CHAPTER 9

Evaluating Mrs. Thatcher's Reforms: Britain's 1980s Economic Reform Program

Patrick Minford

The aims of Margaret Thatcher's reform program were to cure the "British Disease" of the 1970s: low growth, high inflation, and high unemployment. It had two main elements: "monetarism" (namely monetary policy and complementary fiscal policy to defeat inflation) and "supply-side policy." This last in turn consisted of two main components: labor market flexibility to reduce unemployment, and the reduction of barriers to entrepreneurial activity (taxes and regulations), to raise productivity growth.

These reforms were deliberately sequenced for practical political reasons—see Minford (1998) for more details on these policies.

Monetarism and the defeat of inflation came first. Then, starting in her second term, Mrs. Thatcher embarked on her supply-side program, which would then also occupy her third term. A key element that helped her in the supply-side reforms was that, inflation having been defeated, demand policy was reasonably free to support them.

P. Minford (✉)
Cardiff Business School, Cardiff University, Cardiff, UK
e-mail: minfordp@cf.ac.uk

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9.1 The Monetarist Program

The program to defeat inflation, then running at close to 20%, was formulated as a "gradualist" one, following advice from Milton Friedman (explained in Friedman 1980). It would reduce both the growth of £M_3 (a proxy for bank credit) and the fiscal deficit as a share of GDP—the latter included (against Friedman's advice) to ensure credibility of the monetary target, as emphasized in rational expectations models. In the event, "the best-laid plans *gang agley*" and both these targets were substantially overshot, as Figs. 9.1 and 9.2 show. The recession was the cause of the overshoot in both. The deficit (measured here by the public sector borrowing requirement, PSBR) surged as welfare benefits rose and revenues fell with falling GDP and rising unemployment. Bank credit and so £M_3, the chosen indicator, grew rapidly as firms hit by falling receipts borrowed heavily from the banks to stay in business; the Bank of England, which was

Fig. 9.1 PSBR/GDP 4 quarter average. (*Source*: Adapted in simplified form from Minford 1998, Fig. 4.5)

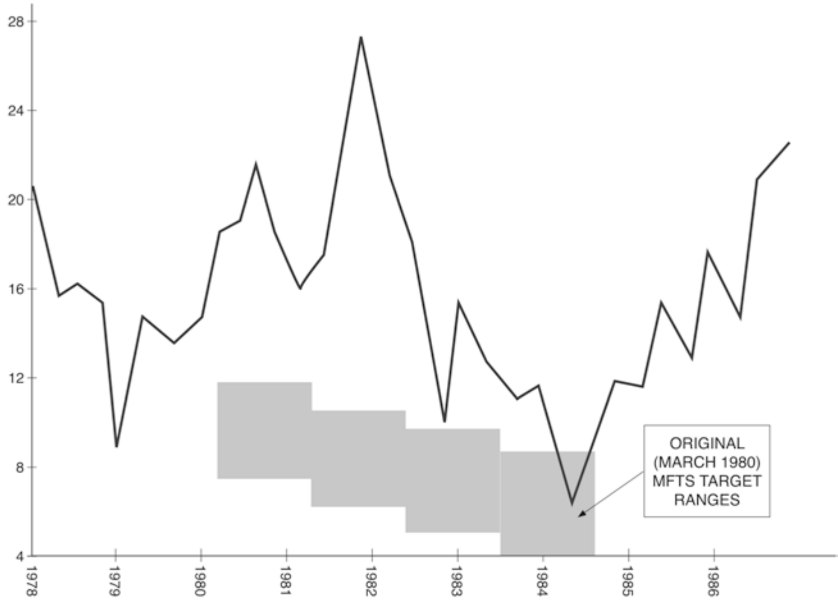

Fig. 9.2 Annual percentage growth in £M_3. (*Source*: Adapted in simplified form from Minford 1998, Fig. 4.6)

opposed to monetarist policies, lent supportively to the banks to facilitate this.

