→ T.L Thanks – I had in fact seen this in draft some weeks ago

THE BATTLE OF BRITAIN

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Maggie Thatcher is fighting an undeclared war against her own economic philosophy, and the British people are the losers.

By JOHN O'SULLIVAN

AFTER ALMOST TWO years of Tory government in Britain, the question that must now be asked is: Will Margaret Thatcher ever attempt to carry out her announced policies of reducing public expenditure, cutting taxes, slimming down subsidies to both nationalized and private industry, and reforming the unique legal privileges of the trade unions? This question must surprise those who innocently assume that Thatcher, in the fearsome guise of Attila the Hen, has been ruthlessly imposing these policies on a nervous country, a cowed civil service, and a queasy cabinet. Indeed, most Americans must by now believe that these policies have not only been tried but been proven a spectacular failure, entangling in their collapse Professor Milton Friedman, the *Wall Street Journal* editorial page, President Ronald Reagan, and assorted enemies of social justice around the globe.

The appropriate conclusion to draw from this is that most reports in the American press about the "Thatcher experiment" are inaccurate to the point of fiction. A typical example—Anthony Holden pronounced confidently in the *New Republic* that "Thatcher's election promises in 1978–1979 were very similar to those of the Republican candidate in 1979–1980: reduce government spending, eliminate waste, cut back the bureaucracy, tighten control of the money supply. For all of Thatcher's patent sincerity in applying what she thought appropriate, if painful, remedies, none of them have worked."

If this passage means that Thatcher actually did reduce state spending, tighten control of the money supply, and the like, then it is simply false. As we shall see, since May 1979, government spending has increased and control of the money supply has been loosened. This makes nonsense of Holden's claim that "none of them have worked." None of what—the rhetorical pledges or the actual policies? The great flaw in U.S. reporting has been to concentrate on the speeches of Tory ministers in praise of free enterprise and "monetarism" without peeking behind their words.

When once the grim statistics are inspected, a very different picture emerges. Let us first examine what critics are pleased to call "Mrs. Thatcher's dogmatic adherence to monetarism." It is certainly true that both Thatcher and the chancellor of the exchequer, Sir Geoffrey Howe, came into office convinced that inflation was a monetary phenomenon and determined to reduce it by gradually winding down the rate of increase of the money supply. It is also true that in March 1980 the chancellor set target growth rates for the money supply for the next four years. But there the dogmatic adherence ended.

Target rates and good intentions notwithstanding, the money supply has lunged wildly out of control. Last year, for instance, the target was an increase within the range of 7 to 11 percent. The actual increase was a horrifying 20 percent. This is higher than in most of the Labour years—but Denis Healey, the former Labour chancellor, still denounces "punk monetarism."

The reasons for this failure are interesting and undermine the widespread contention that Friedmanite monetarism is at the bottom of Britain's economic troubles. Of the various techniques of monetary control, the one most favored by orthodox monetarists is control of the monetary base, that is, the amount of loanable funds available to banks. This method was firmly opposed both by Treasury civil servants, who have always been skeptics about monetarism of any kind and regard monetary base control as the most extreme form of that heresy, and by the governor of the Bank of England, who is a closet Keynesian. Under such pressures the government selected instead the much more complex technique of controlling five different determinants of credit, most notably the public sector borrowing requirement (PSBR), which is Mandarin English for the government deficit.

Of this method Professor Friedman told a committee of MPs last June: "I could hardly believe my eyes when I read the first paragraph of the summary chapter [of the government's Green Paper on monetary policy, published in March 1980]: 'the principal means of controlling the growth of the money

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supply must be fiscal policy—both public expenditure and tax policy—and in- t rates.' Interpreted literally, this sentence is simply wrong. Only a Rip Van Winkle, who has not read any of the flood of literature during the past decade and more on the money supply process, could possibly have written that sentence." Of the many difficulties with the government's approach, perhaps the most important is that, as the Green Paper itself admitted, "it is impossible to forecast the PSBR . . . and very difficult to control it closely."

