew at an annual average rate of 1.1 per cent compared to 2.9 per cent in Italy, 2.3 per cent in France and Germany, 3.7 per cent in the USA and 4.5 per cent in Japan (Kitson and Michie 2000).

EXPLANATIONS OF THE GROWTH PROCESS

Analysing the growth process has occupied much of the effort of academic economists, economic historians and policy makers. This section considers some of the key insights although consensus, not surprisingly, is not a dominant feature of much of the debate (on which see Grossman and Helpman 1991; Barro and Sala-i-Martin 1995; Aghion and Howitt 1998; and the symposium in the *Journal of Economic Perspectives* 1989).

Neoclassical perspectives

Neoclassical models of economic growth assume that in the long run the economy will settle at some steady state where the level of output will be determined by the availability of resources and will not be constrained by insufficient demand. The traditional starting point is the Solow–Swan model⁶ which is designed to show how growth in the capital

⁶ Often simply called the 'Solow model' in the literature – which is disingenuous to the Australian economist Trevor Swan.

stock, growth in the labour force, and advances in technology interact and how they affect a nation's total output. In such neoclassical models the long-run growth of per capita income is dependent on technology – which is exogenous, that is, it is not explained by the model itself – and in some models is universally accessible.

The implication of the traditional neoclassical approach is that economies with similar savings rates and population growth rates will converge to the same level of income per person. Thus, if, for whatever reason, the initial conditions of countries are such that per capita income levels differ, then subsequent growth rates will be inversely related to the level of output per person, with the scope for catching up being dependent on the extent of the productivity gap.

The evidence presented in Tables 2.3 and 2.4 and Figures 2.3 and 2.4 suggest that there has been some catch-up and convergence.⁷ This is also confirmed by an analysis of a wider group of Western countries. In 1950 the per capita income of the leading European economy (Switzerland) was 5.7 times greater than that of the lagging economy (Greece); by 1973 the gap had fallen, with Swiss per capita GDP being 2.9 times greater than that of Greece; and by 1999 there had been a further reduction in the gap with Swiss per capita GDP being 1.9 times greater than that of Greece. These results are consistent with Abramovitz's (1986) view that the period from the end of the Second World War was one of rapid growth by catching-up. The processes of catching-up and convergence, however, are erratic across time and space. Crafts (1992, 1993) shows that traditional neoclassical models fail to predict post-war convergence accurately and he suggests that convergence rates differ substantially. Furthermore, the pattern of world-wide economic growth during the post-war period suggests that although there has been some convergence *within* groups of countries (such as Europe), there have been widening disparities *between* groups (Dowrick 1992).

Overall there is limited evidence of 'conditional' convergence, with catch-up processes being one of many forces that drive the growth process.⁸ This, however, is certainly not evidence of a Solow-type growth process whereby technical progress, the engine of growth, was universally accessible, being an 'exogenously determined, fortuitous and costless occurrence – descending like manna from the heavens' (Shaw 1992: 611). Increased globalisation of the world economy, itself an uneven

⁷ Gordon (1992) makes a distinction (which he attributes to Abramovitz) between convergence and catch-up. Convergence relates to a reduction in the variance of productivity amongst a group of countries, whereas catch-up concerns a reduction in the gap between a leader and its followers.

⁸ Empirical evaluations of the convergence hypothesis provide a range of contrasting results (see Baumol 1986; De Long 1988; Dowrick 1992; Dowrick and Nguyen 1989; and Barro 1991). Mankiw (1995) has attempted to re-establish support for a Solow-Swan type model by arguing that the empirical limitations of the traditional neoclassical approach were due to a failure to estimate human capital correctly.

and variable process, has created the potential for follower countries to borrow and adopt new technologies and management techniques from leading countries. Increased trade integration, the rise of multinational enterprises and, up until the early 1970s, a stable international payments system all facilitated technology transfer between countries. Yet, the ability to exploit such technologies is dependent on domestic economic conditions, which in turn will reflect the historical legacy, the policy regime and the investment record.

The existence of persistent differences in growth rates, and in some cases, evidence of divergences in growth rates, cannot be easily accommodated within traditional neoclassical growth theories. New neoclassical growth theories, such as those developed by Romer (1986, 1994) and Lucas (1988), have attempted to resolve this deficiency by incorporating increasing (or non-decreasing) returns to capital. The major contrast between 'new' and traditional neoclassical models is that the former treat technical progress as an endogenous element of the economic system – an element that can be influenced by corporate strategies, investment behaviour and public policies.

Thus policies which promote investment, or at least certain kinds of investment (such as research and development (R&D) expenditure and investment in education), may be able to influence the long-term growth rate. The proximate sources of growth vary in the different vintages of these endogenous growth models. The models of Arrow (1962) and Lucas (1988) suggest that there is 'learning by doing' where technological progress is a result of the act of producing. In such models all firms collectively benefit from a higher level of aggregate capital stock because there is more 'learning' but there may be little incentive for individual firms to increase investment, as the gains will accrue to all firms not just the one making the investment. In Lucas' (1988) model it is investment in human capital (i.e. people – on this see chapter 5 below) that generates spillover effects to the rest of the economy. The role of human capital is stressed in many endogenous models but also in variations of the traditional Solow–Swan model. The augmented-Solow model divides labour input into two components, so that labour's contribution to output depends on both the number of workers and their skills (often referred to as human capital). Although 'education, education, education' is seen by many as central to economic growth there is, as yet, little empirical evidence to support such a contention – this may, in part, reflect the problem that while 'human capital' may be a useful concept in abstract models it is very difficult to measure (see Crafts 1995).

The importance of knowledge as an input into the growth process is emphasised in many endogenous growth models (Romer 1986). Some stress the importance of investment in R&D and the spillover effects to the rest of the economy and internationally through trade and technological collaboration (see chapter 12 below). In some approaches R&D may have

bigger effects on productivity in sectors that are not undertaking the R&D (Scott 1989). An important implication of many such models is that firms require incentives to engage in research. For instance, public access to knowledge may have to be restricted (through patents or licences) to allow researchers to make monopoly profits on their discoveries.