Faced with these overshoots, the government could have abandoned the policies and accepted defeat. However, instead Mrs. Thatcher pressed on, insisting that the money supply and budget deficits would be curbed to ensure the defeat of inflation, whatever the short-term pain. The main focus was on fiscal policy: the fiscal stance was tightened in the 1981 budget to boost policy credibility. As long-run interest rates came down, it also permitted a cut in interest rates on the grounds that monetary conditions as measured by money supply indicators other than the chosen one were in fact rather too tight—see Fig. 9.3 of M_4.

As is well known, the critical 1981 budget attracted strong criticism in the famous *Times Letter* from 364 economists: The mass of UK economists, who generally opposed the policies, preferring price/wage controls and demand stimulus, argued that the policies would create long-running recession, with little if any effect on inflation (Booth 2006).

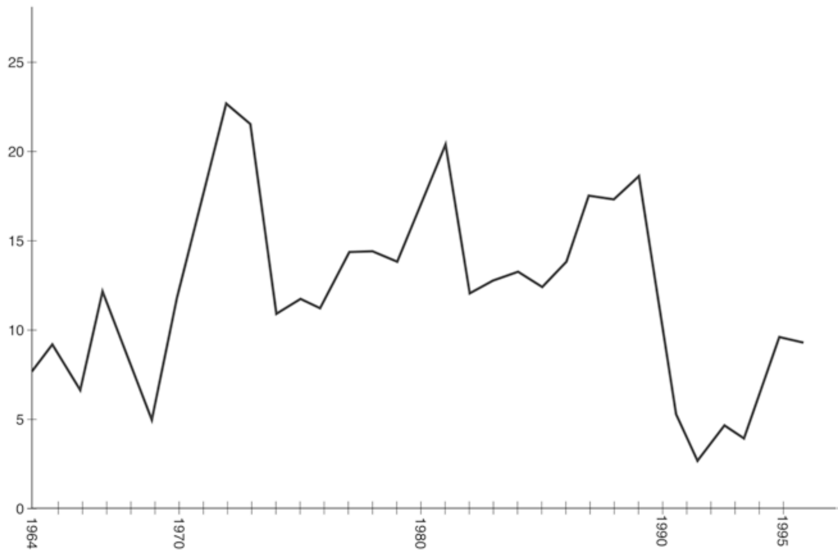

Fig. 9.3 M_4 growth. (*Source*: Adapted in simplified form from Minford 1998, Fig. 4.10)

However, they were wrong, as Fig. 9.4 of inflation shows. By the end of 1982 inflation had fallen below 5%. Furthermore, growth in 1982 picked up sharply, signaling the end of the recession. Unemployment stayed high, but it became plain that this was not through lack of demand, but because of supply-side problems in the labor market: real wages were being held at unrealistically high levels by unconditionally provided unemployment benefits and powerful unions. Also manufacturing productivity was low, after years of subsidies and loose control of credit. It became clear that the supply-side program must be ushered in.

9.2 The Supply-Side Reforms, Part One: Labor Market Flexibility

The first part of the program was focused on labor market flexibility. The unemployment benefits/wage ratio was curbed; eligibility for these benefits was made conditional on proper search, to be monitored in job market interviews at the benefit office under a "Restart" review. Union strike