That has turned out to be a vast understatement. The original March 1980 forecast of the deficit, on which the monetary target was in part based, was $20.4 billion (all dollar figures reflect an exchange rate of £1 = $2.40). By November of 1980 it had been revised to $27.6 billion, or about 5 percent of Britain's gross domestic product (GDP). And in a recent speech to Zurich bankers, the financial secretary to the Treasury, Nigel Lawson, hinted that the final figure was likely to be higher still. Economic commentators now seem to expect it to be about $30 billion. In short, the government deficit, which is the centerpiece of the strategy for controlling the money and thereby gradually diminishing inflation, has gone wild, throwing the entire monetary strategy out of kilter—as orthodox monetarists had long warned.

And why has the government deficit bolted out of control? Most commentators (and even some ministers) now agree that the government's most serious economic error has been its failure, despite four bites at the cherry since May 1979, to cut state spending. What, then, is one to make of those heart-rending stories of nursery schools being shut down for lack of staff? One clue is that in the vocabulary of long-term planning of public expenditures, a "cut" may be simply a reduction in the allocation for some future program. Such cuts are merely disappointed aspirations. And since Labour's spending plans were inordinately optimistic, conceived with the 1979 election in mind, savage cuts could be made without touching any existing programs whatsoever.

That is not, however, a firm guarantee against nursery-school closings or the abandonment of half-built municipal swimming pools. Bureaucrats in town halls and in Whitehall are quick to ensure that, whatever else is sacrificed to economy, it will not be their jobs or the size of their staffs. Hence, in the series of public spending cuts since 1975, overall government expenditure remained static while capital spending was cut by 50 percent. This has meant, ironically, that the jobs axed were largely in the private sector, among construction and manufacturing companies supplying the government, leaving proportionately more civil servants to administer worse and worse services.

Even so, the government leashed its savagery, proposing merely to "stabilize" public spending for the years 1979–81, and then to reduce it year by year to achieve a 4 percent real reduction in public spending by 1984. What made this project dubious was the convenient arrangement of the cuts: piffling cuts timidly proposed for the here and now; large reductions confidently forecast for the hereafter of 1983–84. Worse yet, even the immediate spending reductions sought by Thatcher ran into a deadly political crossfire within her own cabinet. In July 1979 Thatcher and Howe asked for spending reductions amounting to $19.2 billion; the compromise that emerged from the cabinet was a mere $8.4 billion. Still more significant was the episode in November 1980 when the Treasury, with the full backing of the prime minister, demanded $4.8 billion worth of cuts. The cabinet responded with a stinging rebuke and cuts of only half that figure, a real rebuff to Thatcher's power to direct economic policy.

If cuts were small, however, unanticipated rises in current government costs were large. The most striking example in 1979–80 was the sharp increase in the public sector wage bill. This reflected the lavish pay awards determined by a special commission chaired by Hugh Clegg, which was set up by the Labour government on its deathbed. The awards reflected the assumption that public sector workers should be paid on the basis of "comparability" with the private sector, ignoring the unique job security and indexed pensions enjoyed by public employees. According to official estimates, these pay rises added $4.8 billion to public spending in a full year. But this was a case of a very large chicken flapping home to roost. Thatcher herself had promised in Opposition to honor the commission's awards on the straightforward political calculation that to do otherwise might lose the votes of public sector workers.

In the present financial year, 1980–81, public spending has been sharply increased by the larger than expected rise in unemployment. Every loss of 100,000 jobs in the private sector adds approximately $1.2 billion to the government deficit as income tax receipts fall and social benefits are paid out. (Public sector unemployment creates a slight surplus in the exchequer—but there hasn't been much of that.)

The net result is that by every possible test—in constant prices, in money terms, in volume, as a percentage of national income—*public spending has increased under the Tories*. The increase in real terms may be modest, between 1 and 2 percent, but throughout this period national income has been falling, so public spending comprises a significantly larger share of it. According to the official *Economic Trends* (December 1980), public spending as a percentage of national income rose from 45 percent under Labour to 49 percent in the second quarter of 1980.

