Recession and Economic Revival in Britain: The Role of Policy in the 1930s and 1980s

Michael Kitson

Contemporary European History / Volume 8 / Issue 01 / March 1999, pp 1 - 27
DOI: null, Published online: 08 September 2000

Link to this article: http://journals.cambridge.org/abstract_S0960777399000119

How to cite this article:
Michael Kitson (1999). Recession and Economic Revival in Britain: The Role of Policy in the 1930s and 1980s. Contemporary European History, 8, pp 1-27

Recession and Economic Revival in Britain: The Role of Policy in the 1930s and 1980s

MICHAEL KITSON

During the 1980s the discussion of economic policy became increasingly circumspect. The Governments of the Western industrialised countries – led by Britain and the United States – abrogated their responsibility to maintain, or at least pursue, full employment and stable economic growth. Instead the focus of policy was redirected towards nominal variables, in particular inflation and interest rates, and the need for 'flexibility', especially in labour markets. The British Chancellor of the Exchequer stated in 1980 that 'the main objectives of the government's economic strategy are to reduce inflation and to create conditions in which substantial economic growth can be achieved', adding that 'overriding priority must be given to reducing inflation and strengthening the supply side of the economy'.[1] The instability of the world economy during the 1980s and early 1990s[2] has at last led to some, albeit piecemeal, revision to such a non-interventionist approach. Recent meetings of the G7[3] group of leading industrialised countries have at least stressed that jobs and growth are a top priority. The implications of this shift in priorities for economic policy have not, however, been clearly spelt out; there has been little indication how government policy, be it at the national or international level, should be formulated to 'ensure the future prosperity and security of our people'.[4]

The fundamental dispute between economists over the role of economic policy centres on whether growth and employment can be maximised by relying on

I am grateful for comments and suggestions from Jonathan Michie, Solomos Solomou and Frank Wilkinson – whilst they cannot be held responsible for this publication I would nevertheless like to express my thanks. Valuable comments on earlier versions of this paper were received from an anonymous referee and from the participants at the conference on 'The State and Economic Crisis in Twentieth-century Germany', jointly organised by the Institute for German, Austrian and Swiss Affairs at the University of Nottingham and the Goethe-Institut, Manchester, and held at the University of Nottingham in April 1994.

1 House of Commons, *Memoranda on Monetary Policy*, House of Commons Treasury and Civil Service Committee, (London: HMSO,1980).

2 M. Kitson and J. Michie, 'Trade and Growth: an historical perspective', in J. Michie and J. Grieve Smith, eds., *Managing the Global Economy* (London: Academic Press, 1995).

3 The G7 is the Group of Seven leading Western industrialised countries (Canada, France, Germany, Italy, Japan, the United Kingdom and the United States – with the addition of Russia it will become the Group of Eight).

4 G7 communiqué, Naples, 1994.

Contemporary European History, **8**, 1 (1999), pp. 1–27 © Cambridge University Press
Printed in the United Kingdom

market forces and the price mechanism or whether there is a role for government intervention. The late 1970s and early 1980s saw the ascendency of free market economics. The propaganda and hype that went with Thatcherism and its other manifestations across the world economy, such as supply side economics in the United States, created a policy vacuum such that it was almost considered axiomatic that intervention in the economy would be harmful and destabilising. Expansionary fiscal policy, depending on how it was financed, would either reduce private-sector investment or create inflation. The regulation of financial markets would create distortions in capital flows and thus destabilise the monetary system. The regulation of labour markets, including unemployment benefits and minimum wages, would cause disequilibrium between labour supply and labour demand, leading to unemployment.

The dominance of the free-market approach gave credibility and credence to the economic policies pursued by the British government during the 1980s. Throughout the decade a stream of publications extolled the allocative efficiency of the market mechanism and, in particular, the Thatcherite policies implemented in Britain[5]. At the same time, many economists and economic historians re-evaluated previous periods of economic policy in the light of the free-market paradigm and the alleged adverse impacts of government intervention. The interwar period came under severe scrutiny with a number of critiques of government policies, particularly those concerned with international trade and the labour market.[6] Additionally, others have favoured the economic policies implemented during the 1980s when compared with those implemented during the 1930s. Broadberry and Crafts suggest that despite rapid economic growth in the 1930s, interventionist economic policy impaired long run performance by reducing competitive pressures.[7] Conversely, they argue that policy during the 1980s, directed at reducing the role of the state and promoting 'competition', has improved long run economic growth by stimulating the supply side of the economy.

This paper takes an alternative perspective. It argues that economic revival in the 1930s was primarily policy-induced and that there is little evidence of any significant adverse supply side effects. Conversely, economic growth in the 1980s can be attributed to the unintentional demand side effects of policy (such as the impact of financial liberalisation on credit expansion) and to the impact of supply side

[5] See, for instance, K. P. G. Matthews and P. Minford, 'Mrs Thatchers's economic policies, 1979–1987', *Economic Policy* (October 1987), and A. A. Walters, *Britain's Economic Renaissance*,. (Oxford: Oxford University Press, 1986). The exaggerated claims of many of these publications may reflect that they were written during the late 1980s boom – a boom which was a speculative bubble that was to burst, leading to a major economic slump.

[6] F. Capie, *Depression and Protectionism: Britain between the Wars* (London: George Allen & Unwin, 1983). M. Beenstock, F. Capie and B. Griffiths, 'Economic recovery in the UK', *Bank of England Panel Paper*, no. 23 (April 1984), pp. 57–85. K. Matthews and D Benjamin, *US and UK Unemployment Between the Wars: A Doleful Story* (London: Institute of Economic Affairs, 1992).

[7] S. Broadberry and N. Crafts, 'The impact of the Depression of the 1930s on productive potential in the United Kingdom', *European Economic Review*, Vol. 34 (1990), pp. 599–607. S. Broadberry and N. Crafts, 'The implications of British macroeconomic policy in the 1930s for long-run growth performance', Centre for Economic Policy Research, Discussion Paper 386 (1990).

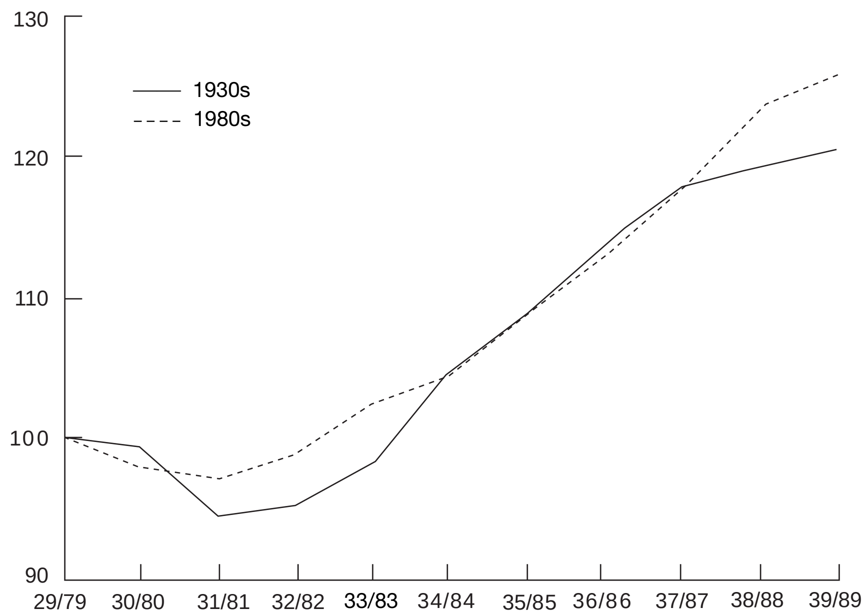

Figure 1. *Gross domestic product (1929, 1979 =100)*
C. H. Feinstein, *National Income, Expenditure and Output of the United Kingdom, 1855–1965*, (Cambridge: Cambridge University Press, 1972) and CSO, *Economic Trends: Annual Supplement* (London: HMSO, 1995).

developments, that were largely independent of the Thatcher policy regime change. This paper argues that an analysis of economic policy must consider the underlying conditions prevailing in the economy during any given period or epoch. Thus the underlying assumption that policy should always approximate to, or at least move towards, the perfect competition model is inappropriate.

This paper is organised in five sections. The first section compares the economic performance of the 1980s with that of the 1930s. The second and third sections consider various aspects of the economic policies pursued during the 1930s, and the fourth and fifth sections consider similar issues for the 1980s.

