Seeking a premier economy

In the 1980s and 1990s, successive UK governments enacted a series of economic reforms to establish a more market-oriented economy. A major new book assesses the impact on productivity, employment and income inequality.

Over the past 25 years, UK economic policy has had one overarching goal: to arrest the country's long-term decline relative to other advanced countries and to establish a premier league economy that would improve living standards for all citizens.

At the beginning of the period, the UK had a highly regulated economy with large nationalised industries, an extensive welfare state and exceptionally obstreperous industrial relations. By the end of the period, the UK had one of the least regulated and least nationalised economies among the advanced countries, with a welfare system based increasingly on in-work benefits rather than benefits to people out of work, and unions concerned more with the 'value added' they bring to the economy.

Indexes of economic freedom that measure the market-friendliness of economic policies and institutions show that the UK has moved from the middle of the pack of advanced countries to a lead position, close to the United States. Nearly all political parties and interest groups have come to accept many of the initially controversial changes that constituted the 'Thatcher revolution', albeit with different emphases and concerns over how best to assure that the reforms benefited society as a whole.

Economic policy changes since 1980

The extent and breadth of the changes in UK economic policies and institutions introduced since 1980 are breathtaking. They include:

- Privatisation of most of the nationalised industries and of many government functions that had never before been performed by private groups.
- New in-work benefits and a reduction in the incentives for people to be out of work, accompanied by other more active labour market policies.
- Revised labour laws that limited union powers and increased the potential for members to affect key decisions, leading to substantial changes in union attitudes and policies and the introduction of new modes for union recognition.
- Changes in the structure and financing of the educational system, covering students from the age of four through to university, with the development of a national curriculum and a more centralised education system.
- New modes of financing pensions that shifted the burden of funding from the state to individuals through company pension plans or private plans.
- Tax laws that encouraged employee share ownership.
- Increased housing ownership by the sale of council flats to residents.
- Elimination of restrictions on capital flows.
- Restructuring of the National Health Insurance medical system.
- Elimination of wage council's modes of setting minimum wages and eventual introduction of a national minimum wage.
- Regular publication of league tables in the public sector to measure the effectiveness of individual hospitals and schools.

Did the reforms improve economic performance and/or increase inequality?

During this period of reform, the secular decline of UK productivity and GDP per capita relative to other advanced countries came to an end. By the 1990s, the country was outperforming most other advanced economies in both the level of unemployment and the proportion of the population in employment.

At the same time, there was a large rise in income inequality, which was the result of rapidly growing incomes for people at the top of the income distribution rather than of falling incomes for people at the bottom of the distribution. This meant that the UK avoided the US problem of falling real earnings for lower paid workers.

The rough concordance of economic changes with reforms provides weak or circumstantial evidence that the reforms succeeded in altering the UK economy. The macroeconomic evidence is circumstantial because at the level of an entire economy, it is difficult to determine what is the appropriate counterfactual. Perhaps the UK's relative economic performance would have improved even without market-friendly changes in policies. New Zealand introduced diverse market reforms much like those in the UK but its economic performance worsened relative to other countries. Some smaller European countries like Ireland and the Netherlands performed well without undertaking massive pro-market reforms.

To determine whether reforms did in fact contribute to the UK's improved economic performance, to the UK's rise in inequality or to both, we need

The overall ambition of UK economic policy since 1980 has been to arrest long-term relative decline

to examine the microeconomics of particular reforms and their impact on intended and unintended economic outcomes. A new book presents a set of studies assessing many of the economic reforms adopted during 1980s and 1990s, focusing particularly on the reforms of labour and product markets that are likely to have had an impact on productivity, employment and income inequality.

The work is almost entirely microeconomic, focusing on the effects of particular reforms on closely associated outcomes rather than on the macroeconomy. This approach offers more readily determinable counterfactuals than analyses of aggregate outcomes. It allows researchers to compare specific outcomes before and after reforms and to compare the outcomes for people, firms or sectors more or less affected by the reforms.

Given the measurement error of GDP, any particular reform is likely to have effects on GDP that are hard to discern. Hence the microeconomic approach provides the only reliable way to assess the benefits and costs of particular changes. At the same time, the approach misses the possibility that reforms cumulate to something greater than their linear sum, perhaps producing non-linear synergies for the aggregate economy.