SINCE THATCHER IS not a supply-sider, this failure to control public spending produced a cautious policy of increases in the tax rate. Tax revenues, as a result, continue to rise. At the time of the budget the total tax take in 1980–81 was estimated to be approximately $149 billion, up from $120 billion for the financial year 1979–80. But that was before the November mini-budget, which added in a full year another $2.4 billion in national insurance contributions (a euphemism for taxation), with an additional $2.4 billion extracted from the oil companies in petroleum revenue tax. As a percentage of national income, state revenue (taxes plus charges for state services) rose from 41.3 percent under Labour to 43.3 percent in the first six months of 1980. The November measures mean it has risen still further.

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So much for the macroeconomic legends, but what of other aspects of economic and industrial policy? After all, inflation and runaway government spending are relatively recent (post-1972) complications of the British disease. The most pronounced and persistent symptom has been simple industrial inefficiency, i.e., the same size workforce producing half as much as in the United States. Postwar British government policy has seriously aggravated this in a number of important ways. State influence over the direction of public and private investment—to subsidize inefficient nationalized industries, to save "lame duck" companies from bankruptcy, to preserve jobs in failing industries, to assist regions with below-average income levels—has led to a massive misallocation of scarce investment capital. Britain's uniquely permissive laws on labor unions, which allow almost no legal redress to employers, union members, or members of the general public who are harmed by union action, have encouraged industrial overmanning and restrictive labor practices. And the British economy, like the American, is littered with boards, commissions, licensing agencies, and regulations that keep new competitors out of the market.

H*ERE AT LEAST THE* Thatcher government can boast some modest achievements. It abolished the commission that had administered price controls since 1972, through the period of the largest rise in prices in British history. It has taken a few tentative and nervous steps in the direction of returning some of the nationalized industries to more efficient private hands: selling the hotel subsidiaries of British Rail and making provision for the sale of shares in British Airways (though not yet putting the shares on the market). "Lakerization" of the long-haul bus routes has brought fares tumbling down as minibus owners rush to compete with established operators. And one economic reform should especially appeal to advocates of economic freedom: Sir Geoffrey Howe abolished at a stroke the system of exchange control that since 1939 had placed severe restrictions on the right of British citizens to invest abroad or even to take out money when emigrating.

Against these modest successes, however, must be set a major failure of nerve, associated, oddly enough, with the government's most controversial minister—Sir Keith Joseph in the Industry Department. Joseph entered office with a reputation as a born-again monetarist who had publicly repented his statist and Keynesian sins in past public office. He announced that, although a Tory politician for over twenty years, he had "only recently become a Conservative." In Opposition, he had ranged up and down the country preaching the gospel of sound money, private enterprise, the signaling function of prices, the folly of state control of investment, the futility of job subsidies and aid to "lame duck" companies, and the like. For every unprofitable job temporarily shored up by subsidies, he argued, a worthwhile job is destroyed through the burden of the extra taxation or borrowing needed to finance the subsidy. He called this process "Dracula economics."

But in office Joseph has been born yet again, this time as a statist tycoon. In the words of one disillusioned Tory MP, "he wrings his hands and pays out." There was some early talk, for instance, of gradually withdrawing subsidies to nationalized industries to force them to compete. But the figures (in constant prices) for external financing of nationalized industry show a spectacular increase. In Labour's last full year, 1978–79, expenditures under this heading were $5.7 billion; in the first year of Joseph's tutelage, the sum rose to $6.3 billion. At the time of the March budget it was planned that the figures for 1980–81 would be almost stabilized at just over $6.3 billion. But during the year, various nationalized industries got into such dire financial straits that the "cash limits" on their borrowing had to be raised by $1.4 billion—an increase of almost a fourth of Labour's total.

The British economy, like the American, is littered with boards, commissions, and licensing agencies that obstruct the entry of new competitors into markets.

British Steel is a dramatic illustration of how the problems of nationalized industries gradually draw ministers from the path of financial virtue. In 1979–80, subsidies to the British Steel Corporation amounted to $1.7 billion. The target figure of $1.08 billion was laid down for 1980–81. Indeed, the government fought a steel strike to resist union demands for easing these financial constraints. But faced with the prospect of the BSC being unable to pay its bills, Joseph has since added another $1 billion in subsidies—to make a grand total of $2.3 billion for 1980–81. As Thatcher wisely observed in Opposition, "We don't own the nationalized industries; the nationalized industries own us."