I. Comparative economic performance

The paths of recession and recovery in the interwar period and during the 1980s were remarkably similar. As shown in Figure 1, which plots the path of gross domestic product (GDP) for the 1930s and 1980s, the start of both periods was characterised by a severe downturn in economic activity. During the period 1929–31, the period of the Great Depression, British GDP fell by an average annual rate of 2.9 per cent, whereas during 1979–81 GDP fell by an average annual rate of 1.6 per cent. Following both recessions, there were rapid growth and sustained

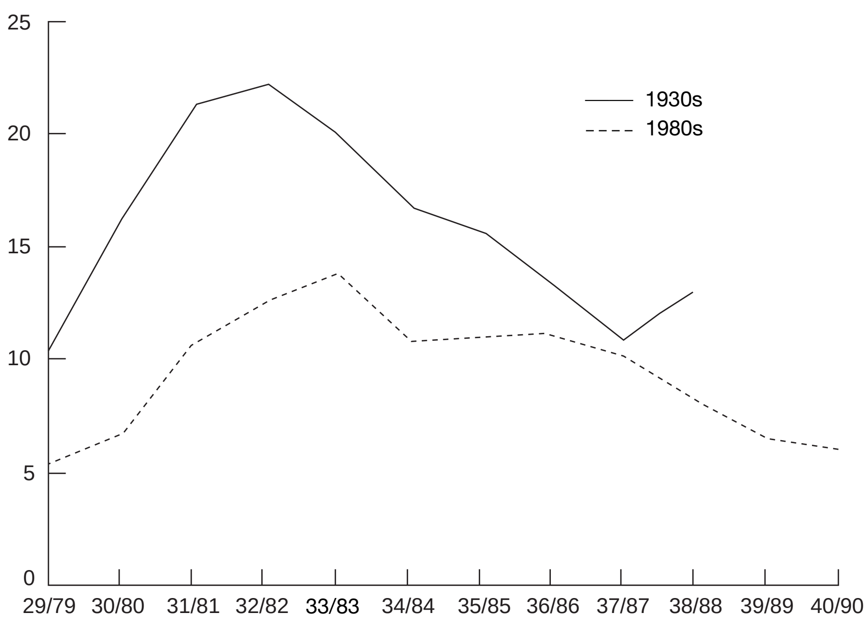

Figure 2. *Unemployment rates* (%, raw data)
N. F. R. Crafts, 'Economics and history', in D. Greenaway, ed., *Companion to Contemporary Economic Thought* (1991).

recovery, an annual growth rate of 3.0 per cent in the 1930s and of 3.2 per cent in the 1980s.[8]

A major economic and social problem which persisted during both the 1930s and 1980s was large-scale unemployment. Figure 2 plots the unemployment rate for both decades based on raw data: the 1930s figures are based on national insurance statistics and the 1980s figures on more recent methods of counting. This graph suggests that the unemployment problem was more severe during the 1930s than during the 1980s. Unemployment peaked at 22.1 per cent in 1932 and averaged 16 per cent for the period 1929–38, whereas during the more recent period, 1979–90, unemployment peaked at 13.7 per cent in 1983 and averaged 9.3 per cent. The usefulness of comparing the raw data series, however, is questionable, as the methods of data collection have changed significantly since the interwar period (see Allin for a description of the changes in the methods of counting[9]). Even since 1979 there have been twenty-nine changes to the method of estimating UK unemploy-

[8] The 1930s growth rate of 3 per cent covers the period 1931–39. If the shorter period, 1932–27, is used, a period which allows a more accurate trough-to-peak measure, then the annual rate of GDP growth is increased to 4.3 per cent. The 1980s growth rate is for the period 1981–89, a reasonable approximation of the trough-to-peak period. The 1980 period is also influenced by oil output which increases the level and growth rate of GDP.

[9] P. Allin, (1993), 'One hundred years of labour market indicators', *Employment Gazette*, (Employment department, December 1990), pp. 553–60.

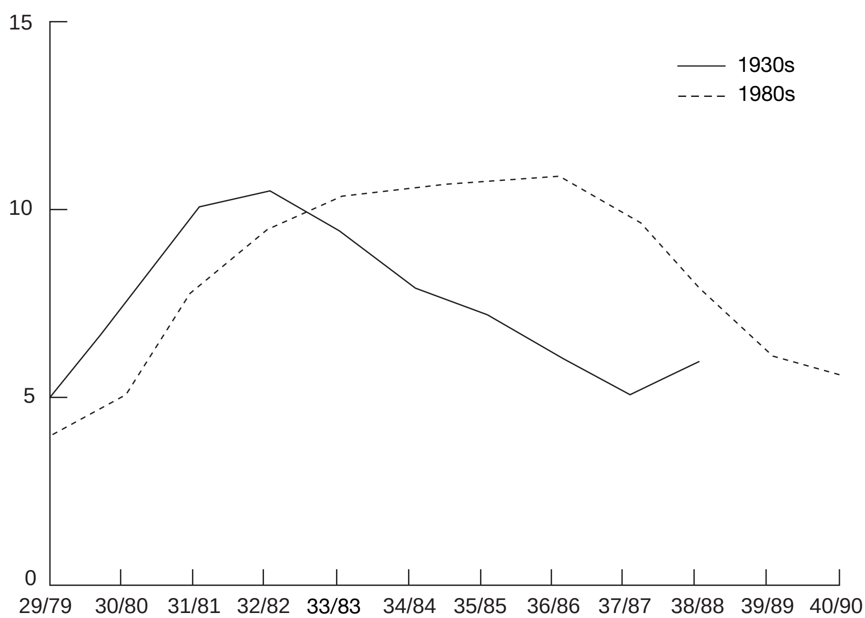

Figure 3. *Unemployment rates* (%, consistent data)
N. F. R. Crafts, 'Economics and history', in D. Greenaway, ed., *Companion to Contemporary Economic Thought* (1991).

ment – all of which have reduced the total or left it unchanged. The most recent method of counting is the claimant count, which has been severely criticised for underestimating the real level of unemployment; according to Wells the discrepancy is in the order of one million.[10] Despite these limitations it is important to compare unemployment rates on a consistent basis. Figure 3 plots unemployment rates for both decades based on recent methods of counting. These adjusted figures show, contrary to conventional wisdom, that the unemployment problem was greater during the 1980s than during the 1930s. During the earlier period unemployment peaked at 10.6 per cent in 1932 and declined significantly afterwards, averaging 7.6 per cent for the period. Unemployment during the 1980s increased throughout most of the decade, reaching a peak of 11.1 per cent in 1986 and averaging 8.4 per cent for the period.

II. Policy during the 1930s: macroeconomic performance

Like the start of the 1980s, the early 1930s witnessed a deep and painful depression. Despite their similar magnitudes, however, there are important differences between the two economic downturns. Most importantly, the Great Depression which

[10] J. Wells, 'Unemployment in the UK: the missing million', *European Labour Forum*, no. 13 (1994).

started in 1929 was a worldwide phenomenon. Conversely, the recession of the early 1980s was, in the main, an internal or domestic downturn in economic activity. This contrast reflects the different causes and propagating mechanisms of the two recessions and in particular the differing impact of policy.

The *causes* of the Great Depression are subject to continual debate. Many studies focus on domestic developments in the American economy which were transmitted to the world economy. Friedman and Schwartz[11] have emphasised tight monetary policy;[12] Kindleberger[13] stresses the fall in consumption due to redistribution of income from the agricultural sector where prices were falling; Romer[14] considers the decline in the consumption of durables due to increased uncertainty created by the Wall Street crash; Lewis[15] considers the collapse of American capital exports; other policy factors include the alleged failure of fiscal policy to provide automatic stabilisers and the argument that the Smoot-Hawley tariff of 1930 initiated a mutually destructive trade war.[16] Other studies have focused on the Great Depression as being initiated through changes and structural problems in the international economy.[17]

The *extent* of the Great Depression can be attributed to the operation of the gold standard.[18] The impact of adverse shocks, such as the recession in the United States and the collapse in capital exports, was transmitted to the rest of the world through the exchange rate regime. As foreign loans were called in due to developments in the domestic economy, the gold flows to the United States increased. The draining of reserves in the debtor countries accelerated and monetary policy was tightened to ensure gold convertibility. Thus the deflationary bias of the gold standard system resulted in a perverse reaction to adverse demand shocks. Rather than facilitating an expansion of demand to ameliorate the Depression, the system magnified the problem, leading to a collapse in world trade.

It is apparent that there is no single satisfactory explanation of the Great Depression. In fact an explanation which embraces the cumulative impact of

[11] M. Friedman and A. Schwartz, *A Monetary History of the United States* (Chicago: University of Chicago Press, 1963).

[12] Cooper makes the acute observation that Friedman and Schwartz 'having never met a central bank they liked, of course attributed the severity of the depression to the perverse behaviour of the Federal Reserve Board' (R. N. Cooper, 'Fettered to Gold? Economic policy in the interwar period', *Journal of Economic Literature*, 30 (1992) p. 2125.

[13] C. P. Kindleberger, *The World in Depression, 1929–1939* (Berkeley, CA: University of California Press, 1973).

[14] C. Romer, 'The Great Crash and the onset of the Great Depression', *Quarterly Journal of Economics*, 105 (1990), pp. 597–624.

[15] W. A. Lewis, *Economic Survey, 1919–1939* (London: George Allen & Unwin, 1949).

[16] See P. Friedman, 'An econometric model of national income, commercial policy and the level of international trade: the open economies of Europe, 1924–1938', *Journal of Economic History*, 38 (1978), pp. 148–80, and F. Capie, *Trade Wars: A Repetition of the Interwar Years?*, IEA Current Controversies, No. 2 (1992).

[17] P. Fearon, *The Origins and Nature of the Great Slump* (London: Macmillan, 1979).