Whereas many endogenous models stress the importance of one narrow aspect of capital (such as education or R&D), others stress the importance of a broader concept of capital – both physical and human (Frankel 1962). In such models all types of capital exhibit constant returns to scale and so a rise in the investment rate leads to rise in the growth rate, so growth is fully endogenous.

The limitations of endogenous growth models are both empirical and theoretical. That they have little empirical support may reflect the long lag before growth increases following a change in conditions. Although the new growth theories provide a more useful insight into the growth process than traditional neoclassical theories, they are limited by the usual neoclassical methodology. The models assume full employment and the competitive process is reduced to alternative specifications of market structure – monopolistic competition, oligopoly and so on. Furthermore, as noted by Skott and Auerbach (1995), the new theories largely ignore the importance of historical and institutional structures. Also, such models ignore the inter-relatedness of many forms of investments – the case that it is not just about ‘ideas’ but having the equipment and know-how to exploit such ideas.

Endogenous growth: a Keynesian approach

Although increasing returns have relatively recently been incorporated into neoclassical models of growth, they have been integral to many alternative approaches to growth, stretching back through the work of Kaldor, Myrdal, Young and Marx to Adam Smith. These approaches, however, do not depend on the assumptions of the neoclassical approach: full employment is not normally assumed and the economic growth is not determined by exogenously given factor endowments.

For Kaldor (1972), manufacturing acts as an engine of growth as it exhibits increasing returns whereas services are characterised by constant returns. This proposition may be too simplistic as increasing returns are likely to exist in services (although there are problems of measurement: see chapter 10 below). The existence of economies of scale means that a nation that is successfully competing in foreign trade can expect that the advantage of expanding demand will increase its competitiveness – including cost competitiveness and other non-price factors, such as product quality, customer service and technological development. Growing economies, for instance, will be able to invest in capital and skills, thus enabling them to improve processes and products. Conversely, a nation

with poor performance in international trade can expect a trend of deteriorating competitiveness and declining market shares – with a lack of investment and a dwindling skill base likely to constrain future growth. Thus, while not explaining why initial imbalances occur, the existence of economies of scale indicates why such imbalances may generate virtuous (fast) or vicious (slow) circles of growth.

In neoclassical models divergences from ‘equilibrium’ can be rectified through price adjustment and/or the correction of market failures. A Kaldorian approach suggests that economies do not behave like this. First, history is important (as recognised by economic historians and, increasingly, economists who use path dependent models) such that the quantity and quality of factors of production accumulated from the past determine what can be produced in the immediate future. This is inconsistent with much conventional equilibrium theory which asserts that an economy is constrained by exogenous variables (with the exception of technology in the new growth theories). Additionally, it implies that it is difficult and expensive to reverse many economic decisions. If a factory is closed or if a market is lost it is difficult to regain the status quo ante. Second, the impact of economic shocks may not only have a once and for all impact on long-run capacity, but may lead to cumulative changes.

A cumulative causation approach may be taken to suggest that economies may be permanently locked-in to a slow or a fast growth path. This would be misleading, as well as being inconsistent with the ‘stylised facts’ of growth. Although cumulative processes may generate forces that encourage divergences in growth, other forces may temper or ameliorate such effects. As noted above, the international transfer of technology may allow the adoption of new techniques – improving the performance of weak economies. Furthermore, successful countries and regions may find that they are ‘locked-in’ to certain techniques of production or become overcommitted in certain sectors (Setterfield 1992) – factors which will constrain their future growth performance. Additionally, a change in policy regime may improve the growth path of a relatively weak economy, and if particularly successful may create the conditions for a virtuous cycle of growth. Thus, although a cumulative causation approach indicates the forces that generate divergences in growth, such divergences will be affected, and probably bounded, by the institutional, policy and technological regime.

Cycles, shocks and growth

Until recently the phenomenon of economic growth and the business cycle were analysed independently in the economics literature: business cycle theorists analysed detrended data and considered the trend as exogenous, whereas growth theorists focused on characterising a long-run deterministic growth path. Developments in economic theory since the

1980s, however, called into question this traditional division. There has been a re-evaluation of previous approaches, such as those of Schumpeter (1934) and Goodwin (1967), which view growth and cycles as unified phenomena and there has been the development of the concept of hysteresis, where short-term shocks have persistent impacts.

The rapid advances in economic theory have produced a rich variety of economic models and the relationship between growth and the business cycle can now be analysed from two directions: the impact of the cycle on growth and the impact of growth on the cycle. For instance, a temporary boom may not only increase output in the short run but it may also increase R&D and 'learning by doing', which in turn will put the economy on a higher growth path. In other models, however, a temporary recession may be a 'virtue' as organisational inefficiencies are reduced and inefficient firms are bankrupted, thereby freeing resources for newer and more efficient firms – a process of 'creative destruction' to use Schumpeter's (1934) terminology.

Other factors

Growth, like most economic phenomena, is influenced by social, political, geographic and institutional factors. Abramovitz (1986) and Abramovitz and David (1996) stress the role of social capability in the growth process. Social capability is a society's ability to assimilate technology and realise its potential and is determined by institutional and social structures as well as market structures. A lack of social capability can be due to perverse incentive structures which dissuade agents (such as workers, producers and government) in the economy from engaging in the most efficient and productive ways and to vested interests hindering the growth process. Olson (1982) has suggested that vested interests can create 'institutional sclerosis', leading to a resistance to the changes that are necessary for an economy to realise its growth potential.

