

The economic legacy of Mrs Thatcher

Nicholas Crafts

The death of Lady Thatcher makes it opportune to consider the difference that her governments made to the UK's economic performance. This column is an 'economic obituary'.

The policies of the Conservative governments led by Margaret Thatcher between 1979 and 1990 remain highly controversial more than 20 years later. In many respects, they represented a sharp break with the earlier postwar period and this was certainly true of supply-side policies relevant to growth performance. Reforms of fiscal policy were made including the restructuring of taxation by increasing VAT while reducing income-tax rates and, notably, by indexing transfer payments to prices rather than wages while aiming to restore a balanced budget. Industrial policy was downsized as subsidies were cut and privatisation of state-owned businesses was embraced while deregulation, including most notably of financial markets with the 'Big Bang' in 1986, was promoted. Legal reforms of industrial relations further reduced trade union bargaining power which had initially been undermined by rising unemployment. In general, these changes were accepted rather than reversed by Labour after 1997.

In fact, before, during and after Thatcher, government policy moved in the direction of increasing competition in product markets. In particular, protectionism was discarded with liberalisation through GATT negotiations, entry into the European Community in 1973, the retreat from industrial subsidies and foreign-exchange controls in the Thatcher years, and the implementation of the European Single Market legislation in the 1990s. Trade liberalisation reduced price-cost margins. The average effective rate of protection fell from 9.3% in 1968 to 4.7% in 1979, and 1.2% in 1986 (Ennew et al. 1990), subsidies were reduced from £9bn (at 1980 prices) in 1969 to £5bn in 1979 and £0.3bn in 1990 (Wren 1996), and import penetration in manufacturing rose from 20.8% in 1970 to 40.8% by 2000.

Ending the trade union veto

The Thatcher government saw itself as ending the trade unions' veto on economic-policy reform, and many of the changes of the 1980s would have been regarded as inconceivable by informed opinion in the 1960s and 1970s. Moreover, the early 1980s saw unemployment return to 1930s levels, which conventional wisdom thought incompatible with re-election. So, how was the government able to break out of the constraints imposed by the political economy of the previous three decades? The answer probably lies in a combination of the economic failures of the 1970s, the Falklands War, political strife in the Labour Party, and a maverick prime minister who over-rode the doubts of the risk-averse majority of her colleagues. When the experiment was carried out, it turned out that unemployment was not such a vote-loser after all—it had much less impact than interest rates and inflation (Sanders 1991).

Performance payoff

Table 1 reports that under the auspices of 'Thatcher & Sons', the UK ended its relative economic decline vis-à-vis France and West Germany and, by 2007, had a slightly higher real GDP per person than either of those countries. In considerable part, this reflected greater employment and longer hours worked as UK labour productivity was still lower than in the other two countries. Nevertheless, by 2007, relative productivity performance had recovered somewhat from the low point reached at the end of the 1970s, as Table 2 reports. In fact, Table 2 significantly understates the extent of relative improvement in the UK since it does not allow for the implications of the labour-market distortions which underlie the differences in labour inputs. The UK's position in 2007 was underpinned by much lower unemployment than in the early 1980s linked to a fall in the NAIRU (Table 3) which was in considerable part due to reforms to benefits, taxes and collective bargaining made in the 1980s. The improvement in relative TFP performance in the UK appears to have been mainly based on reductions in inefficiency since there is nothing to suggest that the Thatcher reforms promoted stronger R&D. Gaps in capital per hour worked remained substantial at the end of the 20th century.

Increased competition and openness in the later 20th century was associated with better productivity performance. Proudman and Redding (1998) found that across British industry during 1970–90, openness raised the rate of productivity convergence with the technological leader. Nicoletti and Scarpetta (2003) found that TFP growth was inversely related to product-market regulation giving the UK an advantage of about 0.5 percentage points per year in the 1990s as compared with France and Germany. Entry and exit accounted for an increasing proportion of manufacturing productivity growth, rising from 25% in 1980–5 to 40% in 1995–2000 (Crisuolo et al. 2004).

Table 1. Real GDP/person (UK = 100 in each year)

	USA	Germany	France
1820	65.6	51.9	54.7
1870	76.6	57.6	58.8
1913	107.7	74.1	70.8
1929	125.4	73.6	85.6
1937	103.4	75.3	72.2
1950	137.8	61.7	74.7
1979	142.7	115.9	111.1
2007	130.2	95.9	91.3

Note: Estimates refer to West Germany from 1950 to 2007.

Sources: Based on estimates measured in 1990 Geary-Khamis dollars reported in the Maddison Project historical database and for West Germany in 2007 calculated from Statistisches Bundesamt Deutschland 2010.