[18] P. Temin, *Lessons from the Great Depression*, (Cambridge, MA: MIT Press, 1989). B. Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939* (Oxford: Oxford University Press, 1992). M. Kitson and J. Michie, 'Depression and recovery: lessons from the interwar period', in J. Michie and J. Grieve Smith, eds., *Unemployment in Europe* (London, Academic Press, 1994).

structural problems, adverse demand shocks and policy mistakes such as adherence to the gold standard, would seem to be a more realistic approach than a monocausal view.

The domestic recession in Britain was initially caused by a decline in exports, although monetary factors were important during the later stages of the recession as the gold standard straitjacket led to rising real rates of interest. The impact of the Great Depression varied across countries: national income in the United States collapsed by an annual rate in excess of 10 per cent between 1929 and 1932, whereas other countries such as Denmark and Norway witnessed little or no decline. These variations reflected national-specific factors. As shown in Figure 4, which plots the paths of GDP for Britain and the world economy, Britain's depression, although severe in real terms, was relatively mild compared with the experience of the world economy; an annual output decline of less than 2 per cent compared with a world average of over 6 per cent. In part, this reflected Britain's low dependence on agriculture and the stability of its financial institutions. Free-falling primary product prices severely affected the incomes of those countries that depended on agricultural output. Countries such as Britain with a relatively small agricultural sector suffered fewer direct adverse effects and also benefited from the terms of trade gain from lower import prices. The stability of the British financial system also helped to moderate the extent of the Great Depression in Britain. The fragmented banking structures in Europe and the United States led to a series of bank failures which caused chaos in capital and currency markets.

An additional factor which moderated the extent and duration of the slump in Britain and initiated the start of recovery was a shift in policy regime. A series of fiscal and balance-of-payments crises led to a number of macroeconomic policy changes starting with the suspension of the gold standard and the devaluation of sterling in September 1931. The devaluation of the exchange rate also allowed the government to pursue a more expansionist ('cheap money') monetary policy. Additionally, the protection of manufactures was extended by the emergency Abnormal Importations Act of November 1931 and the Import Duties Act of February 1932.

The combination of these changes in trade and monetary policies increased aggregate demand for British products, thus helping to promote recovery from the Great Depression. The suspension of the gold standard and the accompanying devaluation had a number of beneficial impacts on the domestic economy. First, it improved trade performance and alleviated the balance-of-payments constraint on growth. The competitive gain of the devaluation was particularly large in 1932. Taking Redmond's figure of a 13 per cent depreciation during 1931–2,[19] Broadberry undertook an elasticities analysis of the policy change measuring the impact of the change, in relative prices in the volume of exports and imports.[20] The estimated

[19] J. Redmond, 'An indicator of the effective rate of the pound in the 1930s', *Economic History Review*, Vol. 33 (1980), pp. 83–91.

[20] S. Broadberry, *The British Economy Between the Wars: a Macroeconomic Survey* (Oxford: Basil Blackwell, 1986).

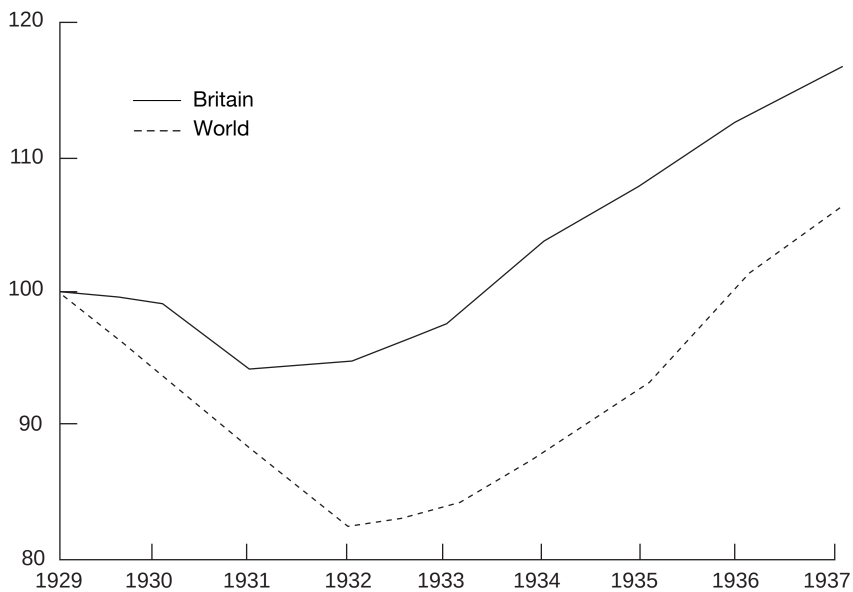

Figure 4. *British and world gross domestic product* (1929 = 100)
C. H. Feinstein, *National Income, Expenditure and Output of the United Kingdom*, 1855–1965 (Cambridge: Cambridge University Press, 1972) and A. Maddison, *Phases of Capitalist Development*, (Oxford: Oxford University Press, 1982).

improvement in the balance of trade resulting from this competitive advantage amounted to £80 million. Assuming a multiplier of 1.75, a 3 per cent increase in GDP can be attributed to the relative price effect, a large factor in the turning-point that was reached in 1932.

The second benefit of devaluation was that it removed the exchange rate constraint on monetary policy, so that interest rates could be determined by domestic economic conditions rather than the need to maintain the exchange rate or to prevent excessive loss of reserves. The 'cheap money' policy has been identified as a permissive policy for economic revival,[21] especially important in stimulating a housing boom.[22] The important contrast with the housing boom of the 1980s is that in the 1930s the main impact was a massive increase in the number of houses, whereas in the 1980s there was a massive increase in the price of houses.

Devaluation and the accompanying introduction of other expansionist policies led to a third, less mechanistic, benefit. Under the prevailing world conditions of

[21] H. W. Richardson, *Economic Recovery in Britain, 1932–9* (London: Weidenfeld & Nicholson, 1967).

[22] G. D. N Worswick, 'The recovery in Britain in the 1930s', in Bank of England Panel of Academic Consultants, *The UK Economic Recovery in the 1930s*, Panel Paper no. 23 (1984) pp. 5–28. For an examination of the strengths and limitations of this argument see M. Kitson and S. Solomou, *Protectionism and Economic Revival: The British Interwar Economy* (Cambridge: Cambridge University Press, 1990).

uncertainty and monetary and financial turbulence, the reorientation of policy towards the domestic economy significantly improved business confidence. The prospect of a stable and growing economy encouraged home producers to increase, or at least bring forward, investment and expand production.

The extension of protectionism also led to an increased demand for domestic products through a number of mechanisms.[23] First, it improved the competitiveness of domestic manufactures which reduced Britain's dependency on imported manufactures and encouraged the production of domestic substitutes. Second, the resulting increase in domestic incomes generated a demand stimulus for the whole economy. Third, the more favourable conditions for manufactures and the expanded domestic market allowed the exploitation of economies of scale and increased productivity.

There is no doubt that a number of policy initiatives contributed to the turning-point from depression to recovery in 1932. These policy changes, however, also contributed to the strength of the recovery throughout the 1930s. As noted previously, there was a sustained increase in GDP from 1932 and, as shown in Figure 4, the rate of increase was similar to that of the world economy. This was a notable achievement, as the British recovery followed a relatively *mild* depression whereas much of the world recovery was a cyclical bounce-back in response to a *deep* depression. Thus the level of GDP in Britain, based on the 1929 benchmark, was significantly higher than that of the world economy.

Many of the mechanisms through which policy sustained recovery were similar to those discussed above that initiated the turning-point away from recession. There were, however, a number of differences, the most important of which was the dissipation of the relative price advantage of the devaluation of sterling due to the global collapse of the gold standard and a series of devaluations abroad – there was a large nominal devaluation of the sterling effective exchange rate between 1931 and 1932 but this advantage was subsequently eroded.[24] Although the competitive effect of the suspension of gold was moderated, the gains of the early 1930s may have provided long-term advantages, as the short-term benefits of improved trade performance could be sustained through the establishment of distribution networks and customer loyalty. Throughout the 1930s Britain maintained a reduced propensity to import which increased the share of domestic demand for domestic products – although much of this improvement can be attributed to the benefits of protectionism which remained throughout most of the decade. Additionally, Britain's share of world export markets stabilised, whereas it had been falling for the previous 50 years; this however, this did not lead to export-led recovery because of the low volume of world trade during the 1930s. Furthermore, despite competitive devaluations abroad, breaking the exchange rate constraint on monetary policy allowed lower interest rates throughout the period.

The policy regime change initiated in 1931–32 was central to Britain's improved

[23] Kitson and Solomou, *Protectionism*.

[24] As well as the appreciation of the nominal exchange rate from the mid-1930s due to competitive devaluations abroad, the real exchange rate also appreciated as a result of higher domestic inflation.

economic performance in the 1930s. There are, however, a number of additional factors which need to be considered. First, policy acted in the context of favourable supply conditions, such as the existence of a technological gap between Britain and the United States which provided the potential for 'catching-up' growth and the development of new industries. Second, there were favourable demand shifts that were, at least in part, independent of macroeconomic policy, such as the favourable terms of trade shift in the early 1930s and the increased demand for housing. Third, firms and employees did not offset all the output effects of increased demand through increased prices and wages.