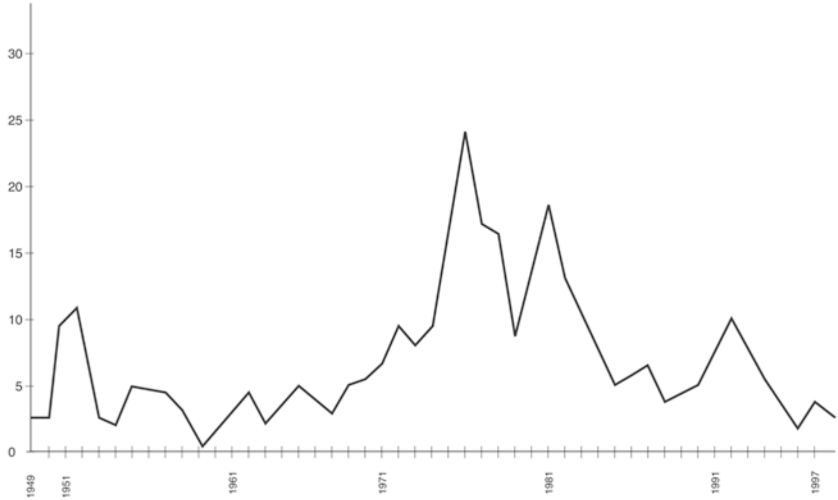

Fig. 9.4 RPI inflation—all items. (*Source*: Adapted in simplified form from Minford 1998, Fig. 4.3)

powers were cut back: strikes would be permitted only after a full members' ballot and only over the pay/conditions of members—no "secondary action" would be allowed, that is, strikes by other workers in suppliers or customers of the employing firm. Strikes in breach of these laws would not be protected against tort contract violation by existing "union immunities" (these allowed unions to "induce contract violation" legally); so civil court action against unions over illegal strikes could and did lead to large-scale damages and fines. These measures proved to be highly effective in curbing strikes and lowering incentives to avoid job search—see Figs. 9.5 and 9.6. Figure 9.6 on the benefit/wage ratio relates to the basic benefit for a low-paid worker where unemployment was concentrated. In addition, there was an earnings-related supplement for higher-paid workers; this was abolished in 1982. Strong conditionality on paying benefits was also introduced in 1986 under the "Restart" process. Figure 9.7 shows both actual unemployment and the estimates from the Liverpool supply-side model of the UK for the natural/equilibrium unemployment rate emerging from these reforms. It can be seen that by the end of the 1980s both actual and equilibrium unemployment had fallen greatly. Actual unemployment was to rise again sharply at the start of the 1990s,

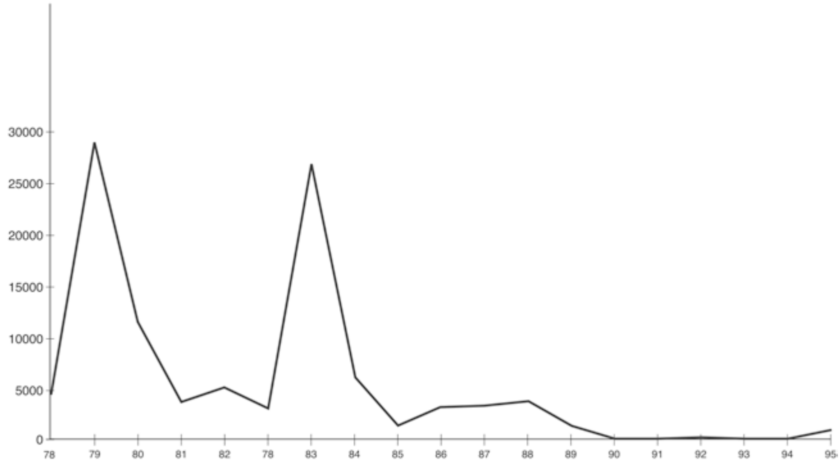

Fig. 9.5 Working days lost in strikes. (*Source*: Adapted in simplified form from Minford 1998, Fig. 5.2)

