Will Mrs. Thatcher Do It?

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The British election in the spring of 1979 brought to power a Conservative government committed to a policy of reducing inflation and increasing the growth of real output and productivity. In the recent past, Britain, even more than the United States, experienced high inflation and slow growth of output, and in common with the United States, suffered from excessive regulation and slow growth of productivity. Between the sixties and the seventies, inflation in Britain increased from an average of 4% to 13%, and the growth of output slowed from 3% to 2% or less.

Past Failures

The proximate causes of the British "disease" are well-known. The welfare state sustained a bloated bureaucracy with little incentive to serve the public. Attempts by government to fine-tune the economy from quarter-to-quarter have been followed by higher inflation, higher unemployment and slower growth of output. Reliance on formal wage and price controls, incomes policies and other informal controls on the pricing of products and labor services forced successive governments to confront the labor unions, produced a series of political skirmishes that made politics lively but left only heightened skepticism about the ability of any government to control inflation.

Nowhere was the belief more widely held, or more often repeated, that inflation could not be reduced as long as the labor unions refused to accept reductions in their real income. Those who held these beliefs had a ready explanation for every failure. Conservative governments were too hostile and harsh in dealing with the unions. Labor governments were too friendly and unwilling to confront their Labor party colleagues. No party seemed to find just the right approach according to the conventional view.

The Current Program

Prime Minister Thatcher's government replaced these counter-productive policies with a medium-term strategy to control inflation and increase growth of real output. There are five main elements in the new government's program.
(1) The government's share of total income is to be reduced 1% a year to reach 40% by the 1983-84 fiscal year. (If the United States adopted a comparable program, government spending would be reduced approximately $25 billion a year from currently projected levels.)

(2) To increase incentives for private saving and reduce the size of the budget deficit while limiting the loss of tax revenues, the government reduced income taxes and raised taxes on spending. The basic income tax rate was reduced by 10%—from 33% to 30%, and the maximum tax rate was reduced from 83% to 60%.

(3) Subsidies to state enterprises and housing were reduced, and publicly held shares in several state enterprises were sold to private investors.

(4) A target growth rate of money, defined as currency demand and time deposits, was set at 7% to 11% for the first year. The target rate was the first step in a policy of sustained, annual reductions in money growth.

(5) Exchange controls were removed; for the first time in many years, Britons were permitted to invest in foreign securities without restrictions.

The first three items are major items in a program of fiscal reform to encourage incentives to work, save and invest. The program recognizes three important principles. First, the main, and lasting, benefit of tax reduction comes from reduction in the size of government, not from tax reductions that leave the size of government unchanged. Second, a main effect on incentives to work an additional hour or an additional day comes from reducing marginal tax rates, while incentives to work, or remain on welfare, are influenced by the minimum tax rate. Third, to increase growth, employment and real income, resources must shift from declining industries to growing industries. Subsidies to failing firms and to state enterprises prevent or delay the adjustment, so they reduce efficiency and the British standard of living.

The full benefit of the new program will not come until the recession ends. There is no reason to expect a high rate of investment during the current recession. Saving rates appear to have responded, however. The share of after-tax income saved rose, following the shift of taxes from income to spending. Although the new tax law became effective in the latter part of the year, the reported saving rate was one to two percentage points higher in 1979 than in any recent year.
Lower Inflation

The higher rate of saving means that consumers spend a smaller fraction of their incomes on domestic goods and on imports. The volume of imports has fallen, and the value of the pound has increased. The effects of tax reform and recession both work to raise the market value of the pound, so the precise effect of tax reform cannot be inferred.

The rising market value of the pound has two effects. The cost of British exports to foreigners rises, deepening the recession. But the cost of raw materials imported into Britain and the prices of substitutes for British production fall, reducing the current rate of price change. Currently, the consumer price index is rising at an annual rate of 11 to 12% compared to a maximum rate of about 22% earlier in the year.

The rising value of the pound, the slower growth of money and the growing belief that the government intends to persist in the policy of reducing inflation have also lowered expected future rates of price increase. A dramatic sign of this change in beliefs is found in the labor market. Recent increases in hourly wages in the unionized private sector have fallen from above 16% for the past year, to below 10% in recent weeks. The government's policy of reducing the rate of wage increase—without intervening in contract negotiations and without developing guidelines, guideposts or contracts—appears to be working.

Sustained evidence of success in reducing the rates of wage and price increase is necessary before anyone can be certain that inflation has been reduced permanently. A sudden reversal of government policy, now, would damage credibility and convince the many skeptics that this government—like previous governments—will not see the policy through.

A sustained, anti-inflation policy is required also to extend the lower rate of increase in wages and prices to other parts of the private sector and to the public sector. Private sector wages are a major element in costs of production. A slower rate of wage increase means that the unions are willing to anticipate slower inflation and to base their contracts on that belief. The slower rate of increase in private sector wages provides leverage for reducing public sector wage increases. This slows the growth of public expenditure and the prospective budget deficit and opens the prospect of additional tax reduction in a year or two.

Can Mrs. Thatcher Do It?

It is too soon to call the British experiment with a medium-term, market oriented
approach successful. Responsible proponents of medium-term policies recognize that it takes about two years to convince the public that the government is willing to impose the initial costs so as to achieve the longer-term benefits. Yet, as we move into the second-year, Mrs. Thatcher's government shows no sign of yielding to the pressures of the public sector unions, concerned about demands for efficiency in the delivery of government services, or private sector businessmen, concerned about short-term losses and the high failure rate of British firms.

Currently, the major threat to success does not come from private sector unions, who have been portrayed as villains in often repeated stories about the intractability of inflation in modern economies. The determination of the government and the growing belief that it will persist in its policies stiffens the back of private sector employers and lessens the demands of private sector unions. For many firms the alternative to hard bargaining is bankruptcy; for many union members, the alternative to a lower rate of wage increase is a long spell of unemployment.

The government's safety net under individual firms and unions has become smaller as the government's determination to reduce inflation has become clearer. But, as the safety net shrinks, the message spreads to workers and managers, and it becomes more useful to believe that the policy can succeed than to insist that it must fail.

Success is not foreordained. Public sector unions continue to demand rates of wage increase far above the increases received by private sector employees. The Bank of England, like the Federal Reserve in the United States, remains unwilling to adopt procedures to control the growth of money. The most frequently used measure of money, known as sterling M3, exploded during the summer, to an average annual rate of increase of 41% for the three months ending in August. The twelve month rate of increase rose to 18%, far above the target rate of growth (7-11%) and the growth rate required for success of the medium-term plan.

Part of the monetary explosion is the result of a change in regulations, so the reported rate of increase overstates the actual rate. Nevertheless, the practices of the Bank of England raise doubts about their willingness to control money growth and leave an uncertain answer to the question: Will Mrs. Thatcher Do It?