It should also be noted that the policy-induced demand shift was not of the traditional Keynesian sort, that is, via expansionary fiscal policy. The 'Treasury View' and balanced budgets were the order of the day. Although the actual budget went into a small deficit during the Great Depression this was due to the operation of automatic fiscal stabilisers – such as falling tax revenue and increased expenditure on such items as unemployment benefits. In fact the government attempted to limit the operation of the stabilisers through public expenditure cuts including cutting the standard rate of unemployment benefit. The discretionary component of fiscal policy, that which excludes the automatic component of stabilisers, was in surplus during the depression, suggesting, from a Keynesian perspective, a deflationary fiscal stance during the depression.[25] This tight fiscal policy was continued during the early 1930s and was only relaxed towards the end of the decade with the advent of rearmament.

Although the policy shift of the 1930s improved economic performance, it has been argued that as it was a response to economic crisis the shift lacked coherence and was not discretionary but was forced on the authorities.[26] This argument, however, overstates the case. Booth has argued that policy-makers had a coherent strategy which was to increase profitability through raising prices.[27] Although, as we have argued, the impacts of policy changes were primarily through other mechanisms, namely output effects rather than price effects, this does not negate the fact that the policy shift had internal coherence. The increased management of the economy can be illustrated by looking at exchange rate policy. First, the timing of policy was important for moderating the recession and promoting recovery. Those countries that detached themselves from Gold early were more likely to experience

[25] R. Middleton, 'The constant employment budget balance and British budgetary policy, 1929–39', *Economic History Review*, Vol. 34 (May 1981), pp. 266–86. It is questionable whether the actual budget balance or the discetionary budget balance (sometimes referred to as the constant employment budget balance) is the best measure of fiscal stance. Additionally, there is the issue of how budget deficits affect private sector expectations and confidence. In the context of the early 1930s, prior to the establishment of Keynesian demand management policies, budget deficits were associated with economic instability and inflation. Thus, their psychological impact on private sector expectations was likely to lead to reduced investment and, therefore the fiscal orthodoxy of the 1930s may have contributed to recovery, albeit not through the mechanisms ('crowding-out') of orthodox economics.

[26] Beenstock, Capie and Griffiths, 'Economic recovery'.

[27] A. Booth, 'Britain in the 1930s: a managed economy?', *Economic History Review*, Vol. 40 (December 1987), pp. 499–522.

faster economic growth.[28] Furthermore, some countries, such as France, Belgium and the Netherlands, despite prolonged recession, were reluctant to leave Gold. This suggests that leaving Gold was not an automatic act, although those countries that remained locked into the system did so because of their fear of inflation (resulting from their recent history of inflation), whereas British policy was more concerned with raising the price level. Secondly, following the suspension of Gold the exchange rate was not allowed to freely float but was managed through the newly created Exchange Equalisation Account. This allowed the monetary authorities to buy or sell sterling to offset movements in the exchange rate caused by private-sector trading.

III. Policy during the 1930s: some issues relating to productivity growth and long-run productive potential

The case against the policy shift of the 1930s rests on the twin propositions that macroeconomic and industrial policy first harmed the supply side of the economy, resulting in a poor productivity performance, and second left an anti-competitive legacy which hindered economic performance after the Second World War.[29] This section argues that the first proposition is inconsistent with productivity evidence of the 1930s and that the second proposition remains unproven.

The notion that intervention in the economy is harmful is derived from orthodox neoclassical theory. In its simplest form, neoclassical theory indicates that intervention distorts the operation of the market mechanism and leads to an inefficient allocation of resources. The validity of this proposition has been widely discussed and criticised, both from inside and outside the neoclassical paradigm, and a full discussion of the issues is outside the scope of this paper. A few observations are, however, apposite. First, as demonstrated by Keynes,[30] unfettered market forces do not ensure that the level of demand settles at the full employment level. Thus, there is a case for demand management policy. This may lead to an increased, but less efficient, use of resources under certain conditions. The issue then is of weighting the advantage of resource mobilisation against the disadvantage of resource misallocation. Under the conditions of economies of scale, however, the increase in output will also lead to efficiency gains – there is no trade-off. Second, neoclassical propositions are generally constructed in a world with no institutions, no history and no uncertainty. Introducing these concepts can radically reduce the relevance of orthodox theory. For instance, efficiency can be increased by improving the internal organisation of enterprises. Inefficiency, however, is often assumed away by

[28] A. Newell and J. S. V. Symons, 'The macroeconomics of the interwar years: international comparisons', in B. Eichengreen and T. J. Hatton, eds., *Interwar Unemployment in International Perspective* (Dordrecht: Kluwer, 1988). Kitson and Michie, 'Depression and recovery'.

[29] Broadberry and Crafts, 'The impact of the Depression' and Broadberry and Crafts, 'The implications of macroenomic policy'.

[30] J. M. Keynes, *The General Theory of Employment, Interest and Money* (London: Macmillan, 1936).

assuming perfectly internally efficient producers. Additionally, effective productive systems do not depend solely on competition in exchange but collaboration in production. Effective collaboration depends not on competition but on cooperation in order to establish an institutional and industrial framework which promotes innovation and skills.

Given the limitations of neoclassical theory, and in particular the assumption of the perfect competition model, it is better to think of competition as a dynamic process such that the formulation of appropriate economic policies depends on underlying economic conditions.[31] Thus policy requirements will alter as market structures and behaviour develop. The interwar period witnessed the development of mass production techniques and increased mass consumption. Furthermore, during the early 1930s there was widespread excess capacity combined with a productive structure which required rationalisation and the exploitation of economies of scale through mass production. Policies such as devaluation and the imposition of tariffs by expanding the domestic market allowed producers to reap the advantages of scale. In addition the objectives of industrial policy, to encourage rationalisation and cooperation in production, were appropriate to the underlying economic conditions. The problem was its flawed implementation. First, industrial policies were piecemeal in design. Second, rationalisation objectives were frequently formulated without credible sanctions if such objectives were not implemented. Third, the raft of industrial initiatives did not include an effective competition policy, in order to combine the reorganisation of production with effective competition in product markets.

The picture we have drawn of the policy stance in the 1930s is a broadly effective macroeconomic policy regime combined with a flawed industrial policy framework. Yet despite the limitations of industrial policy the supply side performed remarkably well during the decade – in part reflecting the benefits to the supply side of an effective demand management policy.

The evidence against the policy shift and in favour of the proposition of a 'supply side sclerosis'[32] is the existence of a productivity gap between the United States and Britain. The estimates of Rostas[33] indicate that productivity in US manufacturing during the mid-1930s was 2.25 times higher than the UK level.[34] This is, however, only a snapshot of prevailing productivity levels. To examine productivity performance, a more revealing test is to consider trends by looking at changes in productivity. Figure 5 shows the long-run path of relative manufacturing productivity levels for benchmark years since 1869. It is evident that Britain's productivity

[31] See the theories of Marx (K. Marx, *Capital* (London: Lawrence & Wishart, 1970–72)), Schumpeter (J. A. Schumpeter, *Capitalism, Socialism and Democracy* (London: George Allen & Unwin, 1968)), Downie (J. Downie, *The Competitive Process* (London: Duckworth, 1958)) and Clark (J. M. Clark, *Competition as a Dynamic Process* (Washington DC: Brookings Institution, 1961)).

[32] Broadberry and Crafts, 'The impact of the Depression', p. 604.

[33] L. Rostas, *Comparative Productivity in British and American Industry* (Cambridge: Cambridge University Press, 1948).

[34] The UK estimates are for 1935 and the US estimates are for 1937. The gap is based on an unweighted average of total factory trades.

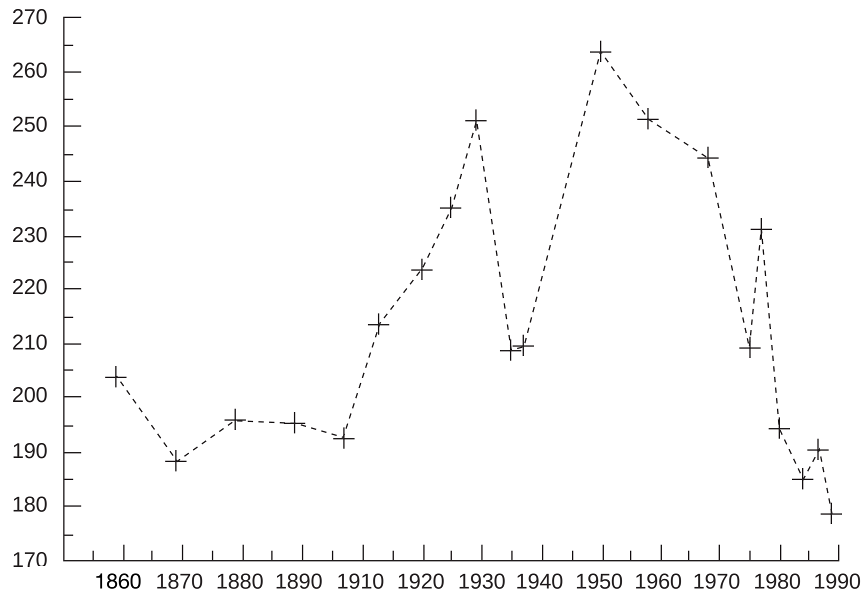

Figure 5. *Manufacturing output per person employed in the United States where the UK = 100*
S. Broadberry, 'Manufacturing and the convergence hypothesis: what the long-run data show', *Journal of Economic History*, Vol. 53 (December 1993).

gap with the United States was large and expanding since the Victorian period; and this compares with the period after 1950, which was one of almost continual catching up. More importantly the only period prior to 1950 which showed any significant closing of the gap was 1929–35. During the period the gap was closing by an average of 3 per cent per annum, whereas in the immediate preceding period, 1925–29, it had been widening by 1.6 per cent per annum. This picture of an improving productivity performance in manufacturing is also evident for the whole economy (see the GDP per person estimates of Maddison[35] and Broadberry[36]). Thus, in the period allegedly characterised by a policy-induced *retreat* from competition there was an *advance* in relative productivity performance.