A related concept is 'social capital' which has some similarities with social capability, although it has emerged independently. Social capital is a broad concept which consists of norms, networks and relationships that help determine society's social interactions (Putnam 2000). It is a difficult concept to quantify but the most commonly used measures are indicators of trust in other people (Performance and Innovation Unit 2002). Changes in social capital vary from country to country: evidence for eight developed countries indicates that it is declining in the USA and Australia; stable in two (the UK and France); and increasing in four (Germany, Sweden, the Netherlands and Japan) (OECD 2001). Social capital may improve economic growth by improving the efficient operation of markets through improved information flows and lower transaction costs. Within firms, networks and norms may improve the working environment and enhance the relationships between employers and employees. Fukuyama (1995)

argues that private sector business depends on high degrees of social trust. The studies of Knack and Keefer (1997) and Whiteley (1997) found a significant relationship between measures of social capital and the rate of economic growth. Social capital is a contentious topic: it has been argued that it is a fuzzy concept and that the term 'capital' is inappropriate as it is not a tangible asset on which returns are earned.

The role of networks is also an important element in the analysis of industrial clusters. Clusters are geographic concentrations of inter-connected companies, specialised suppliers, service providers, firms in related industries and associated institutions (such as universities) that collaborate with one another as well as compete (this is a concept that can be traced back to Alfred Marshall's notion of industrial districts). It is argued that clusters can increase economic growth by promoting knowledge spillovers and interactions; by increasing innovation and technological advance; and through promoting higher rates of new firm formation (Porter 1998). Thus countries that have fostered cluster formation will have higher rates of technological advance and higher economic growth. Successful clusters that are cited include Silicon Valley in the USA and the concentration of high-technology activities in and around Cambridge in the UK (see chapter 13 below).

The theoretical attempts to explain economic growth are vast and, increasingly, there are new insights from disciplines other than economics, including history, geography and sociology – these alternative lenses provide additional perspectives upon a complex phenomenon.

EXPLAINING THE UK'S GROWTH PERFORMANCE

The list of explanations which have been advanced during the past forty years to explain Britain's failure to match her competitors is truly vast. It includes a divisive class system, an innate cultural hostility to industrialisation, the domination of government and industry by the financial interests of the City of London, lack of venture capital, excessive taxation, too much government spending, too little planning, insufficient expenditure on education and training, an adversarial two-party electoral system, restrictive labour practices and over-manning, incompetent managers and obstructive trade unions.

Feinstein (1994: 116)

Explaining Britain's poor economic performance has been, and continues to be, a growth industry: since Feinstein's (1994) assessment, new – or in most cases newly resurrected – culprits include poor entrepreneurship, low levels of innovation and in particular a failure to commercialise science, a paucity of high-technology clusters and low levels of social capital (Treasury 2002; DTI 2002; and chapter 12 below). These explanations may be new to some but many will seem very familiar to those who have studied the literature on Britain's 'decline' since the 1870s.

As Feinstein (1994) pointed out, not only are some explanations of poor performance more persuasive than others (although economists disagree on which these are) but also countries at different stages of development are likely to experience different growth rates. Thus, an assessment of the UK's relatively poor growth rate performance must be evaluated in the context of different stages of development in advanced countries and the potential for catch-up: as discussed above, countries with relatively low income levels *may* have relatively higher growth rates as they have the potential to appropriate technologies and organisational techniques from the leading countries.

The growth of the UK economy was much faster in the period 1949–73 than it was in earlier periods (Feinstein 1994) or in subsequent periods (see Table 2.1 and Figure 2.1). Although this is *prima facie* evidence that post-war growth can be characterised as success followed by failure, analysis must take into account the potential for faster growth during this period. The process of catch-up may help to explain why the UK had higher growth rates in the 1950s and 1960s than previously as it exploited the potential to catch up with the technological leader – the USA. And it may help to explain why the growth rate fell from the early 1970s – as the gap narrowed, there was less potential for the UK to appropriate overseas technologies and know-how. There is, however, evidence to indicate that the forces of catch-up cannot simply explain the UK growth path; there is evidence of a weak performance and a failure to reach potential. Although the UK has been catching up with the USA it still lags behind – in 1999 the average American worker produced 30 per cent more per hour than the average UK worker (Table 2.3). Second, the UK's poor growth rate has not just been associated with other industrialised countries catching up with the UK GDP level, but with those countries overtaking that level. As shown in Figure 2.3, France, which lagged behind the UK in output per hour in the 1950s, not only caught up but also overtook the UK in the mid-1960s.

In the literature that seeks to shed light on the UK's poor growth performance since the 1950s a contrast can be drawn between those who emphasise the importance of market forces in ensuring efficiency and maximising growth and those that emphasise a more active role for the state in intervening in the economy to provide the appropriate macro-economic and industrial conditions. The role of the market and that of the state vary by country – there are 'varieties of capitalism'. Hall and Soskice (2001) distinguish between liberal market economies where firms co-ordinate their activity primarily via hierarchies and competitive market arrangements (on this, see also Williamson 1985) and co-ordinated market economies where firms depend on non-market relationships to co-ordinate activities and to develop their capabilities. Although Hall and Soskice consider that the UK is and has been a 'typical liberal market economy', the operation of markets and the role of the state in the UK have evolved and changed since the Second World War.

The tarnished 'golden age': a lack of competition?

From the end of the Second World War to the mid-1970s the state took an active role in demand management of the economy (see chapter 8 below) and industrial policy was characterised by state ownership of leading industries and state intervention to 'pick winners' (see chapter 4 below). For those who emphasise the efficiency of unfettered market forces this level of intervention created a 'lethal cocktail of weak competition, pervasive agency problems and deleterious industrial relations' (Crafts 2002: 9). Crafts (2002) argues that the origins of the UK's post-war malaise reflected the legacy of the excessive government intervention in the 1930s. During the post-war period the UK economy failed to realise its full potential due to a combination of market and government failures which had adverse effects on investment, innovation and policy making. Industrial policy focused on excessive interventionism such as nationalisation rather than improving the competitive environment.