This economic truth may soon be reaffirmed in a big way. Leaks from Whitehall suggest that, in response to a request from Ian MacGregor, the chairman of British Steel, the government is considering fresh financial assistance for the "MacGregor Plan" of reorganization. It is proposed that the government should "write off" previous capital debts to the tune of $6.5 billion and provide new loans of $1.8 billion. In addition there is now talk in government circles of "redrawing the line between the public and private sectors in Steel." This is again discreet Mandarin English for subsidizing the private sector. Private steel firms are in trouble because of the recession and, ironically, because of underpricing by the subsidized BSC.

But we must not ignore the large and growing subsidies to private industry. In 1980–81, subsidies for regional development alone were set at $1.3 billion. In fact, the total is now expected to be considerably higher because some regions have been "upgraded" into aid recipients as a result of the recession. Such policies represent a vast waste of scarce investable resources. And the burden that they impose on the economy is higher today than it was under Labour. This largesse also makes nonsense of, for instance, Leonard Downie's claim in the *Washington Post* (February 1, 1981) that Thatcher's policies represent "the survival of the fittest."

We must seek the explanation in politics rather than economics. It is politically very difficult to resist the clamor for subsidies in time of recession. The claim is that denial of a subsidy means the bankruptcy of the company—interpreted as not merely the reallocation of its assets, but as its disappearance into thin air, leaving all its employees (and *every* employee of *any* firm that *ever* provided it with goods and services) permanently unemployed. If the government ventures to contest this logic, marches are held, Joseph is hanged in effigy or personally splattered with tomatoes, parliamentary debates are suspended following disorders (Labour cries of "Shame," "Resign," "Butcher," "Suez"), and Tory "Wets" (an old Tory term, originally meaning weak or appeasing, now signifying moderate opposition to Thatcher's supposed hard line) worry publicly about the dangers of social unrest. Eventually the money is paid out.

As the minister concerned, Joseph must accept the principal responsibility for the runaway rise in subsidy costs. Yet the political reality is, as President Carter might have put it, more complex. Behind the scenes, Joseph bitterly opposed a recent vast award to British Leyland, the nationalized auto firm. It was Thatcher who insisted on the authorization. In the words of the *Economist*'s fictitious but shrewdly observed *Diary of A Wet*: "The nationalized industries are much older hands at this game than we are: they force a confrontation with their unions, cover themselves in right-wing virility to get M purring appreciatively, and then, bang, in comes the bill. Michael Edwardes (chairman of British Leyland) is brilliant at it. . . . " And so, apparently, it ran on this occasion. For this installment comes close on the heels of a strike at one of the Leyland factories, which Edwardes strongly opposed; it ended well for him when the workers voted to return to work in defiance of their shop stewards' advice.

AND WHAT OF THE actual economic consequences of Thatcher? Is there a similar chasm between report and reality? Here the answer must be that although Britain's economy is in serious recession and the suffering is real, there is not the unrelieved economic disaster that some critics report. What is wrong can be easily stated. Production is down and falling; bankruptcies are at record levels; unemployment has reached a postwar high of 10 percent of the labor force; and most forecasters predict that these conditions will worsen in 1981.

But unmistakable shoots of economic improvement are thrusting up through the gloom. The most heartening is the rate of inflation. After reaching a peak of almost 22 percent in May 1980, the year-on-year rate is now 15.1 percent. When Labour left power the inflation rate was rising rapidly; today it is falling fast. In the last six months, for instance, prices rose a mere 4 percent, for an annual rate of 8.4 percent.

The second encouraging sign is that, without benefit of a formal incomes policy, late in 1980 unions began settling for much smaller wage increases. British Leyland workers accepted a 6.8 percent boost; two million engineering workers settled for a rise of 8.2 percent; even the much-feared miners agreed to a formula yielding something around 12 percent—about 3 percent below the year-on-year inflation rate. This self-restraint on pay is only one of several indications of greater economic realism on the shop-floor. During 1980 there was also a reduction by two-thirds in the number of man-hours lost in strikes and industrial stoppages. And throughout industry workers accepted layoffs in order to keep their factories in business.