The influences on productivity are numerous. Moreover, drawing inferences from inter-country comparisons is limited, as market conditions and policies are likely to be changing in both countries. That said, the evidence on productivity trends is inconsistent with the pessimistic assessment of policy effects on the supply side. This conclusion is supported by examining the impact of increased protectionism on productivity performance. It is commonly contended in the economics literature that protectionism distorts market forces and lowers efficiency. In this vein it has been argued by Capie that the British tariff harmed the British economy

[35] A. Maddison, *Phases of Capitalist Development* (Oxford: Oxford University Press, 1982).
[36] S. Broadberry, 'Manufacturing and the convergence hypothesis: what the long-run data show', *Journal of Economic History*, Vol. 53 (December 1993), pp. 772– 795.

Table 1. *Manufacturing productivity performance in the interwar period (industries newly protected in 1931/32 and non-newly protected industries)*

	Newly protected	Non-newly protected
Productivity Level (1935 = 100)		
1924	85.1	85.4
1930	87.4	93.0
1935	100.0	100.0
Growth per annum (per cent)		
1924–30	0.45	1.43
1930–35	2.73	1.46
Inter-period growth differences (per cent)		
1924–30 and 1930–35	2.28	0.03

M. Kitson and S. Solomou, *Protectionism and Economic Revival: The British Interwar Economy* (Cambridge: Cambridge University Press, 1990).

during the 1930s.[37] The productivity evidence, however, suggests that protectionism was associated with improved productivity performance. Table 1 shows the productivity performance of the newly protected industries (those protected by the legislation of 1931 and 1932) relative to non-newly protected industries (those protected by earlier legislation or those receiving no protection). In the pre-policy shift period, 1924–30,[38] productivity growth of the non-newly protected sector increased by 1.43 per cent per annum, three times greater than the rate of increase of the newly protected group. During the policy-on period, 1930–35, there occurred a substantial turnaround: the productivity of the newly protected group increased by 2.7 per cent per annum, whereas the annual productivity growth of the non-newly protected group, although greater than in the previous period, was only 1.5 per cent.

If the policy shift of the 1930s did not significantly harm the supply side during that decade there is still the issue of whether it harmed the economy during the post-Second World War period – by creating institutional rigidities and by preventing the necessary structural change that would have accelerated long-term growth. This argument remains unproven. First, it is difficult to construct viable counterfactuals; economic performance post the Second World War was dominated by the impact of the war itself on the world economy and the new world order that was established. This discontinuity makes it difficult to isolate the impact of inherited structures and practices. Of related concern is how the policy changes of the 1930s affected the ability of Britain to fight the war. The protection of strategic sectors, such as iron and steel, may have been important in the

[37] F. Capie, *Depression and Protectionism: Britain Between the Wars* (London: George Allen & Unwin, 1983).

[38] The benchmark years, although not ideal, are necessary due to data limitations as the productivity figures are based on information contained in the Censuses of Production of 1924, 1930 and 1935.

development of the war economy. Second, even if the legacy of the 1930s policy regime was harmful, this does not indicate a failure of the regime itself but a failure to adapt and transform the policies and institutions to the prevailing conditions in the postwar period.

The case for the policy changes of the 1930s is that they improved macroeconomic performance and, at the very least, did not harm the supply side. This is not an argument that they constituted an optimal policy mix. It was, however, an improvement on what went before, and in the next sections it will be argued that it was a more appropriate mix than the policy changes of the 1980s.

IV. Policy during the 1980s: macroeconomic performance

The 'overriding priority' of the Thatcher government elected in 1979 was to squeeze inflation out of the economy. This objective, which stands in stark contrast to the 1930s objective of raising the price level, was to be achieved through macroeconomic policy.[39] The conquering of inflation was considered a necessary condition for economic success despite the lack of empirical support for such a relationship.[40] The other strand of the growth strategy was to improve the supply side of the economy by decreasing the role of the state and promoting the role of the free market. This involved the deregulation of markets, the privatisation of state-owned industries, and reform of the trade unions.

It has been commonly contended that the Thatcher government implemented a monetarist experiment in Britain. In part this is true, as monetarism does place the control of inflation at the centre of macroeconomic policy – real variables such as output and employment are determined independently by the supply side. In its detail, however, the government's strategy was a mixture of libertarian economic ideology and inherited policy instruments. The lack of coherence is illustrated in this parliamentary interchange between Mrs Thatcher and the Leader of the Opposition, James Callaghan:

Mr James Callaghan, Leader of the Opposition – . . . will she tell us clearly whether increases in wages are a cause of inflation or not?
Mrs Thatcher – Over a period the cause of increased inflation is increases in the money supply. Within the money supply, there will be a different distribution both between the public

[39] The government's approach is captured in the views of Nigel Lawson, one of the architects of the economic strategy: 'The views I had arrived at, and which I continue to hold today, could be summarised in terms of two interconnected reversals of post-war conventional wisdom. The first is the conviction that the recipe for economic success is the greatest practicable market freedom within an overall framework of firm financial discipline – precisely how that discipline is best applied is a second order question, though important, and one which was to prove surprisingly explosive . . . The second reversal is that . . . instead of seeking to use macroeconomic policy to promote growth and microeconomic policy to suppress inflation, the government should direct macroeconomic policy to the suppression of inflation and rely on microeconomic (or supply-side) policy, such as tax and labour market reforms, to provide the conditions favourable to improved performance in terms of growth and employment' (N. Lawson, *The View from No.11* (London: Bantam Press, 1992) p. 9).

[40] See W. Stanners, 'Is low inflation an important condition for high growth?', *Cambridge Journal of Economics*, Vol. 17 (1993), pp. 79–107.

sector and the private sector and within those sectors there will be increases in pay within the general money supply well beyond what are warranted, and they may come through in increases in particular products which will not necessarily affect the general price level.
Mr James Callaghan – May I thank her for that reply and say that I did not understand a word of it.[41]

It is not unreasonable to concur with Callaghan's response.

The lack of consistency is also reflected in the use of policy instruments. The foundation of macroeconomic policy was the medium-term financial strategy (MTFS) which identified targets for money supply growth. The instruments initially deployed to achieve these objectives were interest rates and public borrowing (fiscal policy). These were instruments traditionally used to control output and employment. Now their purpose was shifted to inflation control; however, this does not accord with the policy requirements of orthodox monetarism. Monetarists argue that the money supply should be controlled directly and that since the use of interest rates and public borrowing affect money demand they are, therefore, likely to be highly inefficient means of monetary control.[42]

As well as not conforming to the monetarist ideal, monetary policy went through a number of transformations during the 1980s. Table 2 indicates some of the main changes in anti-inflation policy since 1979. There have been continual shifts in policy instruments and policy targets, encompassing various combinations of domestic monetary indicators and the exchange rate illustrating the myths of TINA ('there is no alternative') and of the notion of a'no U-turn' strategy.

From 1979 to 1982 the government myopically focused on attaining its preferred target for monetary growth – sterling M3 (£M3). To achieve this it pushed interest rates to record levels and attempted to implement massive cuts in public spending and public borrowing even though there was high and rising unemployment. Despite these deflationary policies the government consistently failed to achieve the desired growth in money supply. Figure 6 shows the deviations of actual £M3 growth from the mid-point of the target range. Monetary growth, using this indicator, consistently overshot its target, particularly in the early 1980s when most importance was attached to the £M3 indicator. There are a number of explanations for the failure to achieve the desired monetary targets,[43] what was apparent however

[41] Hansard, *Pariamentary Debates* (3 July 1980), quoted in J. Michie, J. and F. Wilkinson, 'Inflation policy and the restructuring of the labour market', in J. Michie, ed., *The Economic Legacy 1979–1992*, (London: Academic Press, 1992).

[42] In his evidence to the House of Commons Treasury and Civil Service Committee Friedman (M. Friedman, 'Memorandum of evidence on monetary policy', *Memoranda on Monetary Policy*, House of Commons Treasury and Civil Service Committee (London: HMSO, 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 motor cars by altering the incomes of potential purchasers and manipulating rail and air fares. 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'.