Market-oriented reforms have accomplished the broad goal of improving relative economic performance

The principal finding of the book is that the bulk of the UK's economic reforms contributed positively to economic performance but with some cost in rising inequality. (But since the real wage rose, policy did not create poverty, although possibly some other set of policy changes might have reduced – or raised – poverty.) Underlying this broad theme is a set of specific findings summarised in what follows.

Making the economy more market-friendly

The reforms accomplished their main policy goal of making the economy – and, in particular, the labour market – more market-friendly. Diverse measures of the degree to which market forces rather than administrative rulings determine economic outcomes show that the UK became one of the most market-friendly economies in the advanced world. These measures range from the broad aggregate indexes of economic freedom developed by conservative think tanks to more specific indexes of labour market and product market regulations developed by the OECD and various independent scholars.

The UK deregulated product markets and privatised nationalised industries earlier and/or to a greater extent than its main European partners. In the labour market, the absence of employment protection and other regulations meant that the UK was more market-dependent than other European countries even while they reduced regulations and the UK did not do so.

Privatisation

Privatisation of traditionally nationalised industries was a major part of the UK reforms and reduced the publicly owned proportion of GDP from 12% in 1979 to 2% two decades later. Much of the privatisation effort was undertaken so that the private sector would make the massive investments needed in the relevant sectors, rather than having the public sector make the investments, which would be counted as part of public spending. In most cases, however, because of the nature of the businesses, privatisation was accompanied by increased regulatory activity.

Privatisation was associated with improved productivity but the improvement occurred largely before the actual act of privatisation as public sector managers restructured existing plants in order to bring the public firm to market. Whether the firms could have undertaken similar changes while remaining public is uncertain.

Foreign-owned firms

With its freedom to move capital and its extensive stock market, the UK has a particularly open capital market, which makes it easy for foreign firms to enter. Establishments that are foreign-owned tend to have higher and more rapidly increasing labour productivity than domestic firms. This is due primarily to higher levels of investment and a larger proportion of skilled and higher paid workers.

But establishments that change ownership nationality do not experience large changes in productivity. Thus, it appears that it is largely through greater investment in human and physical capital that foreign-owned firms make a special contribution to the UK economy.

Employee share ownership

The UK sought to increase share ownership by workers in their own firms in the hope of improving their commitment and raising productivity. The specific policies to encourage employee ownership and involvement varied modestly over time, but the basic idea in all cases was to give tax breaks to firms that provided profit-sharing, share options or share ownership to workers. Unlike in the United States, where employee share ownership plans encourage collective ownership in retirement plans, the UK schemes encourage individual ownership.

The results of the policy appear to be positive. Firms that reward workers in

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part on the basis of company performance have a higher incidence of information sharing and consultation with workers than other firms. And while the productivity effects of programmes vary with the particulars, firms that have profit-sharing and employee share ownership tend to outperform other firms in productivity and financial performance.

Social policy reform

In the area of social policy reform, the UK sought to improve the incentive for working in its social welfare system, with some modest success. Some heralded reforms in social programmes, such as changes in benefit schedules, had more modest positive effects on economic performance than proponents anticipated and correspondingly less adverse effects on income distribution than opponents feared.

The reason for this is that the UK's income-linked benefit system is highly interrelated so that declines in the amount received or the eligibility to participate in one benefit programme are often partially offset by increased participation in other benefit programmes. This makes both the incentive and income distribution effects of reforms much less than might appear from analysis of a single programme.

Income inequality in the UK has become increasingly similar to that in the United States

Tax credits

The main thrust of UK reforms of welfare programmes has been to increase the benefits accruing to those in work relative to those not in work. In 1988, the relevant legislation was the Family Tax Credit of 1988; in 1999, this was replaced by the Working Families Tax Credit.

The UK reforms had a much more modest effect on labour supply than comparable reforms in the United States, where the Earned Income Tax Credit and the Temporary Assistance for Needy Families welfare policy produced a sizeable drop in the number of people on welfare and increased employment among the affected families. The prime reason for this is that in the UK income from in-work benefits counts as income in the computation of housing and other benefits, so that policy reforms have a much dampened impact on the incentive to work. In addition, the UK increased out-of-work benefits while the United States reduced those benefits, providing less incentive to increase labour supply.