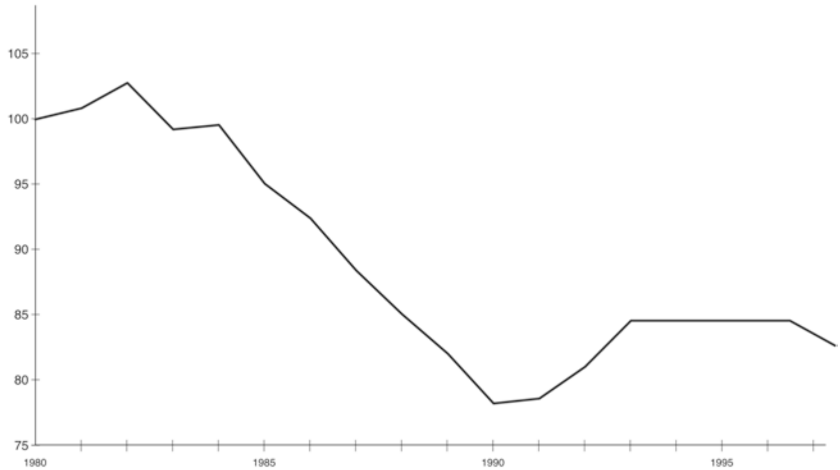

Fig. 9.6 Benefits—excluding earning-related supplement—relative to real wages (1980 = 100). (*Source*: Adapted in simplified form from Minford 1998, Fig. 5.3)

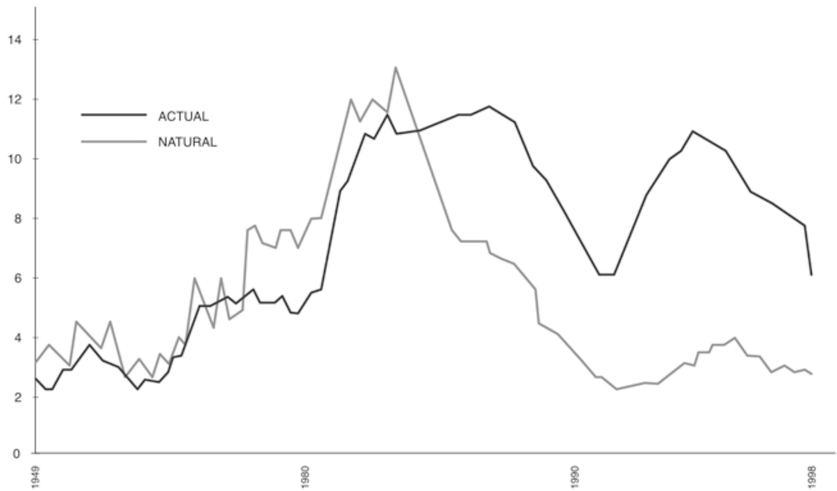

Fig. 9.7 Actual and natural rates of unemployment. (*Source*: Adapted in simplified form from Minford 1998, Fig. 5.5)

as a result of recession associated with UK entry into the European Exchange Rate Mechanism in 1990, a serious policy mistake. But otherwise unemployment has been on a steady downward path to its latest rate of around 2% on the benefits-claimant measure used here.

9.3 The Supply-Side Reforms, Part Two: Improved Environment for Entrepreneurs

For entrepreneurial firms seeking to raise productivity, regulative intervention in the labor market, via union powers and social intervention (labor rights), was a major issue in pre-Thatcher Britain. Hence the labor market flexibility reforms just examined also constituted an important element in the improvement of the entrepreneurial environment. The other main element involved taxes on entrepreneurs: notably the top marginal income tax rates and corporation tax on SMEs.

It has proved difficult to find evidence of causal linkages between such business disincentives and productivity growth. There have been many studies showing that there is a statistical link between the two, but causation cannot be demonstrated by such studies (Minford et al. 2007).