Table 2. *Anti-inflation policy shifts since 1979*

		Targets	Instruments
1979–81	MTFS Mark I	£M3	Interest rates Public borrowing
1982–5	MTFS Mark II	£M1, £M5, £M0	Interest rates Public borrowing Exchange rates
1985–8	Exchange Rate Targeting	Exchange Rate	Shadowing the deutschmark
1988–90	Confused Targeting	?	Interest rates Public borrowing Exchange rates
1990–2	The ERM Solution	Exchange Rate	ERM solution
1992–7	Policy Vacuum	?	?
1997–	Independent Bank of England	Inflation rate	Interest rates

was that the deflationary impact of the Government's policies had plunged the economy into a deep, and domestically generated, recession.

The impact of high interest rates was to discourage both investment and consumption, and it created cash flow problems for many companies, leading to bankruptcies and plant closures. The tightening of fiscal policy removed the fiscal stabilisers which normally operate during a recession, further reducing consumption and public-sector investment. Additionally, the high interest rates, combined with the popularity of the government's policies with the financial community and the high level of oil exports, led to an appreciation of the exchange rate (compared with the depreciated exchange rate of the 1930s). This led to a deterioration in trade performance – lower export growth and rising import penetration.

The impact of the government's policies was to lead to an annual average fall in GDP of 1.6 per cent between 1979 and 1981. The argument that the British economy merely reflected a global collapse in economic activity, as in the 1930s, is

[43] The failure to achieve the desired monetary targets can be explained by either operational problems of monetary control or theoretical objections to the existence of an exogenously determined money supply. In terms of the former, it has been argued that the government failed to use the appropriate instruments; that financial liberalisation led to breakdown of the relationship between £M3 and inflation; and that the relationship between £M3 and inflation broke down when £M3 was used as a target variable as agents searched for other sources of money (C. Goodhart, *Money, Information and Uncertainty* (London, Macmillan, 1975)). In terms of the latter, it has been argued that in a credit money economy the money supply is endogenous and, therefore, it is impossible to control (all forms) of the money supply directly (N. Kaldor, 'Memorandum of evidence on monetary policy', *Memoranda on Monetary Policy*, House of Commons Treasury and Civil Service Committee (London: HMSO, 1980)).

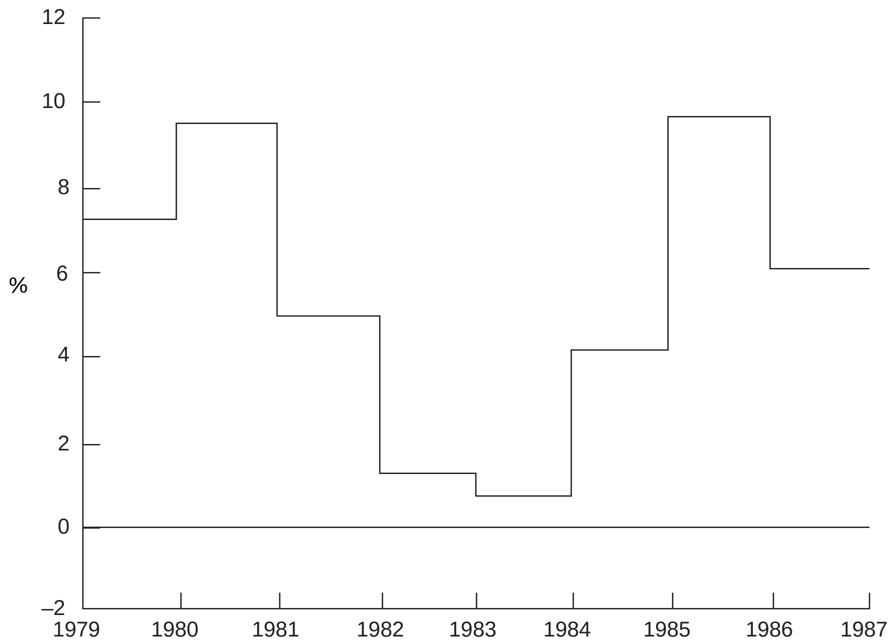

Figure 6. *Deviations from money supply (£M3) targets, 1979–87*
Author's calculations from N. M. Healey, 'The Conservative Government's ''fight against inflation'': ten years without cheers', in Nigel M. Healey, ed., *Britain's Economic Miracle: Myth or Reality?* (London: Routledge, 1993).

not sustainable. Figure 7 plots the path of British and world GDP since 1979. When the British economy was in recession, the world economy was growing, albeit moderately, at an annual rate of 1.7 per cent (1979–81). Thus, whereas the slump of the early 1930s was due to external forces, the slump of the early 1980s was due to internal mechanisms, the most important of which was the deflationary policies of the government.

From 1982 there was a move towards targeting a broader range of monetary indicators (such as M1, PSL2 (later M4), M5 and M0) as well as the exchange rate.[44] More pertinently, in the wake of the massive rise in unemployment there was a relaxation of interest rates and of fiscal policy. Interest rates were reduced from a peak of 16.0 per cent in October 1981 to 8.75 per cent in March 1984. In 1982 and 1983 there was also a number of tax cuts. This change in policy stance, combined with the usual cyclical recovery mechanisms, generated a moderate revival in the

[44] In the 1982 Red Book it was stated that: 'The exchange rate is a route through which changes in the money supply affect inflation. It can also be an important influence on financial conditions. External or domestic developments that change the relationship between the domestic money supply and exchange rate may therefore disturb the link between money and prices, at least for a time . . . They are a reason why the government considers it appropriate to look at the exchange rate in monitoring domestic monetary conditions and in taking decisions about policy.'

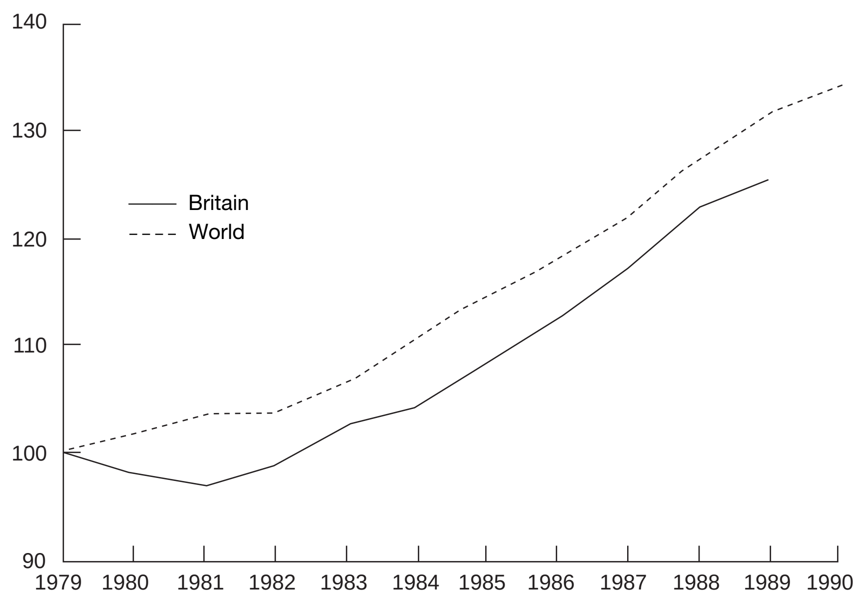

Figure 7. *British and world gross domestic product* (1979 = 100)
J. Wells, 'Factors making for increasing international economic integration' (unpublished manuscript, University of Cambridge, 1993), and CSO, *Economic Trends: Annual Supplement* (London: HMSO, 1995).

economy. The economy started to grow from the first quarter of 1981, but it was not until the second quarter of 1983 that it surpassed the peak of 1979. Despite this economic growth permanent damage had been inflicted upon the economy; high unemployment persisted and the severity of the recession had destroyed much of industrial capacity. Furthermore, the government's objective of zero inflation was abandoned. The Chancellor of the Exchequer, Nigel Lawson, admitted in 1984 that the objective of stable prices had been postponed; as he said: 'There is no point kidding yourself, there is no point in self-delusion.'[45]

The mid-1980s witnessed another shift in policy as monetary targets were downgraded and the exchange rate took centre-stage. The success of Germany in maintaining low inflation encouraged the government to adopt an exchange rate target – which evolved into a policy of shadowing the deutschmark. The adoption of stable exchange rate parities would force inflation to converge with that of the stronger, low-inflation country – in this case Germany. The problem with that policy is that the speed of convergence may be slow and it removes the policy autonomy to deal with domestic economic shocks.[46]

The key domestic shock that occurred in mid-1980s was a domestic credit boom,

[45] Quoted in N. M. Healey, 'The Conservative Government's "fight against inflation": ten years without cheers', in Nigel M. Healey, ed., *Britain's Economic Miracle: Myth or Reality?* (London: Routledge, 1993), p. 137.

[46] Kitson and Michie, 'Depression and recovery'.

fuelled by a cycle of financial deregulation and accelerating house price inflation. The easy availability of credit, including mortgages, led to accelerating property prices, increasing the wealth of the private sector which led to increased consumption and the demand for credit – thus, the spiral continued. The credit boom did generate increased economic growth and a moderate fall in unemployment. It is important, however, to note that expansion emanated from the unintentional demand side effects of policy changes such as financial deregulation. This was not a supply side recovery, nor, in the main, was it a traditional Keynesian recovery, generated by expansionary fiscal policy and public-sector borrowing – instead this was a recovery generated by private-sector borrowing founded on the shaky ground of asset price inflation in the property market.