In the corporate sector there were agency problems where the managers (the 'agents') of companies had few incentives to behave in the best interests of their owners leading to 'low effort equilibria' and slow growth. Competition is supposed to improve corporate productivity by providing a range of checks on managerial behaviour, including increased risk of bankruptcy, greater focus on profitability and increased work effort (Nickell 1996). Within this framework interventionist industrial policies can act to reduce competitive pressures upon managers allowing them to delay or postpone innovative activities. Industrial policy in the UK, however, was informed by a contrary belief that concentrated markets with a few big companies provided the stability and the economies of scale that would promote innovation and growth. Empirical studies by Geroski (1990) and Broadberry and Crafts (2001) suggest that this view was mistaken as market concentration and associated restrictive practices dampened innovative activity and productivity performance.

Even in the absence of a high level of competition, managers may face the threat of a takeover, but in the UK the threat of takeover failed to act as an effective 'market for corporate control' which disciplined poor managers. Although there was a rapid growth in mergers and takeovers during the 1950s and 1960s this primarily reflected managers pursuing their own interests, such as the desire to take control of a bigger business, rather than efficiency, the interests of shareholders and ultimately economic growth (Singh 1975).

A lack of competition in the labour market, and the state of industrial relations in the post-war period have been frequently identified as key weaknesses in the UK economy. The UK system of industrial relations evolved during the post-war period from a centralised system in the 1950s to a more decentralised system based on workplace bargaining from the early 1960s (see chapter 15 below). An unco-ordinated multi-union

system with plant level bargaining may have led to high real wages which reduced the demand for labour and reduced the share of profits in national income. The system could have created a free-rider problem in the bargaining process as there was no incentive for any single wage negotiator to exhibit wage restraint, so all workers through their unions competed for a bigger share of national income. Denny and Nickell (1992) argue that union recognition had a significant negative impact on corporate investment. This may have been due to a number of mechanisms such as a fear that workers would have tried to appropriate the fruits of such investment through higher wage demands, or that unions created restrictive practices which reduced the profitability of some investment possibilities. There were weaknesses in industrial relations in the 1960s and 1970s but these are not sufficient in themselves to explain the poor growth record. Nor do they provide support for the naïve view that strong trade unionism always harms economic performance. In the Denny and Nickell study it was shown that union recognition raises investment if all workers can be efficiently organised behind an investment programme.

Broadberry and Crafts (1996) and Crafts (2002) have argued that the lack of competition in product and labour markets was due to a failure of government to implement supply-side reforms. Once again, inappropriate incentive structures are seen to be at the heart of the problem as governments increasingly adopted vote-winning strategies which involved trading off long-term supply-side opportunities for a better short-term macroeconomic climate. The informal post-war settlement between government, trade unions and employers resulted in an inappropriate policy framework including widespread nationalisation, the support of 'lame duck' companies, a failure to implement an effective competition policy and a gradualist approach to trade liberalisation. Additionally, for some (see Bacon and Eltis 1976), the growth of the public sector squeezed or 'crowded out' resources that could have been more productively used by the private sector. According to Crafts (2002) the UK lacked the appropriate institutional framework to ensure that the managers of companies maximised long-run profitability, that workers stuck to wage bargains, and that governments remained committed to long-run growth.

The tarnished 'golden age': structural change and low investment

For those who argue for an active role for the state, the poor growth of the UK economy was due to macroeconomic policy being repeatedly blown off-course by periodic economic crises combined with a failure to implement a coherent long-term industrial policy (Kitson and Michie 2000; Coates 1994). The world economy grew rapidly during the post-war period reflecting a stable international monetary system, the reduction of trade barriers and the initial boost to growth of the recovery from

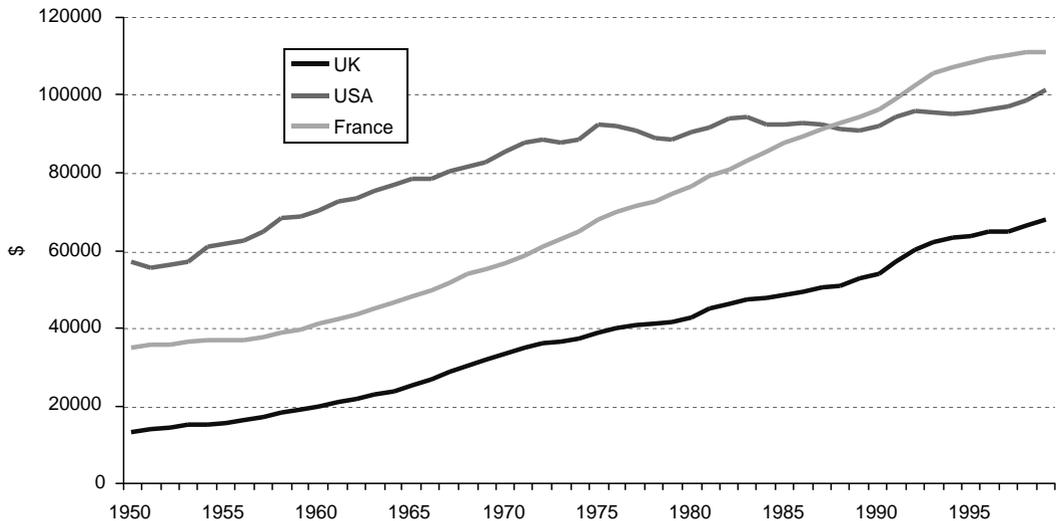
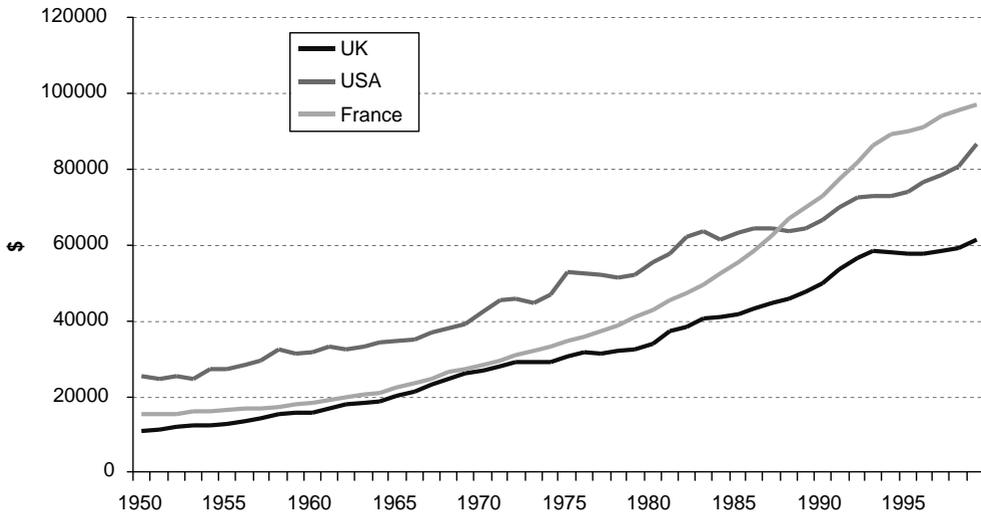


