in brief...
Mrs Thatcher's industrial legacy

Manufacturing's share of national income has fallen from a quarter when Mrs Thatcher entered Downing Street in 1979 to just over a tenth today. **John Van Reenen** asks how much this long-term 'unbalancing' of Britain's economy should be a cause for concern.

The death of Mrs Thatcher in 2013 prompted a re-examination of her economic legacy. In retrospect, her two great failures were a huge increase in inequality and excessive faith in monetarism, which prolonged the early 1980s recession. But her big successes were 'supply-side' reforms that made labour and product markets more competitive. These were continued under subsequent administrations and helped to reverse a century of relative economic decline.

In 1870, GDP per capita in Britain was a fifth higher than in the United States and over 40% higher than in continental Europe. By the late 1970s, US GDP per capita was 40% ahead of Britain; and France and Germany were 10-15% ahead. But over the next three decades, Britain overtook France and Germany once more and significantly closed the gap with the United States.

There is substantial evidence that policies underpinned these economic gains. They included the withdrawal of industrial subsidies; a movement to effective competition in newly privatised sectors with independent regulators; and increases in labour market flexibility through restrictions on union power and tougher conditions for receiving unemployment benefits.

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Today, however, it is often argued that the economy is 'unbalanced' and that because manufacturing is export-intensive, it needs to grow as a share of the economy. Coupled with this is the idea that finance became too large and that Britain's success over the last 30 years was built on an unsustainable bubble. Are these views right?

The global financial crisis of 2008-09 certainly revealed a huge failure of financial regulation that is only now being addressed. But it is wrong to believe that finance was mainly responsible for Britain's growth. In fact, financial services only accounted for about a tenth of the growth in aggregate productivity between Mrs Thatcher's 1979 victory and the eve of the crash in 2007. Most of the productivity growth was in areas such as business services, retail and manufacturing.

What's more, there are many strong manufacturing firms in Britain, including Rolls Royce, Glaxo and GKN. There has also been a renaissance in car-making. People fret that the firms are foreign multinationals such as Toyota and Tata, but surely this does not matter so long as high-quality jobs are created for local workers. An economy that is attractive to foreign capital – both physical and human – is a good model.

Manufacturing's share of GDP fell from 25.5% in 1980 to 11.4% in 2010. This trend is common across the rich world as the production of goods is offshored to places like China and India where wages are much lower. Yet this would have mostly happened regardless of the change in policy direction after 1979. For example, in France, where there was a much more activist industrial policy, the fall in manufacturing's share of GDP was not much smaller than Britain's. The impact of Thatcherite policies on the decline of manufacturing was modest.

But even if different policies could have increased the share of manufacturing, should they have been implemented? British manufacturing has grown more high-tech and knowledge-intensive, which plays to the country's comparative advantage. And services themselves are increasingly exported – not just finance but also business services such as law, accounting, consultancy, design and marketing.

As China and India grow richer, their demand will switch from machine tools that power manufacturing (made in Germany and Japan) towards high-value services. If Britain is open, confident and entrepreneurial, this is a major market opportunity.

A modern industrial policy does not fixate on manufacturing but looks to where potential lies and constantly searches for areas of future growth. Governments need to focus on removing barriers to the growth of these capabilities, regardless of whether they produce heavy goods or 'weightless' services like research and teaching.

Britain has a major strength in higher education, for example, that is being hamstrung by the absurd government target of reducing net immigration to fewer than 100,000 people a year and the cumbersome visa regime that accompanies it. This must change if the country is to seize the growth opportunities of the next 30 years.

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A detailed analysis of the change in Britain's relative economic performance since 1979 is in Chapter 1 of *Investing for Prosperity: A Manifesto for Growth* edited by Tim Besley and John Van Reenen, the book produced by the LSE Growth Commission (http://www.lse.ac.uk/researchAndExpertise/units/growthCommission/home.aspx).