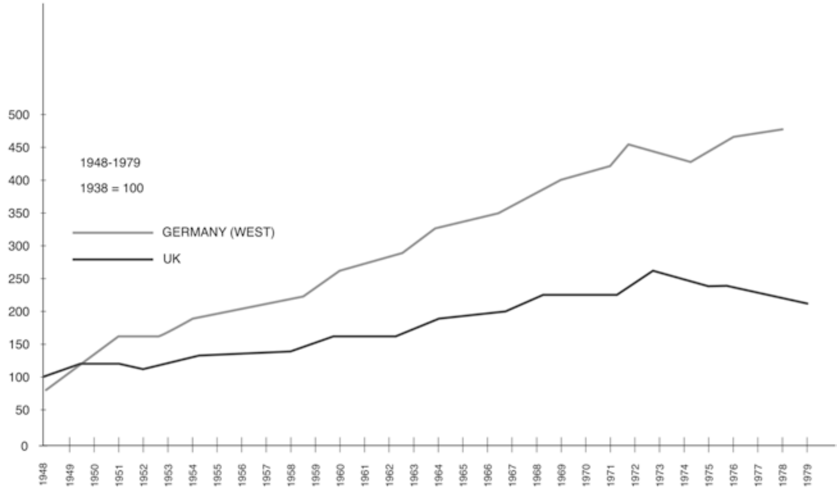

Fig. 9.8 Manufacturing productivity in Germany and the UK, 1948–79. (*Source*: Adapted in simplified form from Minford 1998, Fig. 3.9)

Figure 9.9 on UK manufacturing productivity growth and its comparison with West Germany shows the way relative productivity surged in the UK after 1979, as compared with the poor post-war performance up to 1979 (Fig. 9.8). But we need serious causal analysis to establish a link with the reforms.

In recent research (Minford 2015; Minford and Meenagh 2020) evidence of causation has been established. A model of the UK economy in which regulatory costs affect productivity growth is simulated to generate behavior of GDP and productivity, as well as other economic variables over the period from 1970 to 2009. If this model is a correct representation of the UK, then the behavior of the economy we actually observed in this period should be accounted for by these simulations. This work finds that one cannot reject this hypothesis statistically with 95% confidence.

First, we may inspect the data on tax and labor market regulation (LMR) in the UK over this period of the Thatcher reforms. In the left panel of Fig. 9.9 are three series: the top marginal income tax rate, the small company corporation tax rate, and LMR (mainly reflecting union laws). In Panel 2 are two series representing different weighted combinations of these, Tau(1) and Tau(2). For the main results Tau(1), which

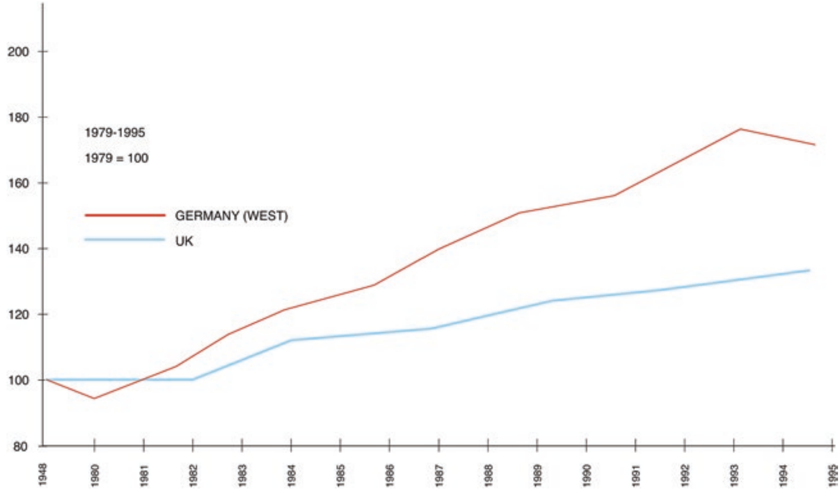

Fig. 9.9 Manufacturing productivity in Germany and the UK, 1979–95. (*Source*: Adapted in simplified form from Minford 1998, Fig. 3.9)

equally weights LMR and the top marginal rate, is used; however. the results are robust to using Tau(2), which replaces the top marginal rate with the corporate tax rate.

The method of testing involved here is indirect inference, checking whether the simulated behavior of the UK economy growth model was the same as its actual behavior. In this instance the behavior is relationships of output, productivity, and the tax/regulation variable. It turns out that the hypothesis the simulated behavior is the same as the actual has a *p*-value of 0.18, well above the 0.05 rejection threshold. Figures 9.10, 9.11, and 9.12 illustrate how similar the actual behavior and the average simulated behavior is for these variables; this underpins the similarity of the actual and the simulated relationships between them.