Table 2. Levels of productivity in the market sector (UK = 100 in each year)

GDP/hour worked	France	West Germany/Germany	USA
1973	95	132	160
1979	112	157	166
1991	123	161/143	156
1995	117	133	146
2007	109	119	147
TFP			
1973	87	112	127
1979	103	135	135
1991	110	133/123	128
1995	104	115	123
2007	101	110	125

Notes: Estimates in 1973 and 1979 are West Germany; in 1991 West Germany is the first number, in 1995 and 2007 estimates are for unified Germany.

Sources: Estimates kindly provided by Mary O’Mahony based on EUKLEMS data as described in O’Mahony and Timmer (2009) and on earlier data underlying O’Mahony (1999) and O’Mahony and van Ark (2003).

Table 3. The NAIRU (%)

1969–73	3.8
1974–81	7.5
1981–86	9.5
1986–90	9.6
1991–97	8.9
1997–2000	5.7

Source: Nickell and Quintini (2002).

End of the easy life for management

The impact was felt at least partly through greater pressure on management to perform and through firm-worker bargains which raised effort and improved working practices. Increases in competition resulting from the European Single Market, which Mrs Thatcher endorsed, raised both the level and growth rate of TFP in plants which were part of multi-plant firms and thus most prone to agency problems (Griffith 2001). A notable feature of the period after 1980 encouraged by capital market liberalisation was divestment and restructuring in large firms and, in particular, management buyouts (often financed by private equity) which typically generated large increases in TFP levels in the period 1988–98 (Harris et al. 2005). The process of privatisation raised productivity performance appreciably as nationalised industries were prepared for sale (Green and Haskel 2004).

Industrial restructuring

The 1980s and 1990s saw major changes in the conduct and structure of British industrial relations. Trade union membership and bargaining power were seriously eroded. This was prompted partly by high unemployment and anti-union legislation in the 1980s, but also owed a good deal to increased competition

(Brown et al. 2008). The 1980s saw a surge in productivity growth in unionised firms as organisational change took place under pressure of competition (Machin and Wadhvani 1989) and non-recognition of unions in the context of increases in foreign competition had a strong effect on productivity growth in the later part of the decade (Gregg et al. 1993). The productivity payoff was boosted by the interaction of reforms to industrial relations and product-market competition.

For the UK, the 1980s' deregulation of services that are intensive in the use of ICT (notably finance and retailing) that reduced barriers to entry was important for its relatively successful response to ICT, as OECD cross-country comparisons reveal (Conway et al. 2006). It is also clear that investment in ICT is much more profitable and has a bigger productivity payoff if it is accompanied by organisational change in working and management practices. This would not have happened with 1970s-style industrial relations under conditions of weak competition. Prais (1981) noted the egregious example of the newspaper industry, where these conditions precluded the introduction of electronic equipment in Fleet Street although an investment of £50 million could have reduced costs by £35 million per year. Success in ICT diffusion was an unintended consequence of the deregulation and reform of industrial relations achieved in the Thatcher period.

There is, of course, an important qualification that has to be made regarding the 'success story' rehearsed above. Deregulation was central to the growth of an unusually large financial services sector in the UK, amounting to about 8% of GDP in 2007, and a banking system that was very highly leveraged by previous standards. This left the UK exposed to a very costly financial crisis which may well have permanently reduced the sustainable level or even the trend rate of growth of real GDP, possibly substantially. In time, it will be possible to reassess the growth performance of the late 20th and early 21st centuries with these issues in mind, but at present it is too soon to tell.

Conclusion

In sum, Thatcherism was a partial solution to the problems which had led to earlier underperformance, in particular, those that had arisen from weak competition (Crafts 2012). The reforms encouraged the effective diffusion of new technology rather than greater invention and worked more through reducing inefficiency than promoting investment-led growth. They addressed relative economic decline through improving TFP and reducing the NAIRU. At the same time, the short-term implications were seriously adverse for many workers as unemployment rose and manufacturing rapidly shed two million jobs while income inequality surged, to no small extent as a result of benefit reforms.

Indeed, any judgement on Thatcherism turns heavily on value judgements concerning the relative importance of income distribution and economic growth as policy objectives. The 1980s saw a very rapid increase in the Gini coefficient by about nine percentage points, which has turned out to be largely permanent. Ultimately, the Thatcher experiment was about making a liberal market economy work better. There will be those who think a German-style coordinated market economy is preferable. That was not really an option available to Mrs Thatcher but in any event it was hardly a vision of which she approved.

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