Figure 2.5 Whole economy capital per worker, 1950–1999 (\$, constant prices)

Source: Calculations from O'Mahony and de Boer (2002).

the devastation of the Second World War (Feinstein 1994). Although this provided a demand boost for the UK economy, the UK's share of world trade was falling and its propensity to import was rising and some have argued that the UK's deteriorating trade performance – which was dominated by manufacturing – acted as a brake on growth. In analysing UK post-war economic policies Kaldor (1971, 1972) argued that the UK had a relatively slow growth of demand because it was suffering from a balance of payments constraint due to an excessive propensity to import relative to the ability to export. Thus the UK's poorly performing manufacturing sector and the process of deindustrialisation locked the overall economy into a 'vicious cycle' of slow growth (Singh 1977).

Additionally, the sluggish growth of demand interacted with poor investment. Output grew slowly because demand for British products was relatively low and investment was poor. Poor investment reduced competitiveness, which in turn depressed demand, which in turn reduced the incentive to invest. In addition investment remained depressed because of the distorted structure of the British economy, combined with inappropriate economic and industrial policies. The growth of the UK capital stock has been slower than that experienced in the other major industrialised countries and has left a legacy of a relatively low level of capital. As illustrated in Figures 2.5 and 2.6, capital per worker in the UK was significantly below that of the USA and France. Kitson and Michie (1996) argue that the UK's inadequate capital stock was a major cause of Britain's indifferent growth performance, constraining technological progress and the expansion of demand. The cumulative effect of this record resulted in British workers lacking the quantity and quality of capital equipment used by workers in many other advanced countries.



The poor investment performance has also been attributed to a number of additional factors. First, short-termism in financial markets and biases against the industrial sector created limits on long-term investment (Hutton 1995). Second, companies were reluctant to invest in R&D and products and processes with long gestation periods. Third, labour markets failed to develop and upgrade the skill base. Fourth, macroeconomic instability dampened ‘animal spirits’, reduced business confidence, increased uncertainty and contaminated the climate for investment. UK macroeconomic policy during the ‘golden age’ lurched from one crisis to another: there were periodic balance of payments crises and politically inspired business cycles leading to exchange rate, and monetary and fiscal, instability (see chapters 11 and 14 below). Such macroeconomic volatility led to another major problem for investment – the lack of a coherent industrial policy. An attempt was made in the early 1960s to improve long-term growth by establishing the Department of Economic Affairs (DEA) to co-ordinate economic policy and plan the use of resources. The credibility of the DEA was, however, destroyed by a sterling crisis and since then there has been no serious attempt to introduce indicative planning in the UK.

Many of those who argue that the UK suffered from a lack of investment and excessive deindustrialisation believe that UK growth would have been greater during the golden age if there had been a stronger manufacturing sector within the UK economy (Cosh, Hughes and Rowthorn 1994). This may have required a more active industrial policy to promote long-term investment. This contrasts with those arguments discussed above that emphasise that the UK’s main problems reflected a lack of competition in product and labour markets.

Figure 2.6 Capital per worker in manufacturing, 1950–1999 (\$, constant prices)

Source: Calculations from O’Mahony and de Boer (2002).

The 1970s transition to Thatcherism

The 1970s witnessed a transformation in economic performance and subsequently economic policy. For the major industrialised countries, GDP growth rates in the 1973–9 period were only half what they had been in the golden age (Feinstein 1994). The international monetary system collapsed and in the UK, as in many other industrialised countries, there was the emergence of rising inflation and rising unemployment – so-called ‘stagflation’. The causes of this are controversial. One school emphasised that inflation was driven by rising costs creating a cost-price-cost spiral. Wage costs were rising due to strength of trade unions and the pressure during the late 1960s for rising real wages. Additionally, in 1973 there was a fourfold increase in oil prices following the response of the oil cartel (OPEC) to the Yom Kippur War in Israel. This quickly increased energy costs which fed the inflationary spiral. At the same time, in a misplaced attempt to control inflation, the government introduced an incomes policy under which wages were permitted to rise in direct proportion to increases to the cost of living above a strict threshold. This helped to strengthen the inflation spiral. For the cost-push school, inflation and unemployment can increase at the same time because they are driven by different factors: rising costs drive inflation but unemployment is determined by aggregate demand. And demand was constrained during the 1970s by a series of factors. First, world trade collapsed and remained low. Second, the oil crises raised the incomes of the oil exporting countries, which they failed to re-inject into the world economy. Third, the decline of demand management ushered in a tightening of fiscal and monetary policy.