Although the credit boom provided a short-term stimulus to output and employment it also fuelled inflation. By 1988 the monetary indicators were spiralling out of control. This led to another shift in policy as the prime minister (and her advisors) and the chancellor disputed the appropriate indicators of monetary control – Thatcher favoured money supply targets and Lawson the exchange rate. The result was confusion, with inflation and unemployment rising towards the end of the decade.

A clear strategy re-emerged with the entry of Britain into the exchange rate mechanism (ERM) of the European monetary system (EMS) in October 1990. This had been Lawson's preferred solution, although its achievement had only been accomplished after he had left the Cabinet. Although entry to the ERM had initially allowed the government to cut interest rates it ultimately acted as an engine of depression. The inevitable collapse of the credit boom plunged the economy into recession. House prices collapsed (reducing private-sector wealth), credit availability was restricted, indebtedness increased and consumption fell. The UK's membership of the ERM removed the policy options to deal with this recession; the exchange rate was effectively fixed and interest rates had to be kept in alignment with German rates. Thus the UK pursued deflationary policies when domestic economy required policies for expansion and growth.

The UK's forced withdrawal from the ERM in September 1992 provided some stimulus to the economy through mechanisms similar to the withdrawal from the gold standard in 1931: a more competitive exchange rate and lower interest rates. These benefits were, of course, not due to a well devised economic strategy. The government remained totally committed to the ERM up until the volume of speculative pressure made membership untenable. Moreover, prior to the exit it was incorrectly argued that interest rates would have to rise following a withdrawal to compensate for loss of credibility and confidence, despite the lessons of history. Despite the benefits arising from leaving the ERM the British economy still lacks any coherent vision of macroeconomic management.

Despite the government's commitment to low inflation the UK has experienced a sequence of shifts in macroeconomic policy since 1979. Additionally, the pursuit of stable nominal variables, such as prices, has invariably led to instability of real variables, such as output and employment. The success of a government's economic policy is measured in terms of its ability to ameliorate recessions and its ability to foster long-term growth. The Conservative government failed according to both these yardsticks. Government policy generated the recession of early 1980s and subsequent growth performance was mediocre – far lower than the much berated 'Golden Age' period of 1950–73. Moreover, the growth that was achieved was more due to the unintended demand effects of financial liberalisation rather than the stimulus of a coherent and sustainable economic strategy.

V. Policy during the 1980s: some issues relating to the supply side, productivity growth and long-run productive potential

Despite the argument that macroeconomic policy was mismanaged there is still the case that the economic reforms of the 1980s transformed the supply side of the British economy, creating the conditions for future prosperity. The two alleged successes have been the permanent reduction of inflation and an improved productivity performance. In this section it is argued that the extent of these successes has been exaggerated and, to the extent that there have been improvements, many other non-policy factors must be considered.

Inflation in the late 1980s and early 1990s has been considerably lower than the high rates that persisted throughout most of the 1970s. Whether this record can be taken as evidence of a permanent reduction in inflationary tendencies is questionable. In particular, low levels of inflation in the early 1990s can be principally attributable to the low level of economic activity and falls in world primary product prices. Rowlatt argued that 'When world economic activity revives and UK domestic output begins to grow again, the survival of the same old relationships . . . suggests that prices will be set so as to rebuild profit margins and that wage settlements will be consistent with rising real incomes. If this takes place, the rate of UK price inflation will rise once again.'[47] Recent experience of continued low inflation suggests that this overstates the case, as the changes in the UK labour market, or at least some parts of it, such as reduced job security and increased use of casual and part-time labour, are likely to lead to a long-term shift in the relationship between prices and wages.

Although there were many facets to the government's supply side programme in the 1980s we will consider four of the most prominent: deregulation of financial markets, deregulation of labour markets, privatisation, and the encouragement of entrepreneurship.

The deregulation of financial markets was seen as central to the efficient allocation of capital. 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.[48] Additionally, it removed one of the key instruments for retaining some

[47] P. Rowlatt, 'Inflation down – but will it last?', *New Economy* (1994), p. 143

[48] J. Coakley and L. Harris, 'Financial globalisation and deregulation', in J. Michie, ed., *The Economic Legacy 1979–1992* (London: Academic Press, 1992).

control over the choice of both the exchange rate and domestic interest rates. As Keynes argued more than fifty years ago:

> It is not merely a question of curbing exchange speculations and movements of hot money, or even of avoiding flights of capital due to political motives; though all this is necessary to control. The need, in my judgement, is more fundamental. Unless the aggregate of the new investments which individuals are free to make overseas is kept within the amount which our favourable trade balance is capable of looking after, we lose control over the domestic rate of interest.[49]

On the domestic front the main developments were, first, the transformation of the London Stock Exchange known as the '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 also 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 was creating the conditions which would hinder growth in the medium term. The credit explosion–house price spiral fed on itself – easily available credit stimulating the rise in house prices (far more than house construction – in contrast with the 1930s), thus increasing private-sector wealth which in turn increased the demand for consumer credit. Despite proclamations of an 'economic miracle' 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.

Thus the major impacts of financial deregulation were, first, to remove discretion over the setting of interest rates and exchange rates; and, second, to generate a consumption-led boom which had nothing to do with an 'economic miracle' and everything to do with unsustainable speculation.

The other 'market' to feel the brunt of deregulation fervour was the labour market. The government purported to tackle unemployment by reforms aimed at 'pricing workers back into jobs' and by squeezing benefits to force people from the dole queues. Attacking the rights of trade unions was central to this strategy. This took the form of expanding, rather than reducing the role of law.[50] A series of Acts reduced immunities, increasing the scope of common law regulation of strike activity. The 1982 Employment Act removed the immunity of unions to liability in

[49] J. M. Keynes, 'Speech before the House of Lords, 18 May 1943', in *Collected Writings of John Maynard Keynes*, ed., by D. Moggridge, Vol. XXV (London: Macmillan, 1980) ch. 3, p. 275; quoted in M. Pivetti, 'Bretton Woods through the lens of state-of-the-art macrotheory and the European monetary system', *Contributions to Political Economy*, Vol. 12 (1993).

[50] S. Deakin, 'Labour law and industrial relations', in J. Michie, ed., *The Economic Legacy 1979–1992*, (London: Academic Press, 1992).

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. One of the alleged benefits of this strategy was a reduction in strike activity – and the data does show a marked decline in the number of stoppages and the number of working days lost. The contribution of legislation, however, to the reduction in strike activity is questionable; although it weakened some forms of industrial action, such as secondary picketing, other forms were paradoxically strengthened (most notably strikes that were supported by ballots). A more cogent explanation of reduced industrial action would include the impact of government policies which increased unemployment and the casualisation of the labour force, as well as long-term trends, such as the decline of many traditional manufacturing industries and the growth of small (usually non-unionised) firms.

The *Economist* has reiterated the received wisdom that 'If the unemployed get almost as much on the dole as they could get in work, they will be discouraged from seeking jobs.' But how 'over-generous' are unemployment benefits? A study published by the Organization for Economic Cooperation and Development, (OECD) reported in the same *Economist* article (26 February 1994) indicates that the replacement rate (the ratio of unemployment benefits to wages) fell from 43 per cent in 1972 to 28 per cent in 1980 and to 16 per cent in 1990. This *fall* in the replacement ratio has been contemporaneous with a *rise* in unemployment – from 2.9 per cent in 1972 to 5.1 per cent in 1980 and to 5.8 per cent in 1990. And these estimates, which are based on the claimant count method of calculation, seriously underestimate the scale of unemployment and its increase over the period.[51] It cannot be argued therefore that higher unemployment has been caused by higher levels of unemployment benefit (relative to earnings). On the contrary, unemployment has increased as relative benefit levels have fallen.

The policy response to the twin problems of increasing unemployment and a growing skills shortage was the creation of new training schemes. These schemes soon acquired a reputation for disguising unemployment, for creating new forms of cheap labour and for failing to provide adequate training.[52] Individuals became increasingly unwilling to take part in training programmes as they provided little long-term improvement in job prospects. Additionally, targeting training at the unemployed to get them into low-paid jobs is an inefficient use of training resources. Low paying firms tend to need skills which are specific to outdated technologies. Thus the cumulative effect of low pay and poor working conditions and the policy responses by employers and the state weakened the skill base and discouraged individuals from undertaking training.[53]

Privatisation was a central element of government economic policy during the

[51] Wells, 'Unemployment in the UK'.

[52] W. Sengenberger and F. Wilkinson, 'Globalisation and labour standards', in J. Michie and J. Grieve Smith, eds., *Managing the Global Economy* (Oxford: Oxford University Press, 1995).

[53] R. Tarling and F. Wilkinson, 'Economic functioning, self sufficiency, and full employment', in

1980s, and it was continued into the 1990s. 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, little evidence that the programme has achieved these objectives.