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Despite the recession, furthermore, real living standards in Britain reached what the *Economist* called "an all-time high in 1980"; prices rose by 16 percent and wages by 22 percent. Indeed, between 1977 and 1980, real disposable income rose by an astonishing 20 percent. This makes nonsense of assertions that Britain is characterized by a "stagnant economy and falling living standards" and that "the windfall of oil revenues only prevents living standards falling more rapidly," as Barbara Goodwin wrote recently in *Dissent*. Nor is this rise in real incomes diverted unfairly from the unemployed and the old. Both pensions and unemployment payments have more than kept pace with inflation.

It is easier to recite these facts and figures than to explain them. But both the strengths and weaknesses of the British economy at present seem to result from the clash of a strong currency (itself the result of North Sea oil and high interest rates) and the high wage settlements of last year. The strong pound, for instance, has lowered the price of imports, sharply increasing the competitive pressures on British companies. In order to retain their markets at home and abroad, they have in turn cut their prices, depleted their stocks, and looked for every possible method of reducing their costs and improving productivity—a shakeout that will stand them in good stead when general economic conditions improve. In the present cold economic climate, however, this survivalism has taken a big bite out of company profits, in effect diverting income to workers in the form of the high wage settlements of last year and to consumers through the prices kept low by competition. Hence the rise in real disposable income and the rapid fall in the inflation rate.

On the other side of the coin, the high wage settlements and falling profits meant higher unemployment. Workers literally priced themselves out of their jobs. (And firms that were scarcely making a profit in the first place were priced out of business altogether and into bankruptcy.) Furthermore, the social benefits that make life more tolerable for the unemployed also tend to increase the rate of unemployment. These benefits are financed by what is in effect a tax, levied on each employed person and collected from the employer. This makes labor more expensive. Recent increases in the tax to pay for increased benefits in turn contribute to the rise in unemployment. And generous and effectively indexed benefits allow unemployed workers to be more choosy in selecting their next job, which necessarily adds to the rate of transitional unemployment.

But, again, the picture is not as gloomy as it seems. Britain's economic statistics are likely to be unduly dismal at present because of the growth of the "black" or underground economy. Sir William Pile, the head of the Inland Revenue, estimated last year that "unrecorded income" might be as high as 7.5 percent of the GNP. If the universal anecdotes about plumbers and electricians who offer a discount on bills paid in cash are accurate, then the total must be even larger. And a high level of economic activity outside the "official" economy would explain otherwise mysterious events like the record Christmas spending in supposedly distressed areas and the local conjunction of numerous job vacancies and high rates of unemployment. The Salvation Army recently opened a soup kitchen in a northern town with an official jobless rate of almost 20 percent. National newspapers on the following morning showed the two volunteer workers drinking their own soup after entertaining only one unemployed visitor the entire day.

We therefore have grounds for qualified optimism about the "Thatcher experiment." At the end of 1980, *Incomes Data* estimated that wage settlements were running between 2.5 percent and 4 percent "below the perceived rate of inflation." As inflation continues its predicted decline throughout this year and perceptions catch up with that reality, wage settlements are likely to follow downward. Indeed, this is already happening. Eventually this will reduce and then reverse the rise in unemployment. Workers will start pricing themselves *into* jobs. In short, there is the possibility in these circumstances of a "virtuous circle," in which lower inflation leads to lower money wage settlements which in turn lead to greater employment and higher real output.

To keep this from becoming a brief illusion before another burst of inflation, the government must achieve two clear objectives: reduce inflationary expectations and get proper control of the public sector. The first objective is not being achieved at present because the Bank of England continues to resist the application of clear guidelines for monetary growth and the methods that would contain monetary growth within them.

But there are signs that the government is moving to correct this. Among the chancellor's measures in November were certain reforms of the banking system that are preconditions for monetary base control. These reforms were opposed by the Bank of England and enforced only through the direct intervention of the prime minister. Still more encouraging is the arrival in Downing Street of Alan Walters, the leading British monetarist, as Thatcher's personal economic adviser. Not only does Walters have the technical expertise that is needed in internal battles with the Treasury and the Bank; he is also a man of great independence of mind, who will not hesitate to resign and return to the easier life of the World Bank and Johns Hopkins University if his prescriptions are steadily ignored. His bargaining position in government is a strong one since the financial markets would regard his resignation as an admission that inflation would never be controlled.