This work represents something of a breakthrough in the longstanding debate over causal evidence in this area. The specific effect of a sustained ten-year 5% rise in the measure of intervention (equivalent to a rise in the effective tax rate) on growth is for a fall in growth of 1.5% a year over two decades—about 30% in total. Over the 1980s the intervention measure (Tau in Fig. 9.9) fell between 5% and 20%, depending on which measure

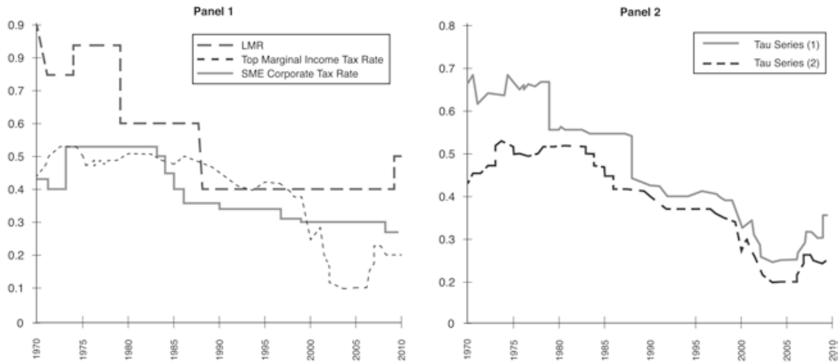

Fig. 9.10 Data on tax and labor market regulation (LMR) in the UK during the Thatcher reforms. (*Source*: Minford and Meenagh 2020, Fig. 2)

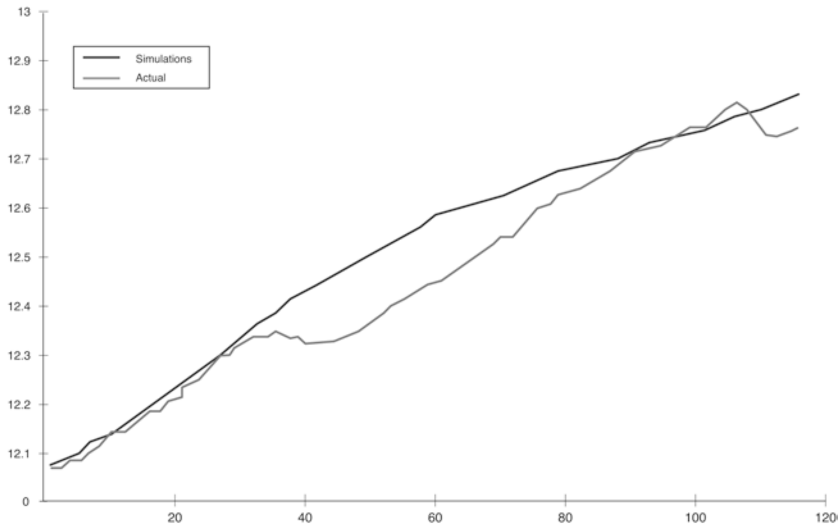

Fig. 9.11 Match of average simulated output to actual productivity. (*Source*: Minford and Meenagh 2020)