Monetarism, which provided an alternative explanation of stagflation, was a major influence on the shift in UK economic policy during the 1970s. For monetarists, governments (or the monetary authorities) cause inflation if they print too much money, and trade unions, and any other forces that impede the operation of the labour market, cause unemployment in the long run. Within this framework stagflation emerged due to an irresponsible and inflationary monetary policy, over-powerful trade unions and an excessively generous welfare state. The conquering of inflation was considered a necessary condition for economic success and economic growth would be raised by supply-side policies that decreased the role of the state and promoted the role of the free market.

Although, for many, the election of the Thatcher government in 1979 started the monetarist experiment in the UK, there were important earlier shifts in policy. In April 1975, the Labour chancellor, Denis Healey, announced that although unemployment was high he did not intend to use the budget to attempt to reverse this. This marked the end of demand management in the UK. This shift was confirmed the following year when the prime minister repudiated the key element of demand management:

he told the Labour Party Conference that a nation could not 'just spend its way out of recession . . . by cutting taxes and boosting government spending' (quoted in Feinstein 1994: 114).

Thatcherism: a successful experiment?

The Thatcher government elected in 1979 focused on inflation as the overriding priority and on reducing the role of the state in the economy to allow markets to operate more efficiently. Despite the government's official adherence to monetarism, the strategy that was implemented was a mixture of libertarian economic ideology and inherited policy instruments. The foundation of macroeconomic policy was the Medium Term Financial Strategy (MTFS) which identified targets for money supply growth. Monetary policy went through a number of transformations during the 1980s and early 1990s with different targets (the money supply or the exchange rate or both) and different instruments (interest rates, fiscal policy, exchange rate targeting). However, this did not accord with orthodox monetarism which advocated that the money supply should be controlled directly.⁹

As shown in Figure 2.1 and Table 2.2, UK growth was more volatile during the 1980s and 1990s with major recessions in 1979–81 and 1988–92. As discussed above, the impact of economic downturns on long-run growth is subject to debate. Some emphasise the positive effects of 'creative destruction' while others emphasise the negative effects of increased uncertainty and the loss of capacity. According to Oulton (1995) macroeconomic instability harmed growth performance by depressing 'animal spirits' and discouraging investment. Kitson and Michie (1996) argued that the depth of the UK recessions harmed the long-run growth potential of the UK economy because they led to the large-scale scrapping of capital and contributed to the UK's poor investment performance.

The other key economic strand of Thatcherism was the improvement of the supply-side of the economy by decreasing the role of the state and promoting the operation of the free market. Among the key elements of this policy shift were privatisation and deregulation, reform of industrial relations and weakening of trade union power, and restraint on public expenditure. Crafts (2002) has argued that these initiatives have improved incentive structures and have helped to halt relative decline.

⁹ In his evidence to the House of Commons Treasury and Civil Service Committee, Friedman (1980) argued that: 'Trying to control the money supply through' fiscal policy and interest rates 'is trying to control the output of one item (money) through altering the demand for it by manipulating the incomes of its users (that is the role of fiscal policy) or the prices of substitutes for it (that is the role of interest rates). A precise analogy is like trying to control the output of motorcars by altering the incomes of potential purchasers and manipulating rail and airfares. In principle, possible in both cases, but in practice highly inefficient. Far easier to control the output of motor cars by controlling the output of a basic raw material, say steel, to the manufacturers – a precise analogy to controlling the money supply by controlling the availability of base money to banks or others.'

Privatisation was a central element of government economic policy during the 1980s and into the 1990s (see chapter 4 below). It was argued that the privatisation programme would improve efficiency, widen share ownership and generate government revenue which would help reduce public borrowing. There is, however, conflicting evidence that the programme has achieved these objectives. Although profits per employee improved, the evidence on the effect of privatisation on efficiency is, at best, ambiguous – there were productivity improvements in some privatised industries and not in others (Parker 1993). Moreover, the productivity improvements that were observed may not have been a result of the privatisation process. Bishop and Kay (1988) concluded that: ‘The privatised industries have tended to be faster growing and more profitable, but it seems that the causation runs from growth and profitability to privatisation, rather than the other way around.’

The deregulation of financial markets was seen as central to the efficient allocation of capital (see chapter 7 below). One of the first measures was the abolition in 1979 of exchange controls over capital movements. This led to a large cumulative net outflow of capital (Coakley and Harris 1992). On the domestic front the main developments were, first, the reforms of the London Stock Exchange known as ‘Big Bang’, and second, the set of reforms which abolished the principal distinctions between banks and building societies. The former did improve the efficiency of the equity market although it led to excess capacity in security dealing which was to prove unsustainable. The latter was of greater concern as the increased competition in the banking system, in particular in the mortgage market, led to a credit explosion and rapid house price inflation. Although in the immediate short term this fuelled rapid consumption-led growth (throwing the government’s monetary targets into turmoil) it created the conditions which would hinder growth in the medium term. The credit explosion – house price spiral fed on itself – easily available credit stimulated house prices thus increasing private sector wealth which in turn increased the demand for consumer credit. The situation was unsustainable – this speculative boom was no different from any other. When the housing market collapsed the spiral went into reverse – falling house prices led to declining wealth, increased indebtedness, reduced demand for credit and stagnant consumption. Furthermore, the property crash particularly affected new entrants to the market who were left with high mortgages and negative equity.