Although profits per employee improved, the evidence of the positive effect of privatisation on efficiency is, at best, ambiguous – there were productivity improvements in some privatised industries and not in others.[54] Moreover, the productivity improvements that were observed were not a result of the privatisation process. Bishop and Kay 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 privatization, rather than the other way around.'[55]

Increasing individual share ownership was central to the creation of a 'property-owning democracy'. Yet despite extravagant marketing campaigns, the privatisation flotations have not deepened share ownership. Although, as the government has heralded, the proportion of adults holding shares has increased, the majority hold shares in only one company. Furthermore, the power of institutional investors has risen, as they have increased their proportion of shareholdings at the expense of the private investor.

The receipts from privatisation have raised funds for the Exchequer (although, somewhat bizarrely, the revenues are treated as negative government spending in the public accounts). Such revenues, however, have only made a small impact on the public sector borrowing requirement – which, on average, remained high throughout the early 1980s, despite the government's expenditure-cutting agenda, as rising unemployment led to increased expenditure and falling tax revenues. The impact would of course have been larger if the government had not consistently set the flotation price below the market valuation. Moreover, not only are the revenue benefits of privatisation small, but they are also transitory – as observed by the late Earl of Stockton, you can only sell the 'family silver' once.

Another aspect of the 'enterprise culture' has been the increased number of small firms and the expansion of the self-employed. Yet the developments in the small business sector do not suggest that government policy has had a significant positive impact. Although the increased number of the self-employed does seem to be a 1980s phenomenon, the growth of small firms reflects a trend that started in the 1960s.[56] Moreover, much of the growth of the self-employed is a response to 'negative' factors – workers pushed into 'entrepreneurship' by unemployment and the contracting-out strategies of large firms.[57] Additionally, although an increasing

J. Michie and J. Grieve Smith, eds., *Employment and Economic Performance* (Oxford: Oxford University Press, 1997).

[54] D. Parker, 'Privatisation ten years on', in Nigel M Healey, ed., *Britain's Economic Miracle: Myth or Reality?* (London: Routledge, 1993).

[55] M. Bishop and J. A. Kay, *Does Privatization Work? Lessons from the UK* (London: London Business School, 1988).

[56] D. Storey, *Understanding the Small Business Sector* (London: Routledge, 1994).

[57] M. Kitson, 'Seedcorn or chaff? Unemployment and small firm performance', ESRC Centre for Business Research, Working Paper No. 2 (1995).

number of small firms are being created, the majority will not survive longer than three years and very few will make a significant contribution to job generation. This may in part reflect the failure of small firm policy which has been introduced on a piecemeal basis and the adverse impact of macroeconomic instability on small firm performance.[58]

The above argument suggests that, at best, the policy changes of the 1980s were ineffective and, at worst, harmful to the supply side of the economy. How does this fit with the argument that the Thatcher years created a productivity miracle? The answer is that this miracle is largely a mirage. Certainly, labour productivity grew in the 1980s, especially in manufacturing, but this was due largely 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, the official productivity figures are constructed using a single price deflator for both output and input prices; Stoneman and Francis have shown that when the appropriate deflators are used, productivity growth is lower.[59] The figures for total factor productivity (TFP), which is intended to capture the increase in output above that resulting from increased quantities of capital and labour, are also questionable: firstly, the growth accounting approach which forms the basis for the construction of TFP measures usually assumes that factors of production are homogenous, that markets are perfectly competitive (ensuring marginal productivity factor pricing), and that there are constant returns to scale. Secondly, there are significant differences in TFP measures depending on the approach adopted and the data used. For instance, whereas the OECD results suggest a 1.3 per cent increase in TFP during the period 1979–89, Oulton and O'Mahony[60] find only a 0.2 per cent increase for the period 1979–86, which, if the industries in their analysis are regarded as a random sample, is not significantly different from zero growth. Oulton and O'Mahony conclude that during this period the growth of output is primarily determined by the growth of inputs. This suggests that the studies which claim that the Thatcher shock generated a productivity miracle are based on questionable data.

Furthermore, the productivity record must be considered in the context of the increased intensification of labour. Nolan[61] and Nolan and Marginson[62] have argued that an increase in output per head as a result of increased labour input through the intensification of labour should not be defined as an increase in

[58] Small Business Research Centre, *The State of British Enterprise: Growth, Innovation and Competitive Advantage in Small and Medium-sized Enterprises* (Cambridge: Small Business Research Centre, University of Cambridge, 1992).

[59] P. Stoneman and N. Francis, 'Double deflation and the measurement of output and productivity in UK manufacturing 1979–1989', Warwick Business School Discussion Paper (1992).

[60] N. Oulton and M. O'Mahony, *Productivity and Growth: A Disaggregated Study of British Industry, 1954–86* (Cambridge: Cambridge University Press, 1994).

[61] P. Nolan, 'Walking on water? Performance and industrial relations under Thatcher', *Industrial Relations Journal*, Vol. 20, no. 2 (1989), pp. 81–92.

[62] P. Nolan and P. Marginson, 'Skating on thin ice? David Metcalf on trade unions and productivity', *British Journal of Industrial Relations*, Vol. 28, no. 2 (1990), pp. 227–47.

productivity unless the growth of output is greater than the increased input; but Nolan[63] and Nolan and O'Donnell[64] have also gone on to argue, in our view persuasively, that far from paving the way for genuine productivity improvements, the government's policies of deregulation and anti-trade union legislation impaired effective labour utilisation and competitiveness in product markets.

Lastly, the productivity gains that have been made went disproportionately into increased profits rather than reduced output prices (which would have allowed increased market share, with higher output and employment than was in fact experienced, along with a healthier balance of payments and lower inflation), and the increased profits went disproportionately into dividend payments rather than investment.[65]

So while labour productivity growth in the 1980s returned perhaps to the rates experienced in the 1960s, these rates of growth were never satisfactory. UK productivity levels still lag behind the other leading industrialised countries. Recent OECD evidence shows that GDP per capita in the UK is the lowest of the G7 group of countries and more than 40 per cent lower than that in the United States.[66] There are significant international differences across industries, but a disaggregated analysis of thirty-five manufacturing sectors shows UK productivity levels to be consistently lower than that achieved in the leading country – in fact there are no industries where the UK leads the world. These productivity gaps show that there is significant potential for the UK to catch up with the leading countries – increasing its productivity *growth rate* as it has a lower productivity *level*. What is surprising is that it has been so slow to release this potential.

VI. Conclusions

Economic performance in the 1980s was poor: overall growth was modest and the short period of rapid growth was unsustainable, unemployment soared and became persistent; and the manufacturing sector stagnated. The so-called success stories were exaggerated: inflation was only suppressed by mass unemployment and the casualisation of the work force; and productivity growth was modest compared with that achieved in the 1960s, especially in the context of the potential for catch-up. Moreover, the policy changes of the 1980s have not created the foundations for future prosperity – the opposite in fact: advanced economies require economic stability and effective institutions to promote investment in skills and capital equipment. These in turn require economic management to be concerned with stable growth of the real economy and the regulation and management of markets.

63 P. Nolan, 'Walking on water?'.

64 P. Nolan and K. O'Donnell, 'The Political Economy of Productivity: Britain 1945–1994', mimeo (1995).

65 M. Kitson and J. Michie, 'Britain's Industrial Performance Since 1960: Underinvestment and Relative Decline', *Economic Journal*, Vol. 106 (January 1996), pp. 196–212.

66 D. Pilat, 'Labour productivity levels in OECD Countries: estimates for manufacturing and selected service sectors', OECD, Economics Department Working Papers, No. 169 (1996).

The 1980s experience was one of an economic roller-coaster fuelled by the vagaries of deregulation.

The experience of the 1980s compares unfavourably with the experience of the 1930s, when increased management of the economy by the State, although in its infancy, was a major cause of sustained economic growth. This is, of course, not to argue that the policy mix of the 1930s was optimal, or that it should have been replicated in the 1980s. Domestic and international economic conditions have changed, and different historical epochs have different policy requirements.

Despite the recent ascendancy of free market economics, however, the case for state intervention has strengthened not weakened. The UK government's failure to manage the economy efficiently during the 1980s and 1990s has led to periodic recessions which have also harmed the long-run growth potential of the economy. This is due to two factors, firstly, the depth of the recessions – they were much deeper than previous (at least pre-1974) postwar recessions – which led to large-scale scrapping of capital equipment and the laying-off of workers. This contrasts with previous recessions where, as the long-term costs of abandonment were high (the cost of restoring capital equipment, severance payments and research and training costs), the moderate extent of the downturns encouraged firms to maintain capacity while waiting for the cyclical upturn. Conversely, during the post-1979 recessions, the depth of the recessions encouraged firms to reduce capacity in order to minimise short-term costs and maximise the possibility of survival. Secondly, as the domestic economy has, albeit falteringly, developed, the industrial structure has shifted to more segmented and niche product markets. These sectors require specialist capital equipment and sector-specific skills. Factors of production such as those lost as a result of recession may be more difficult to replace in a period of recovery. Furthermore, it is not possible to rely on future investment to make good the position; the existence of sunk costs means that restarting operations will be expensive, requiring a higher yield to encourage the replacement investment. This alone indicates that governments should adopt suitable expansionary policies to ameliorate the potential impact of external shocks and certainly should not use severe contractionary policies to counter inflation. The long-term costs of recessions place an increasing premium on achieving stable economic growth.