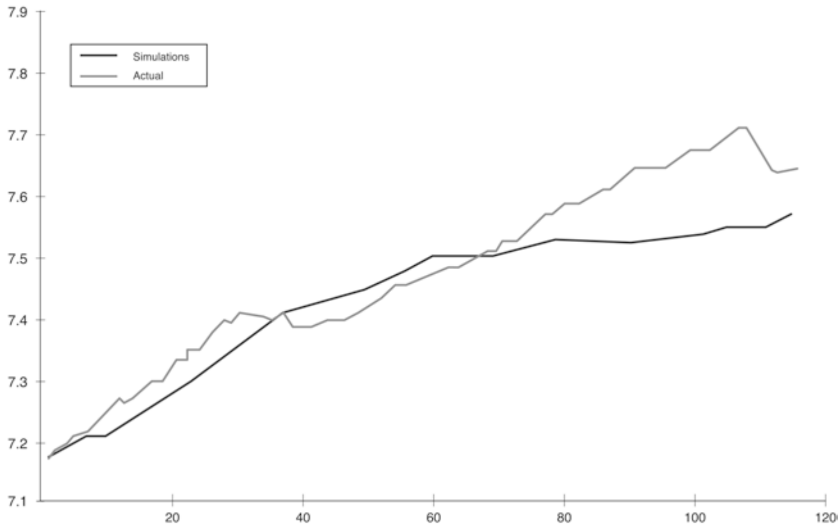

Fig. 9.12 Match of average simulated output to actual output. (*Source*: Minford and Meenagh 2020)

one uses: the effect on the growth rate of productivity could have been between 1.5% and 6% therefore. This is a substantial effect.

9.4 A Note on the Political Economy of Mrs. Thatcher's Reforms

One of the apparent puzzles of the Thatcher reforms is how they came to be politically possible, given the largescale forces arrayed against them. For a start, big business, as typified by the Confederation of British Industry (CBI), was against monetarism with its elimination of easy credit and the end of the associated devaluations. It was also against union reform, since unions acted as an effective entry barrier to new, especially SME, firms. Meanwhile of course unions and the political left were against the reduction in wage inflation and the curbing of union powers. The Tory party was split, with "one-nation Tories" opposed to the reforms, on all these grounds. This created a constant fear of leadership challenge within the Thatcher government. In response to this threat, Mrs. Thatcher put key economic portfolios in hands of trusted allies—Howe, Lawson, Ridley, and Tebbit. Her opponents, lacking economics expertise, found it hard to challenge this group on economic grounds.

The main support for Mrs. Thatcher came from the skilled working class, whose interests manual unions undermined, by pushing up manual wages and disrupting production at the expense of profits and so skilled wages. Adding to this support, the defeat of inflation was extremely popular: inflation, with its effects in redistributing resources to those lucky or smart enough to do well from inflation, had become highly unpopular. The other central policy of "bringing unions within the law" was also widely acclaimed.

However, the key element that buttressed Mrs. Thatcher's position was Tory Party compromise, faced with the threat of a far left-wing Labour government under Michael Foot. (A close parallel with today's recent threat of a Corbyn government.) Hence, the secret of the reforms' feasibility and success was the willingness of the Tory Party to maintain its power, to back the reform program and combine with its "new working class" support base. One of the main intermediaries between the Tory one-nation group and Mrs. Thatcher was William, later made Lord, Whitelaw, who explained these realities to his old-guard friends. In recording her gratitude to him for his efforts and loyalty in buttressing her governments, Mrs. Thatcher much later remarked, "Everyone needs a Willie." Needless to say, in spite of the ensuing hilarity, it was not a joke, and indeed jokes were not her style—rather she made remarks that were barbed with wit as when after a dinner celebrating the IEA's 50th anniversary in 2005 when speaking last after a long line-up of men she remarked slightly testily, "The cock may crow but it's the hen that lays the eggs."

9.5 Conclusions

The reform program of the Thatcher governments is widely regarded as a success story in curing the 1970s ailments—inflation, slow growth, and rising unemployment—of the British economy, then "the sick man of Europe." They began with UK monetarism, and followed with labor market reforms, and finally with the reshaping of taxes and government spending to help the rebirth of an entrepreneurial economy. The early monetarist phase was meant to be gradualist but mistakes delivered a very sharp squeeze; as people understood that the policy regime had changed, inflation fell far quickly and growth recovered. The labor market reforms brought down unemployment by raising work incentives; aided by falling tax rates the environment became propitious for entrepreneurs, raising productivity growth. Margaret Thatcher was able to assemble the support for this ambitious agenda to succeed politically against many opposing interests, because of the ability of the Conservative party to unite its traditional middle-class constituency with the newly emerging, aspiring skilled working-class constituency, which had a strong interest in these reforms.

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