The other ‘market’ to feel the brunt of deregulation was the labour market. The government approach to tackling unemployment was to ‘price workers back into jobs’ and, by squeezing benefits, to force people off the dole queues. Reducing the power of trade unions was central to this strategy (see chapter 15 below). This took the form of expanding, rather than reducing, the role of law (Deakin 1992). A series of Acts reduced immunities, increasing the scope of common law regulation of

strike activity. The 1982 Employment Act removed immunity of unions from liability in tort, narrowed the 'trade dispute' formula which had protected many forms of industrial action and strictly regulated the closed shop. Additional Acts, such as the Trade Union Act of 1984 and the Employment Act of 1988, added to this regulatory framework, undermining the basic rights of trade unions.¹⁰

It has been argued that the reforms to industrial relations were good for growth as they improved the competitiveness of the labour market. This led to a reduction of overmanning and restrictive practices (Metcalf 1994) and also reduced the equilibrium rate of unemployment (Broadberry 1991). There are, however, alternative perspectives to this: others have suggested that the policies impaired the operation of the labour market and the observed productivity gains were temporary and reflected harsher working conditions (Nolan 1989). Furthermore, the decline in trade union power was not solely due to policy as it also reflected changes in industrial, locational and occupational structures.

Another aspect of Thatcherism was the encouragement of an 'enterprise culture' to encourage new firm formation and the expansion of the self-employed. Yet, the developments in the small business sector do not suggest that government policy had a significant positive impact. Although the increased number of the self-employed was a phenomenon of the 1980s, the growth of small firms reflected a trend that started in the 1960s (Storey 1994). Moreover, much of the growth of the self-employed was a response to 'negative' factors – workers pushed into 'entrepreneurship' by unemployment and the contracting-out strategies of large firms (Kitson 1995).

Thatcherism: a new regime but continued failure?

Although the conventional wisdom is that reforms pursued since 1979 improved the UK's long-term growth performance and growth potential, there are those who remain both sceptical of their positive impacts and critical of their long-term implications. The improvement in productivity is one key piece of evidence presented in support of Thatcherism (Crafts 1996, 2002; Eltis 1996; and, for an opposing view, Kitson and Michie 1996). Certainly, labour productivity in manufacturing grew in the 1980s, although it has been argued that published figures tend to overestimate the extent of the increase,¹¹ but this growth was largely due to job cuts rather than increased output, and these jobs were not being lost in a period of full employment when the labour would be taken up productively elsewhere. Additionally, as shown in Table 2.1, labour productivity growth

¹⁰ Regarding the more general claim that deregulation is required to promote the sort of flexibility necessary for a dynamic economy, see Tarling and Wilkinson (1997).

¹¹ See Kitson and Michie (1996) for a discussion of alternative measures of productivity growth during the 1980s.

in the 1979–90 period was only half the rate achieved in the 1964–73 period. Looking at the output performance of the whole economy, GDP grew at a rate of 2.3 per cent between the peak years of 1979 and 1990. Thus, despite the potential for growth through continued catch-up, the benefit of North Sea oil and the impact of an unsustainable consumption-led boom fuelled by asset price inflation and financial deregulation, the UK economy could not match the growth rate achieved during the golden age after the Second World War.

Of additional long-term concern for some was the stagnation of the manufacturing sector, particularly as it made a major contribution to UK exports (Rowthorn 2001). The relative decline of manufacturing may have been exacerbated by UK macroeconomic policy during the 1980s and early 1990s. ‘The overriding priority’ of controlling inflation led to periodic overvaluation of the exchange rate which was particularly damaging during the initial monetarist policies in 1979–80 and during the UK’s membership of the Exchange Rate Mechanism. Furthermore, the prosperity of the private sector was hindered by the retrenchment of the public sector. The government’s attempts to reduce the size of the public sector and public borrowing reduced investment in infrastructure and education (Kitson, Martin and Wilkinson 2000).

Post-Thatcherism: New Labour, post-monetarism and the Third Way

The election of New Labour in 1997 saw a continued focus on market orientated policies nuanced with a sprinkling of other influences including: the ‘Third Way’ (Giddens 1998), the importance of location especially for high-technology activities (Porter 1998) and, most recently, emphasis on social capital (Putnam 2000). There have been subtle shifts in policies with some redefined roles for the state: Coates (2002) has argued that New Labour sees the state as the ‘lubricator’ of the market. The role of demand management has been relegated to providing low and stable inflation. In the new monetary framework, there is an inflation target and one instrument – the interest rate – which is used to hit this target (see chapter 6 below). Importantly, the policy is implemented by an independent monetary authority, the Bank of England, as this has credibility with global capital markets. According to the chancellor, Gordon Brown, New Labour’s economics is ‘post-monetarist’ (Brown 2001). The hollowing out of Keynesian economic policy represents a continuity of Thatcherism, although the chancellor’s fiscal rule, which allows the budget to balance over the business cycle, has resonances of Keynesianism.

In terms of growth, the focus of New Labour’s policies is to enhance ‘competitiveness, productivity and entrepreneurship’ through improvements in the supply side that will create a knowledge-based economy and

improve employability. The theoretical case for a knowledge-based economy rests on the notion of endogenous growth (as discussed above) – Brown has stressed the importance of ‘post-neoclassical endogenous growth theory’ and the Prime Minister, Tony Blair, has stated that his priorities are ‘education, education, education’. In the early part of its first term New Labour’s commitment to the previous Conservative government’s spending limits, and the overriding concern with inflation, meant that policies for growth took second stage. Subsequently there has been more activity; in particular the Regional Development Authorities (RDAs) have been tasked with building knowledge-based local economies. Following the work of Porter (1998) on ‘clusters’ the RDAs are seeking to identify and foster high-technology clusters in their regions. This is a particular challenge to the most depressed regions, especially the North-East and North-West, whose economic structures have depended on ‘traditional’ industries.

As for employability, the policies – the New Deal, the Working Families Tax Credit, skills training – are all concerned with improving the readiness for work or the supply of labour and not with the demand for labour. According to Gordon Brown (Brown 2001) the employability policies are aimed at reducing the equilibrium rate of unemployment and increasing economic growth.