The New Deal

UK policies toward unemployed young people were also designed to move people from dependence on the state to work. The New Deal for young people introduced in 1998 had both 'push' and 'pull' elements to get young unemployed people into work. Some of the push involved toughening the work search criterion along lines originally developed in the mid-1980s. The pull involved a job subsidy for employers as well as government or volunteer work for young people unable to find regular jobs.

Despite publicity that implied that the programme involved massive increases in spending and huge numbers of young people, the programme had a marginally positive impact in raising youth employment at a modest additional cost. The net social benefits of the additional employment appear to have outweighed the costs.

Pensions

The basic design of UK pension reforms was to encourage workers and firms to contract out part of pensions through fully-funded occupational schemes, which would reduce the 'pay-as-you-go' costs of publicly provided pensions. The law required individuals to belong to some pension plan: an employers' scheme, a state-funded scheme or an individually purchased scheme. Favourable tax advantages induced a large proportion of the population to purchase personal pensions in the 1980s and 1990s.

At the end of the 1990s, the government introduced further reforms with its stakeholder pensions for low wage workers. The shift to greater reliance on private pension provision allowed the UK to have the lowest rate of future state spending on pensions among advanced countries. The development of private pensions appears to have improved job mobility, with workers who chose private pensions evincing more mobility than those with company pension plans.

Trade unions

In the area of the labour market and income distribution, the UK moved from reliance on collective bargaining in the determination of wages and working conditions to reliance on the competitive market. The decline was due in part to reforms of labour law designed to curb union power but also to greater competition in the product market, which required firms to reform their industrial relations practices.

Prior to reforms, the UK's unionised sector was marked by lower productivity and considerable strike activity. Faced with a tight macroeconomic environment, greater competition from non-union firms and loss of government statutory and non-statutory support, unionised establishments adopted new work practices that brought labour productivity up to non-union levels. Since UK employers do not have the

Privatisation has been associated with improved productivity

same anti-union animus of US firms, the government's industrial relations reforms that make it easier for unions to gain recognition from firms are likely to have only small consequences for the coverage of collective bargaining.

Inequality and the minimum wage

Institutional changes in the labour market – such as the decline of unionisation and the introduction of the national minimum wage in 1999 – had substantial effects on the level of income inequality. The more rapid decline of unionisation than in the United States was a major factor in the more rapid increase in inequality in the UK.

In contrast, the introduction of the national minimum wage contributed to the convergence in the pattern of inequality among women. Inequality among women was higher than in the United States before the UK enacted its minimum wage and remained higher afterwards. But the minimum wage reduced UK inequality towards the US level in 1999. Overall, the extent and pattern of wage inequality in the UK became increasingly similar to that in the United States as a more market-driven economy was adopted.

Mobility and joblessness

The UK subsidises council housing to

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tenants and sells the housing to tenants at attractive rates. Although home ownership can be viewed as a positive good in itself, it has been criticised as potentially immobilising tenants and thus producing pockets of poverty and unemployment. But the implicit rent subsidy in council housing appears to be less important in reducing mobility than the lack of skills among tenants: UK residential mobility is in the middle of rates in Europe; and the sale of council housing in the 1990s did not produce ghettoised neighbourhoods.

In contrast to the localised job market for non-graduate workers, the UK developed an integrated market for graduate workers. A principal reason for the difference is that unemployed less educated workers rarely move to different regions without having first found a job while university graduates are highly mobile after graduation.

Poverty

In sharp contrast to the convergence of inequality between the UK and the United States, the rates of poverty measured in absolute terms diverged between the two countries. In the UK, expanding government benefits reduced poverty considerably, whereas in the United States the impact of benefits was almost negligible. The greatest divergence in benefits is for workless households, whose proportion has grown sharply in the UK while falling in the United States.

Over the same period, relative poverty, which depends critically on the distribution of wages, rose more sharply in the UK than in the United States, bringing the overall income distribution of the two countries closer together.

The article summarises Seeking a Premier Economy: The Economic Effects of British Economic Reforms 1980-2000 edited by David Card, Richard Blundell and Richard B Freeman (The University of Chicago Press). The book comprises studies undertaken by a team of leading British and North American economists under the auspices of CEP, the Institute for Fiscal Studies and the National Bureau of Economic Research.