There are mixed signals, however, about the second objective—controlling the public sector. The main cause for pessimism has already been mentioned: Thatcher's failure to obtain her full roster of spending cuts last November. On the positive side, the Clegg commission has been abolished and the government recently went to court to deny to civil service unions even the *findings* of the Pay Research Unit that were the basis for "comparability" pay awards. Yet, if Thatcher is to control the money supply and in time reduce taxes, she must first control the size, pay, perquisites, and prices of the public sector.

WHICH BRINGS US, finally, to politics and power. To begin with, once Thatcher enters the cabinet room, she ceases to be a free woman and becomes in part a prisoner of the consensus of ministers. Had she chosen the cabinet, that might be of little moment. But no party leader chooses his or her own cabinet colleagues for the first decade or so. They are inherited from one's predecessor and can be replaced only following resignations or deaths—thus the immortal remark that in British politics, where there's death, there's hope.

Margaret Thatcher is not the Joan of Arc of free market capitalism that the more innocent American conservatives take her for—she's a politician.

Thatcher's cabinet was in the main chosen for her by predecessor Edward Heath, and its majority still bears his philosophical stamp. It is uninterested in economics, skeptical about monetarism, relatively content with the social and bureaucratic status quo (provided that the right chaps are running the show), not especially concerned about cutting public spending, and passionate only about winning the next election.

This attitude is known as pragmatism. Most ministers believe in it for the engagingly simple reasons that it justifies their spending large sums of public money, earns them newspaper headlines like "Minister Announces Massive Ten-Year Hospital Building Strategy," avoids trouble and abuse from the Labour Party and the public sector unions, spares them from painful rows with their civil servants, and seems to be a tried-and-tested way of winning elections by buying votes with the voters' own money. They are strengthened in these lazy convictions by a small group of ministers like Sir Ian Gilmour (minister of state at the Foreign Office) who have become, in effect, dogmatists of pragmatism, burrowing through Burke to find quotations hostile to economic theory per se and indeed to reasoned argument of any kind.

There was thus little prospect that Thatcher would, like Ludwig Erhard in Germany, sweep away long-accumulated economic controls and errors in a single morning. Nor was her intention anything like that. Thatcher is not the Joan of Arc of free market capitalism that the more innocent American conservatives take her for. As minister for education in the free-spending Heath government, she was one of the most extravagant. As prime minister she has carried out policies of subsidy and intervention that are supposedly anathema to the free market principles. In short, she is a politician. In the year leading up to the election, her private conversation dwelt much on the virtues of the Churchill government of 1951–55, which abolished rationing, cut taxes, denationalized the steel and trucking industries, did away with food subsidies, and steadily reduced the proportion of national income spent by the state. And it had racked up these achievements, she mused, with no major clash with the trade unions or great social polarization.

In the harsher economic climate of recent years, Thatcher could not hope to achieve her economic revolution entirely on the sly. Fierce trade union and Labour opposition had to be anticipated. But she did believe that by such political compromises as subcontracting foreign policy to the cabinet pragmatists she would be able to carry out her economic policy in a spirit of Tory unity. Indeed, the full cabinet barely discussed the broad economic strategy in the first year of her government. But the resistance of the cabinet to her plans for public sector cuts has exposed that belief as an illusion. She faces a choice between the success of her economic policy and the unity of the government.

Like the U.S. Fifth Cavalry, however, the Labour Party is riding to her rescue. The strongest argument of the cabinet pragmatists has been that the economic strategy will lose the next election; Thatcher's strongest motive for placing party unity above economic realism is to counter the Labour attack on her policies. The present chaos in the Labour Party, with left-wingers of a particularly militant and unpopular variety apparently triumphant and right-wingers threatening to split the Labour vote at the next election, reduces the force of both argument and motive. It is now politically possible for Thatcher to risk short-term party disunity in order to achieve at least the prospect of long-term economic success. We are about to learn if Thatcher really is the Iron Lady of legend. ❑