During New Labour’s term of office, economic growth generally has been above its historical trend (see Figure 2.1), unemployment has been falling and inflation has remained within its target range. In terms of productivity the performance has, at best, been modest (Nickell 2002). Looking at the government’s key growth benchmark – the productivity gap with the USA – there has been very little change in the relative performance of the overall economy (see Figure 2.3) and for manufacturing the gap has widened (see Figure 2.4). The latter probably reflects the very rapid growth of US manufacturing productivity in the latter part of the 1990s which was responsible for a significant element of overall economic growth in the USA (Solow 2001).

Assessing the impact of New Labour’s policies on growth is complicated by a number of factors. First, it will take a long time before it is possible to assess whether policies that focus on knowledge-based activities have increased economic growth. Second, the growth record of the second half of the 1990s may reflect the policy initiatives of earlier periods. Third, some of the growth performance may have been partly due to favourable external conditions – a buoyant US economy for most of the period and low import prices. Globalisation – particularly of capital markets – has also facilitated UK economic growth in the 1990s. Global capital markets have allowed the UK economy to consume much more than it produces, leading to rising balance of payments deficits (see Figure 2.2). In the 1950s and 1960s small deficits would generate balance of payments

and exchange rate crises. For much of the 1990s onwards, deficits persisted and the exchange rate *appreciated*. This appreciation helped to keep inflation low and within the government's target band and the beneficial terms of trade also helped consumption growth. The behaviour of global capital markets has significantly changed exchange rate determination – in the distant past the value of sterling would reflect trade flows, and subsequently it reflected interest rate differentials, but now sterling is driven by unpredictable 'herding' behaviour in global capital markets.

There are a number of issues which will influence the future path of UK growth. First, there have been significant variations in performance within the national economy – by sector and by location. Imbalances in the macroeconomy – high levels of domestic demand combined with low levels of net export demand due to an overvalued exchange rate – have created a 'multi-speed economy'. The sector most disadvantaged is manufacturing, which, in turn, is having an adverse impact on many regions. In the three years between 1997 and 2000 the UK trade balance in manufactured goods deteriorated by £18 billion, whereas during the same period the surplus on knowledge-based services only increased by £10 billion. The damage to manufacturing capacity and to the regions that are highly dependent on manufacturing is likely to persist as it is difficult – and in some cases impossible – to rebuild capacity and competences.

Second, policy is narrowly focused on 'knowledge-based activities'. These activities are currently a relatively small part of the national economy and tend to be concentrated in the south and east of England. Furthermore, the notion of such activities being an independent development block ignores the important intersectoral linkages between 'new' and 'old' industries and the importance of technology and innovation in the latter. Also, some argue that the focus on clusters is a concept lacking in coherent content as there are a bewildering variety of ways of conceptualising clusters (Martin 2002).

Third, and related to the previous point, there is uncertainty about the impact of information and communication technology (ICT) on economic growth. The Solow Paradox – 'that you can see the computer age everywhere except in the productivity statistics' – seemed to have been contradicted by the surge in US growth in the 1995–2000 period (Stiroh 2001). There remains controversy, however, about the size of the impact of ICT and whether US growth was due to cyclical factors rather than a breakthrough in technology that has increased the long-run growth rate (Gordon 2000). Eltis (2002) suggests that ICT has the potential to raise the UK growth rate by around 0.5 per cent per annum. Crafts (2002) suggests that ICT provides an excellent test of whether the post-1979 economic reforms have provided the flexibility required to exploit the growth-inducing advantage of the new technology. The long-run impact

of ICT on growth is subject to conjecture and many of the estimates seem overoptimistic in light of the business failures in the ICT sector and declines in global stock markets since 2000. Additionally, the policy regime that is most appropriate for exploiting new technologies is also open to debate. Crafts (2002) stresses the importance of reducing regulatory barriers to entrepreneurship and business start-ups, and of educational standards. But the economic environment conducive to growth of another new technology sector – biotechnology – suggests that other policies and institutions are required. Biotechnology has the potential to make a significant impact on health, well-being and growth and the UK has the second largest biotechnology sector in the world, albeit one that is much smaller than the sector in the USA. Biotechnology is a sector that is characterised by high risk (only one in 10,000 compounds becomes a drug), high cost (the average cost of developing a drug is £500 million) and a long product gestation period (the average drug takes fifteen years to get to market). Market forces alone will not ensure the optimum level of drug development – it is too risky and too uncertain for the private sector to develop drugs on its own. If this sector is to make a major contribution to economic growth what is also required is a strong science base, effective mechanisms to commercialise science and available finance to fill the gaps in private sector provision.

CONCLUSION

The level of national output and prosperity in the UK has increased rapidly in the post-war period – GDP per person in 1999 was 176 per cent greater than it was in 1950. But the UK has fallen down the international performance league and the issue of relative economic decline remains at the centre of the policy debate. During the golden age of capitalism in the 1950s and 1960s the UK growth rate exceeded that of earlier and later periods. But this is insufficient to argue that the immediate post-war period was successful and that failure was evident during the later period. After the Second World War, the UK had the potential to grow rapidly by using technologies and practices from the USA, which was, and remains, the world's technological leader. That it failed to catch up quickly and that other countries overtook the UK during this period suggest that that economy underperformed. In the post-1973 period the growth rate of the economy slowed to two-thirds of that achieved in the 1950s and 1960s. Despite this slowdown many have argued that this was a comparatively successful period because relative decline (on some measures) halted and the scope for catch-up growth was more limited than in earlier periods. The most common and widely accepted view is that the shift to more pro-market policies which started in the 1970s improved the UK's growth performance. But this view is not universally accepted;

there remains a body of analysis that believes that fundamental problems remain in the UK, most notably a small and uncompetitive manufacturing sector with a record of underinvestment. These structural imbalances have been masked by the forces of globalisation which have allowed the UK economy to maintain persistent balance-of-payment deficits since the late 1970s, allowing the economy to spend collectively more than it earns.